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REGULATORY UPDATE

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1. EU AND EUROZONE GROWTH AND INTEGRATION CHALLENGES

Improving economic convergence in the EU and Eurozone to deepen the EMU

1. Economic convergence is essential for making the euro viable

1.1 The notion of convergence is at the heart of the EMU

In EMU, monetary policy is centralised, but important parts of economic policy remain national. The introduction of the euro was never intended to solve the structural problems faced by the economies of the euro area. It is in each member's common and self-interest to be able to cushion economic shocks well, to modernise economic structures and welfare systems, and make sure that citizens and businesses can adapt to, and benefit from, new demands, trends and challenges. It is equally in each member's interest that all others do so at a similar speed. This is all the more crucial in a monetary union like EMU where large scale fiscal transfers between members are not possible and where labour mobility is relatively limited.

As early as 1989 the Delors Report, which paved the way for the adoption of the euro, emphasised the need for a greater convergence in economic performance because a "monetary union without a sufficient degree of convergence of economic policies is unlikely to be durable and could be damaging to the Community". In a system of "no bail-out" on which the Maastricht Treaty is based, the EU and its Member States are prohibited from assuming liability for the commitments of another EU Member State. Balances of payments remain national. The euro area is not a federal state. By ruling out the option of being rescued in the event of fiscal negligence, this clause requires that Member States should engage in responsible fiscal policies as a long term commitment. In other words, when economic shocks occur, each country needs a flexible economy and sufficient fiscal buffers over the economic cycle.

In such a legal context, it is the responsibility of Member States to ensure economic convergence and to ensure sufficient growth. The correction in divergences in competitiveness in the euro area can only be achieved through the "internal devaluation" meaning through cuts in labour costs and real wages. This is the reason why the Maastricht Treaty and the Stability Growth Pact (SGP) put in place before the euro was launched institutional safeguards. The Maastricht Treaty and the SGP both focused on convergence as a prerequisite to make the euro area viable. Member States need indeed to achieve a degree of sustainable convergence to share a common currency. To evaluate such a convergence, the Maastricht Treaty defined criteria the Member States must commit to over time. Subsequently, it became clear that Maastricht Treaty was too narrow and in 2011 the macroeconomic imbalance procedure (MIP) was introduced.

This does not mean that all Member States that share the single currency should be similar or follow the same policies. What matters is the outcome: all euro area Member States should pursue sound policies allowing for a quick rebound from short-term shocks and have the ability to exploit their comparative advantages within the Single Market and attract investment, thereby sustaining higher levels of growth and employment.

1.2 It is possible to have countries with different per capita incomes in a Monetary Union

The euro area is a currency area composed of heterogeneous countries in terms of per capita income and productivity levels, productive specialisation of the economy, labour force skills and demographic characteristics. At the same time the euro area is characterised by a lower degree of fiscal federalism.

Countries with very different per capita incomes can be united in a monetary union such as the euro area. But this is possible only if real wage increases correspond to productivity increases. The purchasing power catch up can therefore take place only at the same pace as the productivity catch up. In sum, the convergence of living standards cannot go faster than the increase of per capita productivity. Indeed faster catch-up leads to an unsustainable loss of competitiveness and external deficits.

When significant economic and competitiveness imbalances appear between Member States it is necessary to correct them to maintain the integrity of the Monetary Union. So far internal devaluation is the only tool that has been used. It has been applied >>>

>>> by the Baltic countries, Spain, Ireland, Portugal, Cyprus and Greece with some success.

1.3 A monetary union does not automatically create economic convergence

The elimination of foreign exchange risks fosters greater capital mobility which, in turn, encourages productive specialization within the zone. A monetary union tends to concentrate economic prosperity in certain regions that are better endowed with productive capital and human resources.

The two normal levers used to cope with the inevitable specialization effect are well known: First, labour mobility is an essential ingredient of an effective monetary union: populations of sub regions with fewer growth prospects tend to move to more dynamic parts of the union. The other correcting factor to reduce income differentials between countries are private and public risk sharing (e.g. private capital investments and public transfers).

Under normal circumstances, the euro area's low-income countries, such as Greece, Portugal and Spain, should have benefited from their euro area membership to increase their capital, productivity, potential GDP and per capita income levels. Their additional debt (domestic and external) should have been offset with additional effective capital and not additional consumption, current public spending or financing for a property bubble. Economic analysis shows that a large proportion of the external debt taken out by these countries has financed unproductive spending: property bubble, current government spending. This "misuse of the Eurozone" by the peripheral countries accounts for the reluctance of the core countries, since 2008, to lend them more and notably to Greece.

In such a context, a collective monitoring of competitiveness should be set up without any delay especially to prevent some countries from allowing their cost competitiveness to deteriorate.

1.4 How can sustainable real convergence be achieved?

According to the ECB [2] while there has been real convergence- measured by real GDP per capita- in the EU as a whole since 1999 owing to the catching up of central and eastern European (CEE) economies, there has been no process of real convergence among the 12 countries that adopted the euro in 1999 and 2001. This lack of convergence is related to several factors, notably weaker institutions, structural rigidities, weaker productivity growth and insufficient policies to address asset price booms.

The first condition for sustainable real convergence is macroeconomic stability. Since the crisis, the euro area countries subject to an financial adjustment programme have made notable progress in restoring their macroeconomic balances and have also implemented significant structural reforms. In most of these countries, current account imbalances have disappeared. This has partly reflected a marked adjustment in unit labour costs. Fiscal balances have also improved substantially compared with the very high fiscal deficit-to-GDP ratios observed during the crisis years. To fully overcome these legacies of the crisis, it is important to consolidate the competitiveness gains achieved during the crisis and maintain a stability-oriented fiscal policy stance ensuring that public indebtedness returns to sustainable levels in the coming years.

The second condition for sustainable convergence is increased economic flexibility that can contribute to a correction of the pre-crisis misallocation of capital. This can be reinforced through measures that increase competition in the markets for goods, services and labour.

The third condition for sustainable convergence is the achievement of higher Total Factor Productivity (TFP) growth. Country-specific domestic policies should foster the main drivers of TFP by focusing on three main policy areas: (i) improving the quality of labour, e.g. by increasing the proportion of highly skilled workers, (ii) improving the quality of capital by fostering the adoption of innovation and technology, and (iii) creating an institutional framework that supports innovation in businesses.

1.5 The symmetry of economic adjustments within the euro area should be a priority focus

Within a monetary union, there must be provisions for an adjustment mechanism to prevent any lasting build-up of excessive balance of payment surpluses or deficits. This adjustment system should be symmetrical. The euro area is suffering from not having any such system in place, which creates tensions.

The major differences in economic performance between the main euro area countries – for instance, budget and trade deficits in France, compared with budget and trade surpluses in Germany – are being compounded by the absence of a system to balance competitiveness between the surplus and deficit euro area Members.

Once the deficit countries really make the structural reforms needed to address their competitiveness gap (reducing public spending in relation to GDP, reforming the job market, health systems, pensions, professional training, etc.), Germany is expected to be more inclined to increase its inflation slightly, with an equivalent reduction in the competitiveness of its products in relation to deficit countries like France.

In such scenario, Germany could embark, for instance, on a major infrastructure modernisation programme. Considering its low unemployment rate, such a programme could push up German wages and prices, reducing its surpluses. Such an effort would help adjust the competitiveness of the countries that are facing difficulties.

The rollout of such an economic expansion programme would benefit Germany's key trading >>>

>>> partners provided that their industrial base could cope with this increase in demand.

1.6 Spain's economic recovery is one of the euro area's success stories in the recent economic crisis

Together with Ireland, Cyprus, Portugal and Greece, Spain has introduced economic reforms. Over the four years since Spain requested a financial assistance programme to recapitalise the banking sector, Spain has seen robust economic growth rates (3,2% in 2016 and 2015), well above the euro area average, significant exports performance and a continued improvement in the labour market, with falling unemployment and a fully repaired banking sector.

As explained by P. Artus and Marie-Paule Virard in their latest book[3], the drop in real wages and labour market deregulation have made it possible to reduce Spanish unit labour costs (the cost of an employee in relation to their production) by 10%. This has helped Spanish businesses to become more competitive and their profits more than doubled between 2009 and 2015. Since 2012, business investment has picked up again significantly and Spain's exports to its European partners have continued to grow.

2. Significant progress has been made but France and Italy need to improve economic convergence and meet their liabilities to the other euro area Member States

Europe has made tremendous progress since the crisis mostly because many national governments did their homework (e.g. Spain, Baltic Countries and Ireland) so that fiscal and current account imbalances have disappeared to a large extent and competitiveness has been restored notably in the peripheral countries.

Positive developments also relate to the creation of new institutions during the crisis such as the European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM), the Single Supervisory Mechanism (SSM), the Single Resolution Board (SRB), the Single Resolution Fund (SRF). They make EMU more resilient.

However, despite reforms of the euro governance (European Semester and the Macro Economic Imbalance Procedure) discrepancies can still be observed in the euro area. EU Institutions were unable to prevent public debt from rising in particular in France and Italy for many years. Fiscal rules were violated and the capital markets did not sanction the breaches.

The binding force of existing rules is too weak. Building trust in the current rules of the SGP is essential before Member States engage in new fiscal integration steps. Creating a fiscal capacity may be difficult as long as euro area Member States are confronted with legacy issues and do not meet their economic liabilities to the other euro area Member States. In addition, if France and Italy keep their current rigidities, which paralyse their productive capacities, any stimulus of the domestic demand in Germany would not have positive impacts on these economies.

The current framework is not equipped to sufficiently cushion asymmetric shocks affecting one of its Members when, for example, national buffers are depleted and fiscal space is limited. To address asymmetric shocks and make economies more resilient, EMU governance should be further strengthened through increased risk-sharing between countries. A new fiscal capacity, which could take the form of a stabilisation fund or an insurance scheme, could provide for enhanced risk-sharing without creating permanent transfers or debt mutualisation.

Another route to enhance risk sharing would be through financial markets and the completion of Banking Union and Capital Markets Union (CMU). Banking Union should be completed by creating a common backstop for the Single Resolution Fund, and a common deposit insurance after legacy issues have been reduced. Further development in the area of the CMU is needed, starting by harmonising legal frameworks affecting cross-border EU businesses. This would diversify funding sources for corporates, facilitate cross-border equity investment, and reduce firms' dependence on bank loans. In aggregate terms, it would substitute a part of the shock-amplifying debt flows for shock-absorbing equity flows.

2.1 A comparison between France and Germany shows major discrepancies that need to be addressed for the viability of the euro area

To stabilize and deepen the Monetary Union, it is essential that France should overcome its economic weaknesses in particular compared with Germany, which requires a reduction of public expenditure (57% of GDP in 2016) to the average level of the euro zone (49% in 2016). Indeed, France faces important sources of imbalances related to a weaker competitiveness and higher and increasing public debt, against the background of lower productivity growth. More precisely, in France, the level of public debt compared to GDP is still increasing (almost 100% of GDP in 2016) while it is decreasing in Germany (70% in 2016). The budget is in surplus in Germany but is in deficit in France (3,3 % of GDP in 2016) in a context where the aggregate general government deficit is expected to have fallen to 1.7% of GDP.

Full employment is achieved in Germany (unemployment declined to around 5% of the labour force) while unemployment is still at 10% in France. Industry and exports are successful in Germany but are declining in France: French export performance has deteriorated over the past 15 years[4]. The current account balance is in deficit in France (0,2% of GDP in 2015) while the current account surplus reached in Germany 8.7 % of GDP in 2016. Real GDP growth in Germany stood at 1.9 % in 2016 while it declined to 1,1% in France in 2016.

France will only be able to improve its economic situation if it achieves a rebalancing of its public accounts. The too high level of public expenditure has led to excessive levels of taxes and contributions >>>

>>> which weaken the competitiveness of French enterprises. In order to deal, at least partially with this increase of public expenditure, France has indeed significantly increased the total tax pressure (taxes and social security contributions) which reached 46% of GDP, 7 percentage points higher than the European average.

In such a context, France should focus on moving its percentage ratio of public expenditure to GDP (57%) in 2016 close to the level of the German or Spanish figures (45%). The survival of the Monetary Union is at stake given the importance of France in Europe.

Such a reduction in public spending is possible. As shown in a report released by the French business think-tank Institut de l'Entreprise "Public Spending, State of Alert", public spending in Sweden represented an average of 63% of GDP between 1986 and 1995. It dropped to 53.5% in 2000 and then 50.5% of GDP in 2015. In Canada, public spending averaged out at 49% of GDP between 1986 and 1995, before moving back down to an average of 40% for 2001 to 2010.

2.2 Italy urgently needs to balance efforts to reduce debt with support for growth

Italy, the third largest economy in the euro area, is also experiencing excessive imbalances which represent a major potential source of economic and financial spillovers for the rest of the euro area. Indeed, high government debt – 133% of GDP in 2016 from the trough of around 100 % in 2007[5] – and protracted weak productivity dynamics imply risks with cross-border relevance looking forward, in a context of high non-performing loans (€329 billion -16.5% of customer loans-) and unemployment[6]. This high public debt also makes Italy vulnerable to financial market volatility and higher interest rates. Spreads between Italian and German, bonds widened during the past months and stood at more than 170 basis points in January 2017, which raises concerns regarding the sustainability of the public debt.

Real GDP is expected to have grown by only 0.9% in 2016 after 0.7 % in 2015 while growth is set to remain around 1% in 2017-2018 according to the latest forecasts of the EU Commission. Longstanding structural weaknesses and the legacy of the crisis continue to weigh on economic recovery. Italy's real GDP growth was close to zero over the last 15 years, as against an average annual growth of around 1.2% in the rest of the euro area, as productivity dynamics diverged. Economic growth is notably hindered by the tax system. The tax burden on production factors remains among the highest in the EU.

Substantial progress must therefore be made in addressing these challenges although some progress has been achieved by recent reforms such as the Job Acts (2015), cuts in social security contributions for new permanent contracts, primary fiscal surplus at around 1,5% of GDP, the pension reform by M. Monti (2013). There is a need in Italy to accelerate and deepen reforms, especially before new headwinds emerge. Structural reforms intended to increase potential output and improve Italy's competitiveness are of the essence. Moreover a more ambitious and proactive approach to solving NPLs is of paramount importance notably for financing new credits and encouraging recovery investment.

2.3 What can be asked of Germany?

It is important to note that Germany's considerable trade surpluses are not compatible with a balanced monetary area.

Indeed, Germany can no longer be asked to revalue its national currency, as the DM disappeared when the euro was introduced. However, Germany, which has a fiscal surplus, could increase its budget expenditure to support its household consumption figures, which would drive up imports and reduce its trade surplus. Alternatively, Germany could raise the minimum wage or launch a programme to renovate its public infrastructures (see 1.5). At this stage, the last solution seems preferable, because a fiscal stimulus programme in Germany would probably have minimal benefits for countries like France, whose industrial base is too uncompetitive due to its lack of flexibility and the burden of social security contributions and charges, which are undermining French businesses in particular. It would certainly offer more benefits for exporters from Asia or America.

Requesting such an effort from Germany would be more acceptable from a political perspective if France, within 100 days of its presidential and legislative elections, was to launch work to turn around its public accounts through state and pension system reforms that have been constantly postponed for years. This is the way forward for growth for countries that are struggling.

2.4 Economic convergence, structural measures towards increasing growth potential and reducing unemployment

A monetary union is not workable without fiscal discipline and Members should not accept financing current public deficits generated in other euro area Members that do not follow the rules.

Simultaneously, structural measures are needed to sustainably raise output and productivity growth and reduce competitiveness problems and recourse to debt. Countries with the highest unemployment rates have more rigid labour market regulations.

One way of ensuring that the EU fiscal rules are binding would be to create a new and independent Authority, a Fiscal Council. This institution would not be exposed to the same conflicts of interests as the EU Commission, which has to assess whether national budgets comply with the Stability and Growth Pact.

A regular dialogue looking at competitiveness gaps and divergent trends between euro area >>>

>>> members should also be established between Europe's institutions and euro area Member States. For Members lagging behind the European average for competitiveness, this should result in commitments focusing on a limited number of structural reforms. This approach should make it possible to reinforce the level of engagement among national parliaments, social partners and the civil society for structural reform programmes.

Achieving economic convergence would help to make the euro area more resilient, restore trust between the Member States, restore cross-border investments in the euro area and accelerate private risk sharing within the EU. The single currency is embedded in an incomplete single market and only a partial Banking Union. Enhancing private risk sharing in the euro area, especially through the completion of the Banking Union and a true Capital Markets Union remains a key policy priority. Well-functioning and integrated banking and financial systems would indeed mitigate the propagation of financial shocks to the real economy.

An effective economic convergence among all Member States will not only favour cross border investments but the integration of banking and financial markets in Europe will also be more easily achievable. Lastly, enhanced risk-sharing without creating permanent transfers or debt mutualisation could become feasible with for example the creation of a fiscal capacity in the form of a stabilisation fund or an insurance scheme. ●

[1] Article 125 Treaty on the Functioning of the European Union

[2] ECB, Economic Bulletin, Real convergence in the euro area, May 2015

[3] P. Artus and M-P Virard, Euro par ici la sortie?, Hayard, 2017

[4] French export performance has deteriorated significantly over the past 15 years. Since 1999, its export market shares have fallen by 36.8 % in value, compared to 20.4 % for the euro area as a whole. In volume, the decline is also significant (–25.4 %, against –11.0 % in the euro area).

[5] Compared to 91.5 % of GDP for the euro area in 2016 (85.1 % in the EU).

[6] Youth unemployment rate is around 40 % and more than 1.2 million young people are not in education, employment or training.

The ECB's asset purchase programme and future prospects

The ECB has engaged in a very bold expansionary monetary policy, particularly since the beginning of 2015. It decided then to buy monthly 60 Billion Euros of public and private securities for a period of 18 months. These unprecedented amounts were raised to 80 Billion Euros in May 2016. They represent close to 2/3 of the total issuance of Eurozone sovereign debt. At its December meeting, the ECB decided to extend the asset purchase programme beyond March 2017 with the intention of conducting its purchases until the end of December 2017 or beyond. Starting from April 2017, the net asset purchases will run at a monthly pace of €60 billion, and the ECB will reinvest the securities purchased earlier under its programme, as they mature. This will add to the monthly net purchases.

Fiscal reforms engaged notably in peripheral countries have played an important role in the acceleration of the convergence of interest rates in the Eurozone. But the ECB has decisively contributed to the rapid setting of a lower and more homogeneous interest rate pattern in the Eurozone with its expansionary monetary policy. It is in particular remarkable that the ECB has helped to reduce interest rates on loans to non-financial corporations. These monetary policy measures have increased demand for credit and supported domestic consumption

Many observers also consider that QE has had a strong effect on the exchange rate channel, reducing the euro-dollar exchange rate substantially, potentially supporting exports and that QE has contributed to avoid deflation trends in Europe. The Governing Council of the ECB continues to expect interest rates to remain at present or lower levels until inflation has converged substantially towards of its objective of below but close to 2%.

However according to some observers, a monetary policy that is too accommodative for too long may have several drawbacks and shortcomings and may having decreasing returns over time.

Firstly in Europe there has been no rebalancing of savings and consumption so far.

Yields - close to 0 or even lower – on riskless investments should, normally, deter economic agents from saving and induce more consumption, which would support growth. But, contrary to the hopes of many, "financial repression" does not always result in an increase in consumption especially in Europe.

When the yields fall or, sometimes even disappear, because of monetary policy, it would be logical to see savings switch to equity instruments that can provide, over the longer term, more satisfactory returns, all the more so if investors believe in an upturn of >>>

>>> the economy. This happened in the US as a consequence of QE, where equity markets rebounded exactly in line with the creation of liquidity by the Fed, triggering a "wealth effect" which contributed to more consumption. But in the Eurozone, this process does not seem to work: no significant shift to equities, nor wealth-effect has happened so far. Indeed European savers are not the same as those in the US. They are mostly risk-adverse, their savings are mainly in relatively safe assets and they are not inclined so far to buy shares. Moreover the tax system often does not sufficiently encourage equity investment. More worryingly, the shift of repressed financial savings to consumption does not seem to have happened either. Indeed, probably due to existing uncertainty, a significant number of savers are trying to offset lower returns by further saving.

Secondly very low interest rates have a negative impact on the profitability of banks which may have negative consequences for the financing of the economy and the transmission of the monetary policy in Europe.

EU banks are very sensitive to the spread between their funding costs (deposits and borrowings) and the return on their assets. Clearly the decline in interest rates which is accompanied by a significant flattening of the yield curve, weighs on the profitability of retail deposit banks that traditionally benefit from maturity transformation activities. The consequences of this decline of profitability are manifold.

If banks are not profitable, they will not lend more, which goes against the objective of the monetary policy to support credit. It seems therefore essential that monetary policy and regulation are well adjusted in this respect. Moreover another important issue is that there are less incentives for investors to buy bank shares, which is reflected in the low price-to-book ratio in the EU banking sector.

The balance sheet of insurance companies and pension funds is also a matter for concern. Such institutions have to meet the long term liabilities of their retiring clients, with assets (like sovereign bonds) that carry no return.

Thirdly, resource allocation tends to lose its efficiency when interest rates get very low. Indeed, the only projects that can be financed are the ones which are viable with very low rates. Less profitable and more risky investments (but perhaps socially more beneficial) may be left aside. Furthermore, investment duration is bound to be reduced in an environment of low interest rates; cheap credit may also help unproductive and non-viable firms to survive for too long.

Fourthly, an evolution towards negative interest rates does not seem sustainable over time. Indeed interest rates are the price that a saver is entitled to expect for having accepted, for a given period of time, to postpone immediate consumption. To say that such a price should become negative goes against common sense, abolishing the notion of time and could bear grave consequences for the future. It is for example difficult to see how one could calculate expected returns on an investment with a negative rate. This could have important consequences in particular for long term investment projects that involve high fixed costs and high risks.

More generally, expansionary monetary policies create a growth in the central bank money supply (liquidity) which is a source of financial instability. When a central bank buys a financial asset from any agent and pays for it by giving them money, that economic agent can use the money freely, to buy (and then resell) financial assets (equities, bonds...) or real-estate assets in various countries. As the quantity of this money created by the central bank increases, the buying and selling of various assets also expands, and financial instability is increased.

Finally, systematic liquidity creation does not appear to be the major solution for relaunching growth in many European countries that are mainly hampered by decelerating productivity growth and insufficient structural reforms. ●

Fostering private risk sharing in the EU and Eurozone

The prime objective of the Europe's Economic and Monetary Union is to foster stability and economic growth. But for this to happen, the EMU needs to be able to: first prevent crises by fostering sustainable fiscal and economic policies in each of the participating Member States; and second better absorb shocks-individually and collectively- whenever they occur.

International risk sharing involves pooling risks across countries, by diversifying income streams and providing opportunities for countries to borrow and lend to smooth consumption against positive or negative shocks. All mature monetary unions also involve mechanisms for cross-border shock absorption. These stabilisation mechanisms can take the form of temporary fiscal >>>

>>> transfers (public risk sharing) or of financial flows linked to the operation of banking and capital markets (private risk sharing). In a eurozone where permanent fiscal transfers between Member States are limited and specific, further integrating banking and capital markets could be a key stabilizing force within the euro area.

Residents of a country that experiences a negative output shock can smooth their consumption through income streams generated by financial assets held in other jurisdictions, which are unaffected by the shock. This is the capital market channel of risk sharing. It operates ex ante because when shocks strike, alternative income sources are already available to those who hold investments in other markets not experiencing the shocks. In other words, residents hold an internationally diversified portfolio.

Alternatively, residents of a country hit by a negative output shock can secure consumption levels by borrowing. This can also be done indirectly, for example when public borrowing is used to compensate for the loss of tax revenues after asymmetric shocks in order to sustain government expenditure levels and, in turn, smooth household consumption. This is called the credit market or savings channel of risk sharing. It operates ex post, since those affected apply for and receive funds from locations that are unaffected by the shock before being able to smooth consumption.

The euro area lacks sufficient cross-border risk sharing

According to the EU Commission (see the Quarterly Report on the euro area, DG ECFIN, July 2016) around 80% of an asymmetric shock gets smoothed in the US. The most important contribution comes from capital markets in the form of cross-border ownership of assets (around 45%), followed by credit markets (27%) and fiscal transfers (8%).

By contrast only around 25% of an asymmetric shock is smoothed in the euro area. The main reason for this substantial gap between the US and the Eurozone comes from the very low degree of risk sharing through capital markets flows between Member States.

In principle, in a currency area, the elimination of currency risk allows capital (savings) to flow from the countries with higher per capita capital and therefore higher labour productivity and lower marginal productivity of capital (for example Germany, the Netherlands and France) to countries with lower per capita capital, lower labour productivity, and higher marginal productivity of capital (for example Spain, Italy and Portugal). Before the 2009 crisis, capital did head to lower per capita capital countries, but mainly to finance inefficient investment (in real estate, inefficient infrastructure). Since the 2009 crisis, and especially since the 2011-2012 euro-zone crisis, capital flows in the euro zone have fallen, with smaller flows from higher per capita capital countries to lower per capita capital countries. The ECB's actions have stopped financial fragmentation, but cross-border capital flows within the monetary union remain subdued.

Achieving economic convergence is a pre requisite

Enhancing private risk sharing in the euro area, especially through the completion of the Banking Union (including a common backstop to the Single Resolution Fund and a common deposit insurance scheme) and a true Capital Markets Union, would improve market efficiency and welfare. Moreover, well-functioning and integrated banking and financial systems can mitigate the propagation of economic and financial shocks. However, to achieve the political support for further integration, euro area Member States need to strengthen their fiscal positions and competitiveness, which requires significant domestic structural reforms in many cases.

The importance of a genuine Banking Union

As mentioned by P. Praet[1], "the present institutional architecture of the Banking Union is one where supervisory authorities are shared while the consequences of supervisory failures are not. Many aspects influencing banks' decisions to engage in cross-border activities remain under the purview of national authorities rather than European ones. And even where this is no longer the case in principle, national options and discretions still provide for distinct cross-country differences. This ranges from financial regulation and accounting to insolvency practices".

Moreover, the Banking Union appears at times to behave more a collection of national banking systems than a single entity. As long as this is the case, countries may be insufficiently buffered against country-specific shocks, leading to more procyclical policies. This is why it is essential to strengthen and complete the Banking Union.

Implementing an effective Capital Markets Union is essential

The cross-border provision of financial services by markets is one of the main ways that private risk sharing operates. Developing EU capital markets, including through greater harmonization of legal frameworks (such as insolvency and securities laws), eliminating the current debt/equity bias in taxation, and increasing cross-border equity holdings, should be a key priority.

This objective should be elevated to a higher political level in the discussion. However, EU savers are mostly risk adverse and need to change the way they look at financial markets and investment. This is also a key challenge for policy makers to address. ●

[1] See P. Praet, The importance of a genuine banking Union for monetary policy, Vienna, 24 November 2016

Stimulating productive investment in the EU

The EIB reminds[1] us that EU investment growth in the last three years has been 3.1% per year, slightly below the pre-crisis average rate of 3.4% and well below any historical rate with large differences across regions and sectors. Infrastructure investment has fallen from 2.3% to 1.7% of GDP, since 2009.

In the context of the financial and the sovereign debt crisis, a first contraction was driven by the reduction of private infrastructure finance with public infrastructure investment remaining stable. Later, the fiscal consolidation acted pro-cyclically.

Investment in infrastructure differs markedly across regions. It has generally been higher in New Member States (NMS) than in the Old Member States (OMS) and higher in the Euro periphery than in the countries of the Euro core.

Corporate investment is the main contributor to investment growth at the EU level. However, while it has reached the pre-crisis peak in core countries, it has not in the vulnerable or cohesion groups. Finally, the ratio of corporate investment to GDP in 2015 is below its 1999-2005 average and accounts for a quarter of the decline in total investment to GDP since that period. In particular, investment in innovation-related intangible capital remains insufficient.

The EIB considers in addition that the financial crisis has reduced the ability of the EU financial system to allocate resources efficiently.

Regarding infrastructures, the World Bank identifies several barriers to investment among which are possible regulatory burdens and uncertainties, barriers to competition, national market size, constraints stemming from the public sectors which may weigh on infrastructure efficiency, planning capacities, and increasing uncertainties. Access to finance i.e. the cost of finance and financial availability, and also the existence of appropriate risk allocation tools, are other important barriers to be addressed.

In such a context, early 2013 the Commission proposed a European Long-Term Investment Fund (ELTIF), which is a new type of collective investment framework allowing investors to put money into companies and projects that need long-term capital.

Also in 2016 the Commission held a public consultation to explore what could be done at EU level to develop personal pensions competing across borders (PEPP) as part of the Capital Markets Union action plan. These pensions are expected to play a role in linking long-term savers with long-term investment opportunities.

In addition, as part of the Market Union, in September 2015 based on the advice of the European Insurance and Occupational Pensions Authority (EIOPA), a legislation created a specific infrastructure asset class and reduced the amount of regulatory capital, which insurers must hold against such assets. Similarly, in November 2016, in the context of the revision of the Capital Requirement Directive (for Banks), the Commission proposed to extend the current SME supporting factor to all loans to SMEs and to lower banks charges for lending to infrastructure projects.

Finally, in December 2016 EU Member States agreed on the proposal of the Commission to expand and reinforce the European Fund for Strategic Investments (EFSI), which is intended to provide an EU guarantee that should mobilise private investment.

Taking also into account existing Structural and Investment Funds, the European Union is now equipped with a comprehensive set of financial tools both operational (investment products, public funds, a web portal, a centre providing technical expertise) and regulatory. Furthermore, sizable efforts to address financing challenges have been undertaken through unconventional monetary policies.

Bank lending and more generally access to external finance has improved. However, despite the overhaul of the bank regulatory framework and the asset quality review, confidence in European banks continues to suffer and SMEs continue to face up difficulties regarding access to credit at a reasonable cost.

Consequently, it is now appropriate to assess the whole efficiency of such a comprehensive EU tool kit. Its actual contribution to improving cross border risk sharing are relevant questions. In addition, it is appropriate to wonder if the EU has succeeded in significantly favouring new financing approaches by further resorting to market finance rather than bank lending. In this respect it would be interesting to evaluate the evolution of the share of investment funds, pension savings and insurance companies in the financing of infrastructure and corporates in the EU.

Finally, one critical issue is to understand whether such comprehensive policy efforts achieved better risk sharing and risk pricing in particular from the private investors' point of view and if its contribution to relaunching growth and improving the EU competitiveness of both EU Member States (be they core, or periphery ones) and corporates, SMEs in particular is perceptible and expected to last. ●

[1] Investment and Investment Finance in Europe / Financing productivity growth - EIB report 2016

Leveraging savings to develop cross-border investment in the EU

Most of the Member States of the EU are suffering from declines in corporate and public investment since the crisis and a loss of production capacity in industry. At the same time, the eurozone and the European Union are benefiting from a savings surplus. In 2015, the EU-28 current account surplus represented 161.6 billion euros, equivalent to 1.1% of gross domestic product (GDP). The balance of payment surplus for Germany on its own came in at over 8% of its GDP last year.

A monetary union is established so that the disappearance of the exchange risk within member countries can enable savings from all the monetary union countries to be used to finance the most effective investments within the monetary area. The disappearance of the mobility of capital between EU countries and the eurozone since the EU sovereign debt crisis means that the surplus savings from countries with a balance of payment surplus (Germany, the Netherlands) are being lent to the rest of the world instead of being invested in Europe (peripheral countries, Eastern Europe, etc.). This is illustrated by the balance of payment surpluses for the eurozone and the EU.

In principle, in a currency area, the elimination of currency risk allows capital (savings) to flow from the countries with highrer per capita capital and therefore higher labour productivity and lower marginal productivity of capital (for example Germany, the Netherlands and France) to countries with lower per capita capital, lower labour productivity and higher marginal productivity of capital (for example Spain, Italy and Portugal).

The 2011-2012 sovereign debt crisis halted the circulation of capital flows between EU Members States

However, during the decade from 2000 to 2010, the eurozone's capital mobility funded primarily inefficient investments: budget deficits in Greece, Italy and Portugal, real estate bubbles in Spain and Ireland. In other words, the financing of sustainable cross-border investment has never properly taken place following the creation of the euro, particularly as there is no effective banking or financial integration. In view of the accumulation of large macro-economic imbalances in some Eurozone countries between 2000 and 2007, financial integration in the euro area proved unstable in the context of a financial crisis. Moreover banks refocused on their core and main domestic markets following the crisis; this massive deleveraging (also linked to the strengthening of prudential regulations) also contributed to fragmenting the European banking market.

Today, there exists a lack of confidence between potential lenders regarding the soundness of borrowers and their investment projects as there is no economic convergence between EU countries and this represents a further obstacle holding back the development of cross-border investment.

Cross-border loans between eurozone banks, for instance, were down 6% year-on-year in January 2017 to 1,260 billion euros according to the ECB, compared with over 2,000 billion euros in 2008. However, lending between banks in the same country was up 11% year-on-year in January 2017 to 4,600 billion euros, according to calculations by Reuters based on ECB data. With banks retreating in this way onto their domestic markets despite the Quantitative Easing policy of the ECB, there is a risk of making each eurozone country more vulnerable to domestic shocks, while this also runs counter to the objectives of the Banking Union and single market within which credit can circulate efficiently to meet the needs for credit financing wherever they are expressed.

It is therefore essential to re-establish capital mobility in the eurozone and more generally within the EU. This would help boost both investment and growth, while reducing unemployment in Europe. To achieve this, it is necessary to reinforce the Investment Plan in Europe, accelerate the resolution of non-provisioned non-performing loans in certain EU banks, promote the emergence of EU banks and encourage the development of cross-border capital markets (notably equity). The return to fiscal solvency in all the EU Member States would also have a decisive impact, accelerating the development of cross-border investment.

Reinforcing the Investment Plan for Europe

Member States have long benefited from European structural and regional funds as well as loans from the European Investment Bank. And now the Investment Plan for Europe has proved useful in encouraging a sustainable increase in investment in Member States.

Launched in 2015, the investment plan, often called the Juncker plan, aims at pumping €315 billion into the EU economy until the end of 2017

At the end of December 2016, the European Fund for Strategic Investments (EFSI) had mobilized EUR 154 billion across 28 Member States in just over one year. These investments went into SMEs (31%), energy (22%) and other infrastructure projects (37%).

Nevertheless, it seems difficult to identify sustainable infrastructure and innovation projects to be financed, particularly in the EU's peripheral countries. That is why efforts need to focus on the emergence of these projects in all EU countries.

EU Finance Ministers gave their backing to the Commission's proposal to extend the European Fund for Strategic Investments (EFSI), in terms of duration and financial capacity ("EFSI 2.0"). This is a step in the >>>

>>> right direction to contribute to addressing the severe investment shortfall in Europe and to rebalancing cross border flows within the EU, even if it will not correct existing national economic shortcomings.

Proposal for a European Savings – Investment Fund

Another way of fostering cross border investment is channelling the surplus savings of some Euro countries (Germany, the Netherlands) to areas where investment deficits prevail. Since cross-border private lending is still limited, northern savers accumulate domestic bond holdings and bank deposits earning zero nominal returns while investment in southern countries is constrained by the diminished savings available locally.

In this perspective, the creation of a European Savings Investment Fund has been proposed to use euro area excess savings to fund the euro area investment deficit[1]. This Fund would offer long maturity savings bonds to euro area households and life insurance companies with a guaranteed minimum rate of return over the holding period. Public domestic development banks would guarantee the minimum interest rate and the redemption of these saving bonds provided that those savings are held for a sufficiently long period of time (e.g. until the retirement of the saver) and are invested in diversified portfolios mostly in euro area equities.

Promoting the emergence of European banks

In a monetary union, the banking landscape cannot be made up of a collection of standalone national banking systems. Such an environment also represents an obstacle to the development of cross-border flows.

The creation of the Banking Union, transferring national supervision and bank resolution at the EU level could lead to more efficient integration. However, despite the elimination of more than 100 National Optional Discretions (OND) by the SSM, the banking market remains fragmented.

As P. Praet stated[2] "If we are to achieve a fully integrated euro area banking sector and to reverse the retrenchment behind national borders that took place during the crisis, we need to remove any remnants of the regulatory framework that implicitly support home bias, raise the impediments to cross-border business and disadvantage euro area banks internationally. Though some banks have had cautionary experiences with cross-border expansions in the past, the development of pan-European banks, alongside strong local banks serving local markets, must be part of the financial landscape of a monetary union."

In this environment, the priority for the short term seems to be to understand better what is involved with the remaining specific national regulatory discretions imposed by national legislators (local capital and liquidity cushions, pillar 2 requirements on a solo basis, a macro prudential framework based on national decisions, a national bias in the holding of sovereign debt, etc.) and to demonstrate the benefits of a consolidated regulatory and resolution approach for pan EU banking groups.

Accelerating the resolution of non-provisioned non-performing loans in certain EU country banks (Italy, Cyprus, Greece, Portugal, Roumania, Bulgaria, etc.) would support the level of credit available and help restore confidence and trust between the EU countries.

Encouraging cross-border equity flows

If Europe wants to develop a private risk sharing capacity across the EU and to benefit from an innovative economy, it must be financed through equity in a growing proportion. Europe is lagging behind in this area. The equity share of corporate financing is half as large as in the US-only 52% of GDP in the euro area, versus 120% in the US.

Different solutions have been proposed by the EU Commission to develop equity financing in the context of the CMU and of MiFID.

Increasing equity financing requires changes to taxation frameworks. Working notably on the debt equity bias is of paramount importance. The tax deductibility of interest payments in most corporate income tax systems coupled with no such measure for equity financing creates economic distortions and exacerbates leverage. Addressing the preferential tax treatment of debt over equity would encourage more equity investments and create a stronger equity base in companies. The recent legislative proposal of the EU Commission on the debt equity bias is an encouraging step forward.

Increasing the efficiency and consistency of insolvency frameworks across the EU can also promote cross-border equity finance. Indeed inefficient frameworks raise the cost of recuperating investments and reduce the willingness to provide equity capital. Furthermore, reducing divergence in corporate governance frameworks across Europe can lower barriers to cross-border equity investments.

The forthcoming revision of Solvency 2 also represents a key opportunity to suppress regulatory disincentives to long term financings.

Other measures include the creation of MiFID growth markets, the review of prospectuses and the development of EU venture capital funds (EuVECA) to support the development of SME financing as well as efforts to improve investor information protection and financial literacy.

The return to fiscal solvency in all the EU Member States would have a decisive impact, accelerating the development of cross-border investment.

One of the main obstacles to cross-border investments within the EU remains the absence of fiscal discipline and budget consolidation in all parts of the EU. Achieving economic convergence between all EU Member States would improve the competitiveness of each Member State, make the euro area more resilient as well as restoring trust between Member States and accelerating private risk sharing within the EU. This is also an essential precondition for attracting international investors in Europe. ●

[1] See E. Alphandéry, J. de Larosière, O. Garnier, D. Gros and T. Mayer, "Proposal for a European Savings-Investment Fund", Euro 50 Group, March 2014.

[2] See P. Praet, "Monetary policy and the euro area banking system", Brussels, November 9, 2016.

Challenges and impacts of Brexit for the financing of the EU economy

Impact of Brexit on the financing of the EU economy

Brexit is a major event for the UK but also for the EU. In addition to its potential political and trade implications, Brexit may also have consequences for the financing of the EU economy and for the effectiveness of its financial sector.

The UK is indeed the largest financial center in the EU operating as a hub for other EU countries and concentrating a large part of the wholesale financial services used by EU institutional investors, corporates and governments[1] as well as the most liquid and deepest currency, equity and derivatives markets in Europe. Although estimates vary to a certain extent depending on the reports, around 35% of EU wholesale financial services activity is considered to take place in London[2] and the UK represents more than 50% of EU capital market activity[3] e.g. nearly 50% of EU equity is raised in London and around 40% of EU investment fund assets are managed in the UK[4]. The possible ramifications of Brexit for the EU in terms of financial stability have also been emphasized given the position of the UK in the trading and clearing of euro-denominated hedging instruments. 75% of euro-denominated interest rate OTC derivatives, as well as 43% of euro-denominated forex OTC derivatives are indeed provided by UK-based players[5].

London has been a leading financial centre since the 19th century building on the position of the UK in international business and trade and its trustworthy legal system[6] in particular. But EU passports[7] have helped the City to strengthen its financial ecosystem[8] and its position in Europe during the last few decades, by allowing many financial service providers to concentrate their European activities[9] in the UK, thus achieving a high level of scale and efficiency. However on Brexit the UK will leave the single market, becoming a so-called third-country, and after a likely transition period UK passports will be discontinued.

Possible way forward

In order to preserve the current integration of UK and EU financial markets[10], the UK-based financial industry is in favour of a bespoke trade agreement, hinging on a broad mutual recognition of the equivalence of EU and UK capital market regulations[11] and supervisory cooperation. Existing cross-border arrangements (e.g. third-country rules[12], reverse sollicitation[13]) are indeed considered to be too patchy or uncertain to be used in the long run on a widescale basis[14]. Moreover operating through EU27 subsidiaries is costly[15] and normally requires capital and staff to be transferred to EU27, potentially increasing operational and execution risk in the short to medium.

The outcome of the trade negotiations between the EU and the UK is however quite uncertain at this stage and it is possible that there may be no agreement at the end of the two year period. This lack of certainty is challenging for the UK but also for the EU27, given the current importance of UK based activities for the financing of the EU economy, and thus calls for clear policy options to be defined at the EU27 level.

From an EU27 standpoint and irrespective of the outcome of the trade negotiations with the UK, a first challenge consists in adjusting to the new interdependencies with third-country jurisdictions created by Brexit. On Brexit the share of financial services involving non-EU jurisdictions and counterparties will indeed increase significantly. EU27 supervisory arrangements need to be adapted accordingly, notably regarding the supervision of financial services that are of systemic relevance for the EU. This may require endowing ESMA with a stronger power to supervise or jointly supervise activities conducted outside EU27 notably in the UK e.g. with a joint-supervision mechanism of certain entities (e.g. CCPs) or a reinforcement of the powers of ESMA in cross-border colleges.

A second challenge for the EU27 involves strengthening its financial services sector in order to guarantee financing of its economy whatever the future of its relationship with the UK. This objective is in line with the on-going Capital Markets Union and Banking Union initiatives, but its achievement could be hindered by persistent fragmentation within the EU.

Significant legal and fiscal obstacles, together with economic divergences across Member States, continue to hinder the integration of EU financial sectors and limit cross-border investment and movement of capital in the EU. Secondly, although the EU27 financial sector should benefit from some relocation of staff and activities from the UK, these activities will go to different financial centres on the continent or at least in the Eurozone (e.g. in case location requirements are decided for euro-denominated clearing activities). This dispersion could be made worse by possible regulatory competition between EU27 Member States, notably regarding substance requirements in local EU subsidiaries.

Addressing these different elements of fragmentation across EU27 Member States is becoming >>>

>>> increasingly important with Brexit, in order to minimize possible impacts in terms of liquidity and efficiency. This requires in particular an acceleration of CMU initiatives to lift legal and fiscal obstacles to cross-border investment and an optimized use of technology in order to support the interconnection between different EU financial centres, as well as tackling local regulatory requirements which hinder the achievement of the Banking Union. A review of supervisory arrangements in the EU27 and notably of the powers and governance of the ESAs should also be considered in order to ensure a more consistent implementation of EU rules and to foster an appropriate level playing field between EU27 jurisdictions.

A third challenge is ensuring an appropriate transition towards Brexit that minimizes disruption, allowing a continuation of services to clients and a preservation of financial stability, which might involve the grandfathering of certain arrangements, as some have suggested. ●

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1 e.g. issuing and trading of debt and equity securities, foreign exchange trading and derivatives

2 IRSG report sponsored by TheCituUK – The EU's third country regimes and alternatives to passporting – Jan 2017.

3 The UK government's White Paper states that over 75% of the EU27's capital market business is conducted through the UK. Moreover, the New Financial think tank (What do EU capital markets look like post-Brexit? – September 2016) estimated that only one third of all EU capital market activity in the EU is conducted in EU27. In sectors such as the trading of equities, FOREX or OTC derivatives more than 2/3 of the total EU activity is conducted in the UK. The position of the UK is also important in the asset management sector with 40% of total EU assets managed out of the UK, although the proportion is much higher in some market segments such as hedge funds (75% of assets managed) and private equity (60% of funds raised), where the UK concentrates the main players operating on a pan-EU basis. Moreover UK capital markets are overall about twice as deep (value relative to GDP) as EU27 ones and even more so in pension assets, venture capital and private equity. Also 70% of euro-denominated OTC interest rate derivatives are cleared in London

4 Source: EU Parliament Briefing 9 December 2016.

5 Source Bruegel Policy contribution – Brexit and the European financial system - 2017

6 The UK financial sector is also supported by a very effective ecosystem comprising the largest stock exchange in the EU, major clearing houses, rating agencies and data vendors, many of which use EU passports, as well as multiple consultancy, auditing and law firms.

7 Passports allow firms in EU Member States to provide financial services across the EU under a common set of rules and a single authorization from their regulator. The EU has reinforced since the financial crisis and the G20 commitments its set of financial regulations providing EU passports for EU based firms (e.g. in areas such as derivatives, clearing and settlement market infrastructures, alternative investment funds, rating agencies…), which now cover most areas of the financial sector.

8 The UK financial sector is also supported by a very effective ecosystem comprising the largest stock exchange in the EU, major clearing houses, rating agencies and data vendors, many of which use EU passports, as well as multiple consultancy, auditing and law firms.

9 Mainly wholesale financial market and portfolio management activities (a significant part of EU asset and portfolio management activity is also conducted in the UK, using the delegation provisions of EU asset management legislation).

10 The UK Government has called for the pursuit of "a new strategic partnership with the EU

11 which should normally be the case with the planned implementation of EU rules in UK law

12 Third country provisions allow the EU authorities to rely on the compliance of foreign entities with their home framework deemed equivalent and may apply to the entire regulatory framework of a third-country or to some of its authorities only

13 Reverse solicitation which allows non-EU finance firms that are not registered in the EU to provide cross-border services to an EU client (if the client has approached the firm first) is permitted in some directives (e.g. concerning hedge funds or trading activities) and jurisdictions but is subject to possible changes of EU or domestic legislation and to limitations (e.g. restriction to certain services and products)

14 According to the IRSG report (The EU's third country regimes and alternatives to passporting), third country regimes only exist for certain EU regulations: they are available for certain market infrastructures (e.g. CCPs, benchmark administrators), and are being introduced for firms undertaking investment business (through MiFID II) and alternative investment funds (through AIFMD), but are not available for many banking services, UCITS funds and insurance activities and are very limited for retail clients). Moreover these are quite uncertain: they can be revoked unilaterally by the EU at short notice, equivalence determinations have been so far quite complex and must be performed for each regulation, and improving them would probably be a very long and complex process.

15 Direct cost of operating one or several subsidiaries and indirect costs related to economies of scale, reduced netting opportunities and liquidity.

2. CMU IMPLEMENTATION

Delivering CMU with Brexit

Progress made with the CMU and upcoming priorities

The Capital Markets Union (CMU) project was designed as an EU-wide project aimed at developing EU capital markets in order to connect savings to investment, enhance private risk-sharing and foster growth by providing alternative sources of financing for SMEs and infrastructure projects. The Action Plan of September 2015 set out the actions necessary to put in place the building blocks of CMU by 2019. A mid-term review launched with a consultation published in January 2017 is due to take stock of the progress made with CMU and update priorities.

Progress has been made on the short term actions of the CMU (modernization of prospectus rules, implementation of simple, transparent and standardized (STS) securitization, revised rules for venture capital fund passports, revised prudential rules for insurance companies investing in infrastructure projects…). Issues are however still raised regarding the securitization proposals in particular and the prudential requirements that would be imposed on banks and insurance companies investing in securitization products.

In a communication published in September 2016, the EU Commission rightly called for an "acceleration of the CMU". Actions are underway to address the inefficiencies resulting from differing insolvency frameworks and taxation rules. These include a proposal made on business restructuring and second chance, a benchmarking review of loan enforcement regimes (including insolvency), as well as actions to address withholding tax refund procedures and the preferential tax treatment of debt over equity.

The mid-term review consultation document published in January 2017 emphasizes additional upcoming priorities for building a CMU which include proposals for an EU personal pension product, actions to support sustainable finance and the promotion of Fintech developments. A review of Solvency II prudential rules regarding equity investment is also anticipated. Moreover views are also sought on measures to further support access to finance by EU businesses for example through better corporate governance and the development of non-bank finance to finance companies ahead of IPOs.

Implications of Brexit for the CMU

Brexit and the announced withdrawal of the UK from the single market is potentially an important challenge to the deliverability of the CMU as EU capital markets are quite dependent at present on UK-based counterparties and financial services provided by the City. The UK capital market indeed currently acts as a wholesale hub for other EU financial centres and accounts for 30 to 70% of EU activity in capital market segments which are essential for the CMU, including venture capital, OTC derivatives and equity trading. Moreover, some observers are concerned that the CMU initiative may lose political momentum with the country with the largest capital markets and presumably the highest interest in further strengthening them leaving the Union.

On the other hand, Brexit also reinforces the importance for the EU27 of developing its capital markets and achieving an ambitious CMU. At this stage the outcome of trade negotiations between the EU27 and the UK is indeed quite uncertain and an absence of agreement on Brexit cannot be excluded, potentially making access to the City more costly and more difficult in the future. Moreover existing arrangements such as third-country regimes are not considered to be an appropriate substitute. Whatever the outcome of EU27/UK negotiations, further developing EU27 capital markets seems therefore essential, as well as putting sufficient focus and ambition in the CMU action plan on addressing the possible impacts of Brexit on the financing of the EU economy.

A first challenge is ensuring the sufficient availability in EU27 of capital market activities that are essential for the financing of the EU economy (and notably SMEs) and which are currently strongly concentrated in the City, such as venture capital and private equity, the trading of equity and bonds and Fintech solutions.

Further integrating EU capital markets in order to achieve sufficient scale and legal certainty, >>>

>>> with activities potentially handled in a more fragmented way across different EU27 financial centres following Brexit (with the possible relocation of activities to different EU27 jurisdictions) is a second objective. This entails notably ensuring that EU capital market regulations are implemented with sufficient consistency and that legal and fiscal obstacles to cross-border investment and integration are lifted, as well as improving supervisory convergence, which may involve strengthening the powers of ESMA and reviewing its governance.

Another essential issue is to ensure that EU27 has appropriate rules for interacting with non-EU countries i.e. for accessing global markets when needed (e.g. OTC derivatives markets for the provision of hedging instruments), for receiving non-EU investment and for ensuring the supervision of activities of systemic relevance for the EU that may be performed outside the Union. ●

Developing the EU cross-border investment fund market

Current fragmentation of the EU investment fund market and underlying barriers

Asset management is expected to play an increasing role in Europe with the objective of the Capital Markets Union (CMU) of developing capital markets in order to further diversify the financing of the EU economy and of better linking savings with growth.

Despite EU frameworks covering a wide variety of fund ranges (UCITS, AIFMD, ELTIF, EuVECA, EuSEF[1]...) and the longstanding success of UCITS in particular which has grown to €8 trillion assets under management, the EU fund market remains quite fragmented, with a high number of funds and a small average size compared to the US (where there are 3 times less funds and an average size 5 times larger than EU ones). This fragmentation increases management costs and lowers potential investor returns.

Cross-border fund distribution is also still relatively limited in the EU despite the passports provided by UCITS and AIFMD directives and harmonized client information and investor protection rules (MiFID rules and the Key Investor Information Document (KIID) for UCITS). Although 80% of UCITS funds benefit from a passport, the proportion of funds actively marketed across borders is significantly lower. One third of funds with a passport are only sold in one Member State in addition to their home country, and mainly back to the Member State where the asset management company is domiciled. Another third is not sold in more than 4 Member States outside their home country[2].

This is due in particular to persistent regulatory and non-regulatory barriers that currently hinder the cross-border marketing of funds, thus reducing competition and choice for investors and increasing their costs. Removing them, through legislative changes if necessary, is a key objective of the CMU action plan

Following initial comments received in the Call for Evidence, the EU Commission organized at the end of 2016 a consultation seeking further evidence on the following barriers to cross-border fund distribution, their rationale, their potential impacts for asset managers, distributors and their clients and on possible solutions for removing them:

- Specific marketing requirements imposed by host Member States (relating to e.g. the content of communication intended for investors or the process of approval of cross-border funds)
- Regulatory fees imposed by home and host Member States for the processing of notifications related to passporting (although these are not mandated by EU fund regulations)
- Specific administrative arrangements regarding the subscription or redemption of fund shares or payments related to cross-border funds, when they are sold to retail investors. Examples cited include requirements for UCITS funds to appoint a paying agent located in the host Member State or for information contacts to be located in the host State
- Regulatory barriers that hinder the use of online and direct distribution across borders
- Issues related to the notification process of cross-border funds (e.g. additional information required by the host regulator, delays in the notification process)
- Taxation issues such as difficulties in obtaining refunds of withholding taxes or unjustified tax discrimination in favour of domestic funds.

Possible way forward for improving investment fund cross-border distribution across the EU

Lifting these barriers requires improving regulatory and supervisory consistency at EU level. Different options may be considered. One option is fully >>>

>>> using and reinforcing ESMA's supervisory convergence prerogatives. Different processes already exist within the ESAs to ensure a consistent implementation of EU regulations but these mainly involve peer pressure and mediation[3] processes, which have their limits. Suggestions have been made to supplement these prerogatives with powers of sanction and to review the governance mechanisms of the ESAs in order to remove domestic bias[4]. Another solution could be to harmonize at EU level certain requirements notably those that relate to cross-border marketing to professional client (e.g. pre-marketing requirements for AIFs in terms of content and timing). A third more ambitious possibility could be to centralize certain processes at EU level related to cross-border funds (e.g. concerning their notification or their reporting processes).

The existence of non-regulatory or non-administrative barriers related to demand and distribution model issues[5] is also pointed out. A first issue is the prevalence in Europe of integrated or closed distribution models, primarily bank networks, which mainly distribute in-house products. A possible solution could be to facilitate the development of open architecture distribution supported by digital solutions, which involves from a policy standpoint making sure that the specificities of these new channels are well taken into account in investor protection and distribution requirements and that these requirements are sufficiently well harmonized. Another issue is the lack of investor confidence with regard to foreign funds and the frequent bias in favour of local products that needs to be addressed with appropriate information and marketing material and efficient supervision. •

[1] ELTIF: European Long Term Investment Fund regulation, EuVECA: European Venture Capital Fund Regulation, EuSEF: European social entrepreneurship funds

[2] Source EU Commission consultation document – CMU action on cross-border distribution of funds – September 2016

[3] ESMA has a coordination and mediation role (participation in colleges of supervisors, peer reviews, thematic reviews, mediation mechanisms, Q&A…) and may investigate breaches to EU laws

[4] The ultimate decision-making body of each of the ESAs is a Board of Supervisors composed of the Chairs of the National Competent Authorities. The present governance is therefore mainly a consolidation of domestic interests with the risk of domestic bias.

[5] For example : Survey of the French AMF on cross-border distribution of funds in Europe – September 2016

Impact of bank prudential rules (FRTB, NSFR) on EU capital market activities

Among the amendments to the CRD IV and the CRR, proposed by the EU Commission, the implementation at the EU level of the global standards regarding the Net Stable Funding Ratio and the Fundamental Review of the Trading Book deserves a specific attention as far as EU market finance activities are concerned.

FRTB

The Basel committee has initiated a Fundamental Review of the Trading Book (FRTB) in order to address the flaws remaining in international standards related to bank trading activities, despite their general overhaul (Basel 2.5) achieved in the aftermath of the financial crisis.

The European Commission tried to address some of the shortcomings identified within the proposed FRTB, by introducing targeted adjustments regarding notably some EU sovereigns, covered bonds, STS securitisation. In addition, a 0.65 factor could be applied to the new capital charges (the new rules are mandatory two years after the enforcement of the EU proposal) during a three-year period. During this phase-in period, the EBA is expected to report on the appropriateness of the calibrations of the framework.

The industry acknowledges the need to address the flaws specific to the Basel 2.5 framework. However, many EU and non EU market-players express concern regarding the new trading book framework.

Firstly, they consider that the design and calibration of the proposed framework are far from being ready either in the EU or globally.

More fundamentally, the framework's architecture – i.e. the usage of both internal models and the standardised, extensive back-testing, etc. - is proving extremely complex and costly due in particular to the need to enhance the scope, the form and the amount of data to store and process, in order to define the various sensitivities needed to feed such an approach, furthermore on a desk by desk basis. Such >>>

>>> complexity seems to go against the objective of defining a framework combining simplicity, proportionality and risk sensitiveness.

Beside the complexity of the framework, the industry also anticipates large increases of capital requirements, which suggest that the framework goes far beyond correcting the flaws existing in the current Basel 2.5. It is important to highlight in this respect the commitment made by international and European bodies (the GHOS and ECOFIN respectively) that overall capital levels will not increase significantly.

Finally, the industry is of the opinion that the consequences for market making of an increase in market risk capital, even if it affects only a relatively small number of banks, must be carefully considered given the broader economic implications notably in a context where the EU is trying to increase the share of market finance.

Furthermore, the industry insists on the fact that such framework should not be recalibrated and implemented at the EU level only, and that sufficient coordination is necessary at the global level, since the financial institutions concerned by the framework are mainly large international institutions actives across financial markets on a global basis what raises both financial stability and level playing field challenges globally.

NSFR

In the proposed revision of the CRD, the Commission introduced a binding net stable funding ratio (NSFR), which requires credit institutions to finance their long-term business with stable sources of funding in order to increase the resilience of banks to funding constraints.

The Commission following the advice provided by the EBA, aligned the rules of calculation of the EU NSFR with the BCBS' standards, but adapted some of them to take into account European specificities.

However, several services and market functions are negatively impacted by their proposed treatment in the NSFR framework. The framework is apparently failing to differentiate the economic purpose, funding profile and underlying risk exposure of certain derivative portfolios, and therefore it introduces unnecessary costs for derivative transactions, costs that are disconnected from the actual funding risk.

In addition, this liquidity framework is negatively impacting market makers in equities and other securities, though related markets are vital for supporting the real-economy. This is even more important in the context of the Capital Market Union (CMU), which aims at reducing Europe 's reliance on bank financings, by developing capital markets.

According to the EBA QIS 2015, there seems to be already strong compliance with the NSFR in most EU credit institutions since 70% of banks are already compliant and only 14% of the banks in the sample have NSFRs below 90%. The average NSFR of non-compliant banks is 90.5%. Nevertheless, the EBA states that the shortfall of non-compliant banks in the sample in December 2014 amounted to EUR 595 billion. Such a significant shortfall was mainly concentrated in a small fraction of banks, where, in some cases, significant and difficult adjustments could be expected.

In addition, trade associations stress that these assessments are too general. Provided that NSFR deficits arise mainly in connection with capital markets activities, and that acting as a market maker in capital markets requires major fixed cost infrastructure investment in technology, trading expertise, risk management expertise, and product development... a bank primarily operating in retail markets and benefiting from funding excesses, would not be able to become a market maker without a costly strategic expansion into such activities.

Finally, the impact of the NSFR and the FRTB should be assessed together, with also all other regulatory reforms adopted in the aftermath of the 2008 crisis (among which MREL, TLAC, leverage ratio, ...), so that their cumulated costs and benefits are comprehensively evaluated. ●

3. BANKING AND INSURANCE REGULATION

Priorities for progressing towards a single banking market

The benefits of a single banking market

The euro area needs an institutional framework that allows banks to thrive as euro area banks in order to reap the benefits of a genuine single banking market. In the context of a monetary union, a single banking market would also improve what economists call allocation – that is credit allocated efficiently and without reference to location. That would not necessarily mean that the Portuguese SMEs would borrow at the same cost as German SMEs; but that Portuguese SMEs would borrow at the same cost from Portuguese banks as they do from German banks if the balance sheets of these banks are of equal quality.

Moreover a single banking market would improve private risk sharing – that is if banking markets are integrated in such a way as to help companies and households cushion domestic bank shocks. Reversing fragmentation would be an additional expected benefit from the single market potential. This "de-fragmentation" would contribute to breaking the 'vicious circle' between banks and sovereigns, and improve the resolution of banks, which would therefore reduce the risk of taxpayers' money being involved in bail outs.

These are the reasons why the priority is to make the Banking Union effective and to keep the development of supervisory practices in the Banking Union well connected with the EU-wide convergence agenda.

EU cross-border banking groups do not operate in a Single Market

Despite the elimination of more than 100 National Optional Discretions (NOD) by the SSM, the single banking market remains fragmented.The euro area is not treated as a single jurisdiction for the purposes of bank regulation. There is still non-negligible national discretion in implementing rules. Liquidity remains national (cross-border groups are submitted to liquidity requirements in each of their subsidiaries located in the euro area). Pillar 2 capital add-ons are still used by national supervisors notably to address macro prudential risks. And the lack of single-jurisdiction status – or the multiple national jurisdictions - may impose additional capital charges on euro area banks. Symptomatic is the treatment of additional capital charges for systemically important banks related to cross-border euro area exposures, which are still considered as international exposures from a regulatory perspective and which hinder cross border consolidation.

Moreover the process of disposing of Non-Performing Loans is moving too slowly in some jurisdictions and is challenging the implementation of the new EU resolution framework notably in Italy.

In addition, cross-border banking remains the exception rather than the rule and banks have a much stronger home bias than before the crisis. Indeed, the 2011-2012 sovereign debt crisis halted the circulation of capital flows between eurozone countries and the European Union. Cross-border loans between eurozone banks were down 6% year-on-year in January 2017 to 1,260 billion euros according to the ECB, compared with over 2,000 billion euros in 2008. However, lending between banks in the same country was up 11% year-on-year in January 2017 to 4,600 billion euros, according to calculations by Reuters based on ECB data. With banks retreating in this way onto their domestic markets, there is a risk of making each eurozone country more vulnerable to domestic shocks, while this also runs counter to the objectives of the Banking Union and single market within which credit can circulate efficiently to meet the needs for credit financing wherever they are expressed[1].

Finally, many banks in the EU continue to receive a significant exposure to their domestic sovereigns. According to a study of the ESRB[2], in almost all euro area countries, bank' exposure to their domestic sovereigns (in relation to total assets) followed a declining trend between the end of the 1990s and September 2008, when the Lehman default occurred. This date coincides with a reversal of this trend: the home country bias increased until it stabilised in 2014. For banks in non-stressed countries, the increase was less marked[3].

In general, banks in stressed euro area countries increased their exposure to domestic sovereign >>>

>>> debt in response to increases in its yield. This response may have been motivated by different factors, including the banks' search for yield by engaging in carry trades that take into account redenomination risk, the desire to increase holdings of liquid assets, moral suasion exerted by sovereigns, or the banks' attempts to preserve the stability of their respective countries.

Need to remove home bias in the EU regulatory and supervisory framework

As P. Praet stated[4] "If we are to achieve a fully integrated euro area banking sector and to reverse the retrenchment behind national borders that took place during the crisis, we need to remove any remnants of the regulatory framework that implicitly support home bias, raise the impediments to cross-border business and disadvantage euro area banks internationally. Though some banks have had cautionary experiences with cross-border expansions in the past, the development of pan-European banks, alongside strong local banks serving local markets, must be part of the financial landscape of the monetary union."

In a monetary union the banking landscape cannot be made up of a collection of standalone national banking systems. And in an environment where bank profitability is weak, and where macroeconomic stabilization policies are already at full throttle, the benefits of such cross-border integration – efficiency and risk-sharing – are even more in demand. Thus a true Banking Union needs to be completed in a reasonable period of time. And that includes, establishing a European Deposit Insurance Scheme that can ensure the fungibility of insured bank money across all parts of the monetary union.

To make progress, a pre-requisite is for all euro Member States to strengthen their fiscal positions and competitiveness.

But this requires trust and confidence between national supervisory authorities and among political leaders. And such confidence can only be achieved when legacy issues are effectively addressed and economic convergence between all Member States becomes a reality. If we want to progress towards a single banking market (and also to integrate financial markets) in a way that delivers real diversification and risk sharing, it has to be attractive for investors to hold assets across a broad range of euro area countries and for EU banks to hold diversified sovereign debt assets. And this is not realistic unless all countries are fiscally stable, dispose of their legacy issues and implement structural reforms to raise their growth potential. ●

[1] Savings no longer flow from the high per capita capital countries to the low per capita capital countries. The ECB's actions have prevented this interruption in capital mobility from driving apart euro-zone countries' interest rates, but they have not restored capital mobility.

[2] ESRB report on the regulatory treatment of sovereign exposures, March 2015.

[3] According to the EU Commission, only a minor reduction was recorded in Italian banks 'exposure to the sovereign (from UR 398 billion at the end of 2015 to EUR 383 billion, or 23% of GDP, at the end of 2016). At the same time, foreign private investors remain rather reluctant to invest in Italy and their share of public debt declined slightly (from 30% in June 2015 to 28,4% in June 2016).

[4] See P. Praet, « Monetary policy and the euro area banking system » , Brussels, 9 November 2016.

The future of EU banking business models

The number of regulatory changes or additions (e.g. leverage, short and longer term liquidity, certain countries constraint banks' structures, systemicity of certain banks, bail-inability of bank liabilities, resolution planning…) has increased the regulatory burden.

Digitalisation also burdens the banking system. It has to further invest, share customers' data, address evolving customers' needs, and eventually face up to renewed competition.

The economic context weighs on banks, while ECB's low interest rate policy hits the banks whose profits come from interest rate businesses.

Today the EU banking sector – though an important variability across banking groups and geographies - is characterised by insufficient profitability, excessive non-performing loans and a reliance on central bank funding. Such a context exposes the European economy traditionally financed by banks, and reduces the number of banks able to support the development of market finance.

Therefore, some point to possible overbanking. Many ask for a normalisation of the European monetary policy. Stabilising and defining simpler regulations and reporting duties are evoked to alleviate notably the burden on smaller European banks.

However, many aspects of banking have to change in the next few years. Though digitalisation should favour improved profitability and competitiveness it is also a source of threats. Banking business models are expected to undergo profound changes. ●

CRR II/CRD V: are we on the right track?

In November 2016, the EU Commission presented a banking reform package, which aims to complement the reforms that the EU implemented in the wake of the financial crisis (the so-called Basel III). Actually, following the CRD IV regulatory package, which introduced higher levels of high quality capital and complemented bank regulatory frameworks with liquidity constraints and a leverage ratio aiming at providing a backstop to an excessive reduction of own funds resulting from inappropriate risk modelling practices, the current EU Commission proposal, which calibrates the leverage ratio and NSFR, is primarily an almost final contribution to the implementation of Basel III in the EU.

However, the EU Commission is aiming to implement certain additional standards defined at the global level such as possible excesses in leverage and the definition of the effective internal loss absorbency capacity of G-SIBs (TLAC). Global regulators are also seeking to make trading book regulations more sensitive to tail risk.

In this context, the package notably encompasses

- A binding leverage ratio (LR),
- A binding Net Stable Funding Ratio (NSFR) which will require credit institutions to finance their long-term activities with stable sources of funding, which will become a minimum standard globally by 1 January 2018,
- A capital requirement on the trading book based on the work of the Basel Committee (the Fundamental Review of the Trading Book - FRTB).
- A new standard on the total loss-absorbing capacity (TLAC) of global systemically important institutions (G-SIIs),
- A new calculation of large exposures limits.

However, the proposed bill of the EU Commission is also assessing whether the EU regulatory framework for banks fits EU bank and economy specificities (e.g. a leverage ratio set at 3%, NSFR adjustments regarding some matched asset and liabilities, trade finance, centralised regulated savings, specific (reduced) market risk capital requirements regarding Simple, Transparent and Standard securitisations (STS), etc.) and allows EU banking institutions to provide the necessary funding for the economy and in particular for SMEs and infrastructure projects. On this occasion the EU Commission also considered some means to make EU bank rules more proportionate and less burdensome for smaller and non-complex banks.

Another expected added value of the proposed package, is the reduction of the regulatory fragmentation of the EU and consequently a contribution to the deepening of the Banking Union. Indeed – in addition to the well-known so called National Options and Discretions (NOD) – general Pillar 2 capital add-ons, which are imposed by certain member states to all the financial institutions though they are normally institution specific, contribute to fragment the actual implementation of bank regulation.

The Commission beside the implementation in the EU of international standards regarding internal loss-absorbing capacity of non-EU G-SIIs seeks to simplify and strengthen the resolution process of third-country groups with significant activities in the EU. To this end, as the US the Commission proposes to make mandatory for third-country groups that are identified as non-EU G-SIIs or that have entities on the EU territory with total assets of at least EUR 30 billion, the creation of intermediate EU parent undertakings uniting the European subsidiaries of such third country financial groups. These holding companies will be responsible for ensuring the compliance with resolution legislation on an EU consolidated level.

At the moment when the regulatory framework for banks is close to completion, it is finally worthwhile to step back and check its overall ability to impose an optimum level for the ratio financial stability versus the contribution of the EU banking sector to the financing of the economy. In addition, since despite the efforts provided by the EU Commission through the Capital Market Union, enhancing sufficiently the role of non-banks will take time, it is appropriate to clarify whether the addition of the many complementary bank regulations, actually preserves EU bank responsiveness to the EU monetary policy, which drives asset portfolio reallocations and change risk appetite through interest rate changes, or if conversely the cumulated costs of regulatory capital, loss absorbing liabilities and liquidity... , increase the inertia of banks' investment patterns by disconnecting lending/risk-taking conditions with the cost of bank borrowings. Finally, it is also important to identify possibly significant negative evolutions or trends that the new regulatory framework might have eventually initiated among EU banks e.g. reduced international coverage, refocus in home countries, reduced range of financial services...

Proportionality in EU banking regulation

The BCBS stressed[1] that having substantially strengthened the banking system's regulatory framework, the Committee's attention had to turn to the international framework's complexity and to the comparability of capital adequacy ratios across banks and jurisdictions.

However, the Committee puts forward that a risk-based capital regime should remain at the core of the regulatory framework though complexity is largely driven by a desire for risk sensitivity. Finally, the challenge for the Committee is to strike an appropriate balance between complementary goals, which are risk sensitivity, simplicity and comparability. However, the Committee insisted on the need for a full, timely and consistent implementation of Basel III in order to building a resilient financial system, maintaining public confidence in regulatory ratios and providing a level playing field for internationally active banks.

In the EU, in December 2015 at a CRR Review Conference, the former Commissioner Jonathan Hill - commenting the Impact of the CRR and CRD IV on Bank Financing of the Economy - exposed the necessary focus on proportionality. Indeed, many consultation responses called for the CRR-CRD 4 framework to differentiate better between financial institutions in order to avoid disproportionate compliance costs and be sensitive to its impact on bank's competitiveness.

Since, the Commission undertakes to define whether there is a case to distinguish between large and small banks and drafts proportionate approaches. In particular the Commission emphasises a reduction in the burden on smaller institutions in all the recent reform areas of the CRR/CRD, notably it has proposed a variety of relief measures and related thresholds.

In the US specific regulations have been dedicated to smaller banks since 2013. Yet, US official[2] still consider however that it is worthwhile

- to continue to simplify capital rules for small banks,
- to streamline the number of rules that apply to them of separate compliance exams to which they are subject, and
- to reduce reporting requirements and the administrative burden

Actually, there are at least two possible approaches to achieve such an objective.

The first – the work being done by the EU Commission - is a details-driven approach which introduces special exceptions or adjustments on a rule by rule basis. That would systematically address the excess burden placed on smaller institutions' operational capacities, and encompass the definition of graduated and less complex requirements.

The other one is the creation of a separate specific and dedicated regulatory framework for smaller institutions in addition to the framework specific to large multinational institutions, which would only be subject to the fully loaded Basel III requirements in the EU. Indeed, many regulators consider that smaller, simpler and less interconnected banks are less risky and thus require less strict regulatory requirements.

Yet, regulators add that any relief being discussed have to focus on the real problem, which is not minimum capital requirements but primarily operational burdens imposed by the need to comply with complex rules. Otherwise there is a risk to create regulatory loopholes. For this reason, certain in the EU call for focusing simplicity on less risky activities more than the size of the banks. Finally, the general challenge is to avoid both stimulating smaller institutions, creating the condition for a possible general distress, or encouraging excessive consolidation in the industry. Diversity in terms of bank size and business model is considered as making EU banking system more stable.

However, the creation of a specific frame work for smaller entities supposes explicit and robust criteria for tiering the requirements within the prudential regulatory regimes. The Dodd-Frank Act reflects this principle, since it defines asset-size thresholds in order to establishes the various regulations. Yet in the US, the appropriateness of existing thresholds is debated (e.g. should the appropriate threshold to enhance prudential standards, be set at the current $50 billion level or at $100 billion? Should community banks with less than $10 billion in assets, be entirely exempt from some regulations such as the Volcker rule and the incentive compensation rule? ...) Conversely, in the EU one insist on the need to be careful not to set the thresholds too high, as otherwise there would be considerable risks that would be inadequately regulated...

The final question going forward, is related to the appropriate timetable to address the proportionality issue. The substantial revision of existing standard regarding credit risk assessment offers, of course, an opportunity to address related challenges.

All in all, the remaining issue is that even for larger banking groups, regulations can become excessively complicated. In particular such a complexity imposes an unaffordable burden on supervisors notably to validate and monitor the models rigorously. In particular, such a complexity may make hard to detect deficiencies on risk modelling in a timely manner. Without asserting that simpler regulations are always optimal, one general question is also for regulation to strike the right balance between complexity and accuracy in risk assessment. ●

[1] The regulatory framework: balancing risk sensitivity, simplicity and comparability - July 2013

[2] Daniel Tarullo tailoring Community Bank Regulation and Supervision April 2015

Insurance macro and micro-prudential policy outlook in the current global and EU economic context

The global and EU economic and monetary contexts are challenging for the insurance industry

Low growth, low inflation, low and even very low and sometimes negative interest rates, and finally high financial markets volatility are increasingly challenging long standing insurance business models.

According to the Global Insurance Market Report issued by the IAIS in January 2017, sluggish economic conditions led non-life insurance activities to witness a deceleration of premium growth in most developed economies. In parallel their investment income is gradually declining since interest rates remain low. However, the industry succeeded in maintaining the level of the combined ratio (the sum of incurred losses and expenses, divided by earned premiums), which proves that the profitability of insurance companies is broadly unchanged. Finally, profitability was preserved probably thanks to reserve releases which allowed insurance companies to face up to an environment which was also very competitive.

The low interest environment was an important source of vulnerability for life insurance groups, since previously guaranteed benefits could not be delivered in such an unexpected low interest rate context, i.e. unusually, the spread between their investments and guaranteed returns was reduced or partly negative. The impact of such a phenomenon differed across the countries and in the EU, Germany and Austria were the most impacted. In Germany for example, investment yields declined progressively from 7.5% in 2000 to 4.5% in 2015.

The negative consequences of the economic and monetary environment were compounded by the competitive landscape. According to the IAIS, the most important factors of financial impairments in both life and non-life insurance companies, were deficient loss provisioning (45% of impairments) and inadequate pricing (12%), which were probably triggered by a tough competitive context. This deserved close monitoring from supervisors.

Finally, in the US and the EU as well the industry had to consolidate. In the EU the number of active undertakings declined by 6.9% between 2010 and 2014. In addition, the profession is also increasingly selling products with reduced sensitivity to interest rates i.e. without guarantees, and policy holders now increasingly directly bear the risk without necessarily having the necessary expertise.

In parallel, life-insurance companies are now responding by lengthening the duration of their investments in order to better match them with the liabilities and benefit from higher remuneration. The companies also search for higher yields though there is no evidence that they are taking greater risks due in the EU at least to the implementation of the risk sensitive regulatory framework Solvency II.

Finally, life insurance companies are obliged to engage in ambitious cost efficiency programmes since they increasingly fail to appropriately remunerate their capital (the estimated cost of capital was 9.6% on average from 2000 to 2013 while the average return on equity was 8.8%).

Important regulatory and supervisory evolutions underway

The EU has just rolled out a new regulatory framework i.e. Solvency II.

Furthermore, in the EU, the possible impacts of severe lasting monetary, economic and financial conditions have led the EIOPA to stress test the insurance sector on the basis of a sample of insurance undertakings involving mainly those exposed to long term guarantees and encompassing a large number of small and medium institutions.

At the global level, the focus has been put in particular on potential vulnerabilities specific to large international financial players regarding notably their possible systemic importance resulting from their interconnectedness with the financial sphere and their ability to spill over systemic shocks. Additional loss absorbing capacities and improved arrangements to smooth the recovery and resolution of insurance undertakings, are part of the solutions put forward in this context.

An additional macro-prudential approach

In addition, the need for a more specific macro-prudential framework for the insurance sector is being discussed.

Indeed, both the financial crisis, and more recently lasting adverse economic and monetary conditions illustrate that due to the mere specificities of certain features of some of their activities, extended parts of the insurance sector may be notably exposed to similar macro risk and therefore to potential simultaneous asset liquidation.

Complementary to the Global-Systemically Important Insures framework, the mitigation of such macro exposures is leading to a reflection at the global level on an activity-based approach targeting the identification of the traditional insurance activities giving rise to systemic risk, and the appropriate micro prudential tools and macro prudential possible overlays. This would apply to the sector as a whole, factoring in the specificities of the insurance sector, notably the need to preserve its countercyclical behaviour.

An unprecedented context of rapidly evolving insurable risks

In the meantime, the development of the sharing economy and the perspective of autonomous vehicles replacing current ones, would possibly eliminate >>>

>>> large quantities of existing insurable risks and thud lower premium volume. This would happen in the context of developing digital sale forces and the progressive adoption of the so called Internet of Things (IoT), which interconnects physical devices, vehicles, buildings, etc. in order to collect and exchange data for reducing risk and improving related pricing based on highly advanced analytics and data processing.

Such unexpected dynamics, require engaging in the development of new insurance offers despite still uncertain related business cases, but also rapidly adapting legacy IT systems in a context of rapidly changing technology. This will lead to the development of ultra-customised dynamically-priced products by processing internet enabled data, which are sold through new distribution channels. It also necessitates the further achieving of cost efficiency at the appropriate pace.

This will happen in the context of emerging "Insurtechs", which will explore opportunities that incumbent insurance firms will have less incentive, flexibility or skills to address.

Climate-related risk: both threats and opportunities

Climate-related threats and opportunities are also heavily impacting the insurance sector. Related risk should therefore be taken into account in the regulatory framework.

Indeed, the insurance industry is firstly exposed by climate-related risk to unexpected worsening of the risk embedded in their existing portfolios of risk (more frequent damages to compensate for, due to climate changes, customers failing to adapt to increased exposures, but also indirect impacts due to second order consequences scarcely incorporated in existing risk modelling tools such as financial losses due to supply chain breaks or business disruptions).

Furthermore, insurance companies are confronted with climate-related risk similar to those faced by any investor (assets losing value due to the increase of their exposure to climate-related hazards, securities issued by fossil energy producers or consumers facing sudden and sharp adjustments of their market value, securities issued by non-financial firms failing to adapt to climate-related risk).

Lastly insurance undertaking may also be directly affected by the challenges raised by the new obligation to manage and disclose climate-related risk, as would be any corporate.

Additional regulatory challenges

Altogether in the economic, financial and monetary context, technologic and climate-related evolutions/risk form an unprecedented array of constraints, which raise varied and complex threats and opportunities for insurance undertakings globally. Indeed, they have to adapt to data collection and processing, improve their costs, price new risk appropriately and be up to the fast evolving tough competitive landscape.

Last but not least, since large parts of the risk will increasingly be directly passed through to the customers, consumer information and protection will also require specific developments.

This situation challenges the ability of the existing though evolving regulatory framework and insurance supervisors to cope with incoming and evolving challenges in order to both ensure the soundness of the insurance sector in the EU but also to facilitate the adaptation of the sector to varied challenges, since the insurance sector is even more needed to mitigate emerging risk, develop modern and attractive financial services and increase its contribution to the financing of the economy notably in the context of the Capital Market Union. •

Consistent and reliable use of internal models in the insurance sector

Internal models represent the best approach to accurately assess risks. Yet, material differences between supervisory authorities regarding the internal models of insurance groups, can have a huge impact on the level playing field between firms as well as on policyholder protection. An appropriate validation and monitoring of internal models is therefore essential. Certain areas may require specific attention e.g. modelling sovereign risk, volatility adjustment and more generally the complexity and diversity of modelling techniques in a context of risk evolving over time and in volatile markets.

This should finally, contribute to the preserving of the confidence of investors in the insurance sector and affirm its stability, in a context where it also plays a major role in the financing of the EU economy. This is particularly important for EU insurance groups active globally and the comparability of model outcomes is a vital issue in this respect.

Beside the provision of harmonised processes for validating internal models and consistent interpretations of the legal framework across the EU, additional tools such as appropriateness indicators, benchmarking and back-testing internal models, peer reviews, data collection from market participants, etc. may contribute to improving the credibility of internal modelling. Finally, the appropriateness of the role, powers and capacity to access the relevant information of the EIOPA, is certainly an important topic to address in order to achieve such an essential objective. •

4. TECHNOLOGY AND CLIMATE-RELATED INNOVATION

Climate-related and green finance

2016 has been a good year for green finance

At the political level, the follow-up of the successful COP21 in Paris has been very positive.

The ratification of the Paris Agreement on the fight against climate change has processed very swiftly. The Agreement entered into force on 4 November 2016, thirty days after the date on which 55 parties to the Convention, accounting for more than 55% of the total greenhouse gas emissions have deposited their instruments of ratification. The USA, China and the European Union, the three biggest polluters, have been amongst the first to ratify. Today, 133 parties of 197 parties to the Convention have ratified.

However the position of the new President of the USA, Donald Trump, who has campaigned on a climate change sceptic platform, is a source of concern.

A record year for the green bond market

The total amount of green and climate-related bonds issued in 2016 has broken a new record at $80bn, compared to $42bn in 2015.

2016 was also the year where the market matured with bonds from an increasing number of countries (24), bond types, issuers, ratings and of use of proceeds. Green debt issued by China (which does not match completely the definition of green bonds by the Green Bonds Principles) rose to $23bn (1st place by country). The use of proceeds went to Energy (38%), Buildings and Industry (18%), Transports (16%), Water (14%) etc. Poland issued the first sovereign green bond of €750m in December 2016, followed by France which issued an impressive €7bn green sovereign bond in January 2017. Investors with and without a green mandate are showing interest in the market, with oversubscription a commonplace.

A continuing increase of other green financings in Europe

In the European Union, the volume of finance provided by the EIB and by national promotional banks (Caisse des Dépôts, KFW, Cassa di Depositi e Prestiti etc) has continued to increase and the so-called "Juncker Plan", which has been rather successful, has been modified to increase the share of green finance in it. In 2016 the EIB alone has financed investments against climate change for a record amount of EUR19bn.

The boom of renewable energies

A large part of green finance has been devoted to renewable energies, for which 2015 has marked a turning point: for the first time, they reached more than half (precisely 55%) of the new electrical generating capacities. And their cumulative production capacity is now superior to coal. Their production of electricity is however only 23% of the total because they do not produce electricity all the time.

But more green investment is still needed

Very bad news for climate in 2016

It was the hottest year on record according to both NASA and NOAA (National Oceanic and Atmospheric Administration, USA).Global sea ice cover was at record low and CO_2 levels broke also new records (above 400ppm).

More investments are needed

According to the OECD, the annual global investments needed for renewable energy and energy efficiency to limit global warming to a 2°C scenario are $839bn (2015-2020), 2,230bn (2021-2025) and 2,404bn (2026-2030). In the policy proposals of the European Commission on energy in November 2016, it is estimated that a supplement of €177bn per year from 2021 will be necessary to reach the European Union climate and energy goals in 2030.

Green finance is still too small

The green bonds market represents only 0,13% of the global bond market.

The European Commission published a study in December on the potential of green bond finance for resource-efficient investments, which describes the growth of this market, some bottlenecks and concludes that it could play a key role in helping to finance the investments needed for the transition to a low carbon economy. To address the bottlenecks, the authors of the study propose in particular >>>

>>> of the public sector in Europe in support of the green bonds, through focusing on information, standardization, helping the development of investment projects and aggregation measures, especially in countries which are lagging. It also discusses other forms of public support, like regulatory or fiscal incentives.

New regulatory initiatives to increase green and sustainable finance

In its paper for the Amsterdam Conference in April 2106, Eurofi recommended a public-private partnership to develop the role of finance in the transition to a low-carbon economy, and stressed the interest of building on market forces (for instance the green bonds market), on "green transparency" (disclosure by financial actors of their investments in fossil energy and in "green investments"), and on a right mix of new constraints and new incentives. These orientations are still valid today and there are important initiatives of regulators in this direction.

At the G20 level, the FSB "Disclosure task-force", chaired by Michael Bloomberg, has published its recommendations, endorsed by the FSB

The TF recalls that one of the most significant risks that organizations face today relates to climate change. It recommends that companies with public debt or equity disclose material climate-related risks, following the same governance process for existing public disclosures. Those organizations in early stages of evaluating the impact of climate change on their businesses can begin by disclosing climate-related issues related to governance, strategy and risk management practices. Organizations already reporting climate-related information should also disclose the potential impact of climate-related risks and opportunities under different potential future situations, including a 2°Celsius scenario. The TF also provided guidance to assist accounting preparers by providing context and suggestions. For the financial sector and certain non-financial sectors, supplemental guidance was developed to highlight sector-specific considerations.

At the European level, the European Commission has created a High-level experts group on sustainable finance (HLEG)

The mandate of this group is to provide, by the end of 2017, recommendations for a comprehensive EU strategy on sustainable finance as part of the Capital Markets Union. The HLEG is chaired by Christian Thimann, who is already the Vice-Chair of the FSB Disclosure task-force. The Vice-President of the European Commission Dombrovskis invited the HLEG 1) to help determine how the financial policy framework should be adjusted to get private capital to sustainable investments; 2) to help create a clearer picture of financial risks related to the transition to sustainable economy. The complete terms of reference of the HLEG are still under discussion, notably on the scope of "sustainable finance": should it be focused on green finance or should other sustainable issues (like circular economy) be included?

One set of possible measures is, like the FSB task-force, about disclosure; some European countries have already a legislation obliging financial investors to publish specific "green information" (including the carbon footprint linked to their assets). Another is about regulatory incentive, like the "green supporting factor": this factor would reduce the regulatory capital ratio linked to green finance for banks, insurances etc. The European Union has already inserted in its transposition of Basel 3 a "SME supporting factor" for loans to SMEs, which the Basel Committee has finally accepted and included in its framework. The arguments for a "green supporting factor" is that it would add incentives to green finance, but also that it would be consistent with a decrease of risk linked to climate change due to green investments.

Conclusion

Eurofi welcomes the increase of green or sustainable finance in 2016, based on public and market forces. In the same time, there is a need to strongly increase the volume of green and climate-related investments. Regulatory initiatives should complement the development of public and private finance. The recommendations of the FSB Disclosure task-force to increase "green transparency" are an important step; these recommendations will now have to be implemented under the control and with the help of supervisors. Eurofi hopes that the High-level experts group of the European Commission will go even further by proposing elements of regulation increasing incentives to the financing of the transition to a low carbon economy. ●

Eurofi thanks J.-F. Pons, Alphalex-Consult, who drafted this regulatory up-date

Can digitalisation accelerate the implementation of a single retail banking market?

According to the factsheet of the European Parliament website the internal market "is an area of prosperity and freedom, giving 500 million Europeans access to goods, services, jobs, business opportunities and the cultural richness of the Member States" (...). Consequently "policies promoting free movement of goods, services, people and capital have a strong potential to boost the GDP".

As far as retail financial services are concerned, concrete objectives for the single market include the reduction of discrepancies between the prices of financial services in the different Member States, and the development of new financial offers. Similar positive evolutions are notably expected from enhanced competition among service providers, the development of multinational EU financial service providers and finally the ability to contract servicing in the financial area across borders.

Naturally, fast developing digital technologies, which cause deep changes across the board with new services as well as unexpected customer experience break-throughs emerging up, are now strongly impacting the EU Single Market and are expected to provide an important contribution to the deepening of the EU single market, in particular from the EU citizens point of view.

In the meantime, financial services have both relevant opportunities and even more efficient tools for deepening such a single market at large. Already in 2011 this was illustrated by the Single Market Act "Twelve levers to boost growth and strengthen confidence", which stressed for example that the insufficient mutual recognition of electronic identification and authentication across the EU, interoperability barriers, as well as the lack of consumer confidence, the prime cause of which is payment security, are among the main impediments to the completion of the (digital) single market.

However, in the area of retail financial services and products, building an EU single market has always proved challenging. Related markets are particularly fragmented. In particular, consumer protection and anti-money laundering (AML) and the combat against the financing of terrorism (CFT) and its regulations and not less importantly related operational arrangements are still mainly working at the national level in the EU. Digital financial entrepreneurs are also mainly developing at the national level as are the regulatory approaches to addressing the issues posed in particular to consumers, by related innovative services (the so called sand boxes).

Since Fintechs or Insurtechs are innovative players using new business models involving peer to peer services, or advanced automated tools such as distributed ledgers... the regulatory challenge is therefore to preserve innovation but also consumer confidence, financial stability and a level playing field. Indeed, incumbents are also very active in addressing emerging competitive challenges and taking advantage of the possibilities opened by fast evolving technology. This has to be preserved in a context where financial players have to simultaneously adapt to the unprecedented tightening of financial regulations triggered by the financial crisis.

So EU policy makers must also aim at accelerating the emergence of a single market for retail financial services. The initiatives of the EU Commission regarding electronic identification, e-signature, Know-Your-Customer (KYC) and Customer Due Diligence (CDD) are all bringing their contribution in this respect. Recently the Payment Service Directive 2 (PSD2) delivered an essential contribution to the EU Single Digital Market, by defining and harmonising the conditions for making available bank data.

However, to be up to the challenge which is "to lay down the right conditions to support innovation and for a future-proof environment to emerge", the European Commission set up in November 2016 a Financial Technology Task Force (FTTF). It is co-chaired by DG FISMA and DG CONNECT, it brings together EU services responsible for financial regulation and for the Digital Single Market, along with those within the EU Commission who deal with competition and consumer protection policy. The Task Force should propose policy suggestions in the first half of 2017.

Such a Task Force provides the opportunity to enlighten many critical issues regarding the single digital retail financial services market. Among these issues are the most promising areas of retail financial services in terms of digitalisation and their cross border potential; the actual perspectives opened by the collection and use of consumers' data; the challenges raised by the already existing innovative digital initiatives (crowd funding, new payment services and providers, etc.); the main digital trends witnessed in the financial industry; the actual added value of the regulations already unfolding in the EU and nationally, in terms of consumer confidence and protection and level playing field, but also regarding the development of cross border transactions; the stability of existing and forthcoming EU regulations, all of which is required to reassure digital entrepreneurs as well as financial incumbents.

Finally, the EU Commission should also have a look at the old issue, which was already raised before the digital wave, which is the coexistence in the EU of 27 different and specific regimes for most of the retail financial services, which represent the main – though non-technical - obstacle to the EU Single Market. ●

5. KEY VULNERABILITIES IN THE EU FINANCIAL SYSTEM

Systemic risks associated with asset management: are the issues settled?

Measures at the EU and global levels for mitigating systemic risks associated with asset management

The asset management sector has experienced strong growth over the past decade both at the EU and global levels and is playing an increasing role in securities markets (corporate bonds in particular)[1]. This growth is expected to continue with the implementation of on-going bank reforms and of the Capital Markets Union. Regulators welcome this trend, since a diversification of financing sources should help to enhance the overall efficiency and resilience of the financial system. Moreover, the general resilience of investment funds in particular during the financial crisis is acknowledged. Some Money Market Funds (MMFs) were exceptions but a specific EU regulation recently adopted should help to tackle the risks posed by these funds i.e. potential run risks and interconnections with the banking sector[2].

Authorities however emphasize the need to monitor potential systemic risks associated with the sector. Concern has notably been raised regarding the increasing volume of assets managed by open-ended funds that offer daily redemptions while investing growing amounts in less actively traded securities (e.g. emerging market or high yield bonds) creating potential liquidity and contagion risks[3]. Liquidity transformation issues may also be present in some ETFs involving e.g. less liquid assets, according to the FSB, although mechanisms differ from traditional open-ended funds[4].

The FSB and IOSCO led consultations in 2015 on methodologies for identifying Non-Bank Non-Insurance (NBNI) G-SIFIs including potentially some asset management entities, but decided to refocus primarily on the vulnerabilities associated with asset management activities and in particular on liquidity and redemption risks. The approach regarding NBNI G-SIFI risk is however due to be finalised by 2019 once the work on vulnerabilities has been completed. The FSB published in January 2017 policy recommendations to address residual structural vulnerabilities stemming from asset management activities. This document sets out 14 policy recommendations (covering four main types of structural vulnerabilities) that are due to be further elaborated by IOSCO:

- Liquidity mismatch between fund investments and redemption terms (measures proposed for open-ended funds and ETFs[5]): improvement of disclosure on liquidity risk to investors, guidance on the need for consistency between assets / investment strategies and redemption conditions, guidance on the use of exceptional liquidity management tools both pre-emptive and post-event[6], guidance on the use of stress testing at the individual fund level and consideration to be given by authorities to potential system-wide stress testing
- Leverage within investment funds: consistent measurement of leverage in funds to facilitate its monitoring and related data collection requirements
- Operational risk and challenges for asset managers in stressed conditions: requirement to have risk management frameworks in place regarding business transfer and continuity plans
- Securities lending activities of asset managers and funds: request for approaches regarding securities lending indemnification consistent with those of other agent lenders[7].

Many of these issues and notably those relating to liquidity mismatch and leverage risks are already covered in EU fund legislations (UCITS, AIFMD, MMF), on which possible future policy steps should build. Moreover liquidity management tools such as swing pricing, anti-dilution levies and redemption gates are available in many European jurisdictions and on-going supervisory convergence efforts by ESMA are helping to ensure their broad consistency.

Macroprudential politicies and tools

Regular stress testing of individual funds is also already mandatory under European and >>>

>>> domestic requirements[8], although the methods used (scenarios, test models) often vary at present according to the investment strategies and assets managed. Guidelines have been established by some domestic regulators (e.g. the French AMF) to help asset management companies implement and use stress tests. ESMA is also planning to develop an EU approach to investment fund stress testing in 2017 as part of its risk assessment workplan.

The use of wider macro-prudential policies (i.e. tools designed to anticipate and mitigate systemic risks before they materialise) for non-bank activities is however still being investigated. "System-wide stress testing" covering a wide scope of vehicles (e.g. investment funds, pension funds, insurance companies) and the related asset owners, which is mentioned by the FSB as a possible option to be considered, raises several issues that need to be clarified in terms of data availability, behaviour modelling (with a very diverse range of market players and clients) and scenario definition (e.g. difficulty to differentiate between market risks and systemic risks)[9]. Moreover the possible shortcomings of limiting system-wide stress testing to a subset of the non-banking market (e.g. mutual funds) have also been emphasized since mutual funds only represent part of investable assets (around 30%) and are not a homogeneous sector (there are notably diverse investment strategies).

Macro-prudential tools for mitigating potential systemic risks that may have been identified by stress tests (such as mandatory liquidity buffers, redemption fees and gates, haircuts for SFT, leverage limits...) also need to be further examined. Although the use of some of these tools in exceptional circumstances is already possible in many EU jurisdictions and regulations, they have generally not been designed in a macro-prudential perspective, according to the ESRB[10]. Moreover some industry representatives question the effectiveness of some of them and stress their potential procyclical and market distortion effects[11]. ●

[1] Global assets under management rose from $53.6 trillion in 2005 to $76.7 trillion in 2015, equating to 40% of global financial system assets according to the FSB report on vulnerabilities from asset management activities (January 2017).

[2] The EU MMF regulation aiming at reducing their susceptibility to runs and their connections with the banking system was adopted in Nov 2016. The choice was made not to impose a capital buffer but instead to limit the use of a constant NAV to retail funds or those mainly invested in public debt. The creation of a new type of MMF (Low Volatility NAV MMF), which may continue to use a stable NAV in normal market conditions, was also retained, as well as a ban of sponsor support. MMFs will also be subject to strengthened liquidity and diversification requirements and CNAV / LVNAV funds will have additional safeguards such as liquidity fees and redemption gates.

[3] Market stress could indeed potentially expose investors suddenly to a greater loss than expected, leading to a significant number of simultaneous redemptions, in turn increasing pricing and liquidity strains in underlying asset classes and creating possible contagion risks.

[4] Global ETF assets under management rose from approximately $400 billion in 2005 to almost $3.2 trillion in October 2016. ETF sponsors have in recent years increasingly offered products investing in asset classes less actively traded than equities, in particular products tracking indices on fixed income, emerging markets or commodities (source FSB).

[5] Such recommendations may require being tailored to the peculiarities of ETFs according to the FSB

[6] Pre-emptive measures: appropriate liquidity constraints, monitoring fund liquidity, stress testing, appropriate portfolio composition and diversification, use of notice periods for redeeming shares or settlement periods. Post-event measures: e.g. activating gates, suspensions or limitations of redemptions.

[7] When monitoring performed by the authorities detects the development of material risks or regulatory arbitrage that may adversely affect financial stability, authorities should verify and confirm that asset managers that provide indemnification for their clients adequately cover potential credit loss

[8] The UCITS and the AIFMD directive both require asset management companies to perform periodic stress tests. More specific requirements apply for the management of AIFs where the scope of assets in which the fund may invest and the strategies implemented are broader.

[9] Scenarios concerning e.g. the impact of a market stress on possible redemptions and the subsequent impact of significant reemptions on prices. Some observers moreover stress that market and liquidity risks do not necessarily have systemic consequences.

[10] ESRB – Macroprudential policy beyond banking – July 2016

[11] Some observers stress that margin haircuts for example might have procyclical effects, since their application in stressed markets might cause investors to retreat, when their participation might otherwise have had a stabilizing effect. Macroprudential tools such as capital flow management measures might prevent prices from accurately reflecting risks creating asset price bubbles and market distortions. Moreover the use of fund gates for macroprudential purposes might create fairness questions imposing losses on certain market participants over others.

CCP resilience, recovery and resolution

Proposed EU CCP recovery and resolution framework

With the implementation of the mandatory central clearing of standardised derivative transactions, CCPs[1], which also clear a wide range of other financial instruments such as equities, bonds or commodities are becoming an essential part of the financial system, making their safety vital for preserving financial stability. Moreover CCPs are highly interconnected with other financial institutions (e.g. clearing members) and are cross border (and in many cases global).

EMIR[2] already provides measures for ensuring the resilience of CCPs, requiring them to implement risk management policies, capital requirements, disaster recovery arrangements and the establishment of a default waterfall including pre-funded loss-absorbing mechanisms with the capacity to handle the default of the two largest clearing members of the CCP. Most EU CCPs also have additional rules and loss allocation arrangements in place such as "rights of assessment" which are an unfunded obligation to replenish the default fund[3]. ESMA moreover conducted in 2016 the first ever EU wide stress tests on CCPs, looking at the entire system of EU CCPs in order to monitor potential systemic risks, and is now working on the second exercise.

However EMIR and existing CCP arrangements cannot totally eliminate the risk of a CCP failing in a disorderly manner. This is why the European Commission (EC) proposed legislation on CCP Recovery and Resolution (R&R) at the end of 2016. The focus of this proposal, which builds on the same principles as the Bank Recovery and Resolution Directive (BRRD), is on ensuring that CCP critical functions are preserved while maintaining financial stability, and this without any reliance on taxpayer support and avoiding any unnecessary destruction of value due to the resolution process[4]. The proposal also seeks to ensure that CCPs and supervisory authorities (the national supervisory and resolution authorities) are adequately prepared for any crisis and have the appropriate tools and powers for taking rapid and effective action when a CCP failure cannot be avoided.

Key requirements of the framework are for CCPs to draw up R&R plans on how to handle possible financial distress which would exceed a CCP's existing resources[5] and for a national resolution authority to be designated in each Member State[6] (charged with reviewing R&R plans and stepping in if resolution is needed[7]). A CCP will become subject to resolution when there are no realistic prospects of recovery[8] and when winding up the CCP under normal insolvency proceedings is not appropriate.

The EU framework provides resolution authorities with specific tools aiming at preserving essential clearing functions, without the need to bail-out the CCP, meaning that shareholders should bear an appropriate part of the losses. Proposed resolution tools include the sale of all or part of the failing CCP to another entity, the transfer of essential functions of the CCP to a "bridge entity", position allocation tools (the partial or full termination of contracts), loss allocation tools (haircutting of variation margin and cash calls in order to cover the losses of the CCP), the write-down and conversion of losses into capital and debt instruments or other unsecured liability tools…The framework does not mandate which tools and powers to use in different scenarios but the resolution authority is asked to act in line with the agreed resolution plan where practicable[9]. Moreover the use of these tools is governed by certain safeguards intended to ensure all parties affected are fairly treated. One of them is the principle of "no-creditor-worse-off" (in resolution than in the event the CCP entered into insolvency).

The EC's objective is also for the EU CCP R&R framework to be well aligned with existing international guidance given the implications of CCPs for global financial stability. Global standards have been developed by CPMI and IOSCO on the recovery of Financial Market Infrastructures (FMIs) including CCPs and by the FSB on effective resolution regimes. Following joint work with CPMI, IOSCO and BCBS, the FSB has proposed further guidance for assisting jurisdictions and authorities with implementing effective resolution regimes and developing credible resolution strategies and plans for CCPs due to be finalized in June 2017. This guidance covers a number of aspects similar to those of the EU proposal (powers of the resolution authority, available tools…)[10]. The FSB will also undertake further work on the financial resources needed for CCP resolution and determine by end-2018 whether it should develop further guidance in this area as well.

Brexit implications for UK based CCPs clearing euro-denominated instruments

One new aspect that needs to be considered regarding measures to ensure CCP resilience is Brexit. Some UK based CCPs indeed clear a large amount of euro-denominated OTC swaps[11] and may have an impact on the Euro currency. There have been calls by some Eurozone representatives to mandate the move of euro-denominated instruments clearing to the Eurozone. Financial stability reasons are put forward, notably the uncertainty that Brexit and the fact that the UK will no longer be subject to the European Court of Justice (ECJ), >>>

>>> creates about the future of the supervision of UK based CCPs[12].

The legal and operational challenges involved in moving euro clearing operations and the related open interest pools to the Eurozone[13], as well as the possible liquidity fragmentation and cost impacts[14], have been emphasized by many UK representatives. Scepticism has also been expressed in the UK about the actual benefits such a change would bring to EU27's systemic resilience if current information exchange and multi-currency swap arrangements between the ECB and the Bank of England (BOE) are maintained[15]. Alternative solutions for preserving the current level of supervision and oversight of these CCPs after Brexit have been proposed. These include allowing Eurozone and EU authorities to conduct extraterritorial (or joint) supervision of relevant clearing houses in the UK after Brexit (assuming that UK and EU regulations remain equivalent) and further reinforcing the current level of supervision by the BOE of UK based CCPs clearing euro-denominated instruments. ●

[1] There are currently 17 CCPs in the EU. In 2015 on average more than 50% of the OTC derivative market was centrally cleared by CCPs and this proportion is growing. 70% of all new OTC derivative transactions can now be cleared (source EU Commission). The scale and importance of CCPs will significantly increase following the implementation of the G20 commitment to clear standardized OTC derivatives through CCPs. The clearing obligation for financial counterparties is progressively being rolled out in EU countries in 2017 first for IRD denominated in G4 currencies and then CDS and IRD in other currencies.

[2] A review of EMIR is underway and should lead to some targeted adjustments in 2017 notably in terms of proportionality. Initial proposals have been made to enhance the proportionality of rules and reduce undue regulatory burdens for non-financial and small financial counterparties. ESMA is also proposing to rethink the equivalence and recognition process of third-country regulations to make it more effective.

[3] Some market observers however point out that the effectiveness of such unfunded arrangements is mostly untested.

[4] i.e. higher losses of costs associated to the resolution actions than would otherwise be required to meet the resolution objectives

[5] CCPs are required to ensure that the measures set out in R&R plans are legally binding across jurisdictions and authorities are asked to engage in cooperation with third country resolution authorities to be able to enforce their decisions in relation to any relevant assets or contracts governed by the law of that country.

[6] A resolution college should also be set up for each CCP including the relevant authorities from across the EU concerned by the CCP. ESMA is also required to set up a Resolution Committee composed of the CCP resolution authorities designated.

[7] Supervisory authorities may also intervene at an early stage when a CCP is in breach of its prudential requirements under EMIR, in order to tackle problems before they become critical.

[8] i.e. default management procedures foreseen in the CCP's operating rules or its recovery measures have been exhausted or could impede the financial stability of one or more Member States

[9] The use of these tools is governed by certain safeguards to ensure that all parties affected are fairly treated. One of these safeguards is the principle of "no-creditor-worse off" according to which no creditor should be worse off in resolution that they would have been in the event of the CCP entering into insolvency.

[10] including policy objectives for CCP resolution, the powers of the resolution authority to maintain the continuity of critical CCP functions and address default and non-default losses, the use of loss allocation tools and provisions to protect creditors, as well as the steps authorities should take for CCPs that are systemically important in more than one jurisdiction

[11] 75% of euro-denominated interest rate OTC derivatives and around 50% of foreign exchange ones

[12] ECB representatives have declared that euro-clearing in the UK is only possible at present because of close cooperation with the Bank of England, use of EU law and being subject to the European Court of Justice. The fact that the ECB would no longer be able to use the ECJ after Brexit to claim regulatory authority over euro clearing services of CCPs in the UK has been stressed in particular.

[13] LCH and ICE Clear have CCPs registered in France and the NL. Moving their open-interest pools (derivatives contracts that have not yet settled) would be quite challenging and costly according to many market observers. The recipient CCPs need to have sufficient capital, infrastructure and licenses to handle a large volume of trades and possibly different products. Most derivatives that use the ISDA agreement are governed by English of US law and such a transfer would mean that end users have exposure to French or NL clearing law. Moreover clearing members would probably have to post more margin by splitting their business and would also need to connect systems to additional CCPs.

[14] The possible impacts that a restriction would have for US clearing business are also emphasized.

[15] UK CCPs should be following equivalent rules to EU27 ones in the future and are supervised by the Bank of England. Moreover, it is likely that the agreement signed in March 2015 between the BOE and the ECB to enhance information exchange and extend its bilateral swap arrangement with the ECB to ensure temporary multi-currency liquidity support to UK CCPs in case of stress will be continued after Brexit.

[16] EU rules allow the ECB to have joint oversight of UK based clearing houses but do not authorize the supervision of clearing houses based outside the EU

Accelerating the resolution of the NPL challenge

The resolution of NPLs would unlock significant benefits to the European Banking system and the European economy.

Size and scope of the NPL problem

At the end of July 2016, EU banks held around € 1 trillion of impaired assets , according to the EBA. Banks directly supervised by the ECB held € 921 billion of NPLs at the end of September 2016, representing 5,4% of total loans and equivalent to nearly 9% of the euro area GDP.

NPLs ratios are very unevenly distributed across EU countries: the ratio of NPLs is still at two digit level in six euro area countries: Cyprus, Greece, Italy, Ireland, Portugal and Slovenia. In two countries, Cyprus and Greece about one-half of total loans are not performing, accounting for about one –third of total bank assets. Eastern EU countries are also often impacted by high levels of NPLs (e.g. Bulgaria, Hungary, Romania).

The distribution of non-performing exposures by sectors is quite mixed across countries. In a recent speech , V. Constâncio stated that taken together, "about 60% of currently distressed loans were extended to non-financial companies, of which about a third is related to lending backed by commercial property. But lending to households also constitutes a significant part of troubled debt exposures, accounting for more than a half of the NPLs in some countries.

A sizeable part of the NPL stock is no longer a risk to bank balance sheets. Provisions, made under applicable accounting standards, amount to about 46% of the stock of NPLs. The remaining value of NPLs is supported by expected future recoveries".

However, according to the EBA , the country dispersion of the coverage ratio is significant, as it ranges from 28% to 66%.

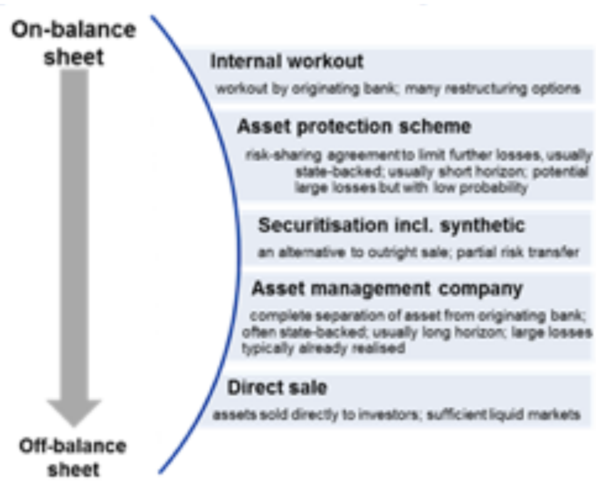
Solving the NPL issue notably in Italy is therefore an essential matter for the Banking and Monetary Union.

High levels of NPLs lower the profitability and threaten the solvency of the banks concerned. They also impair the lending channel and therefore impact on the transmission of monetary policy. Such high levels of NPLs may contribute to explaining the mistrust of investors regarding EU banks and are one of the major roadblock on the road towards the completion of the Banking Union and further public risk sharing.

Non-performing loans challenge the implementation of the new EU resolution framework. Indeed, in certain EU Member States, the bail-in requirements of the BRRD which have taken effect since the start of 2016, should impact retail investors if any resolution were to occur. For example, in Italy, bank bond retail holdings are relatively large i.e. about one third of the 600 billion bank bonds and half of €60 billion subordinated bank bonds. The authorities are very concerned about the social and potential confidence effects of resolution.

A range of possible solutions to address large scale NPL stocks is available, often complementing one another within the same jurisdiction (see ECB chart below)

A wide range of solutions to the NPL problem is available



Source: Fell, Grodzicki, Martin and O'Brien (2016) "Addressing market failures in the resolution of nonperforming loans in the euro area", Special Feature B in Financial Stability Review, ECB, November 2016.

Resolving Europe's NPL burden www.ecb.europa.eu

The lack of a deep and liquid secondary market for impaired assets and the remaining structural impediments that widen the gap between bid and ask prices (lack of high quality data for the assets in question, ineffective legal frameworks governing debt recovery and collateral enforcement, asymmetric information arisen from banks 'cherry picking of assets....) contribute to slow down the resolution of NPLs.

An asset management company (AMC) at the EU level would be a welcome initiative

Government-sponsored AMCs have often played a role in resolving acute, systemic banking crises. An AMC at EU level would facilitate raising private funding in the market. As A. Enria, explained in a speech in February 2016 , such an EU AMC could apply with the BBRD and EU State aid rules and would not imply any burden sharing across EU countries. Existing shareholders would bear an immediate loss if the net book value is higher than the transfer price to the AMC (i.e. the real economic value) and is diluted if the eventual sale price is lower than the transfer price and a recapitalization is necessary.

>>>

>>> The implementation of such an initiative would require leadership.

According to the ECB, a true European AMC faces difficulties in the present environment. In more immediate terms, a way forward could be the creation of a European blueprint for AMCs to be used at the national level. This European blueprint should clarify what is possible within a flexible approach to the existent regulation and encourage countries to adopt all necessary measures in a well-defined time frame.

At the same time, a European NPL-information platform should be implemented to enhance transparency and facilitate transactions. In the medium term, the introduction of IFRS 9 and more forward-looking provisioning rules could be conducive to a faster recognition of losses. ●

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