REGULATORY UPDATE

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1. MACRO-ECONOMIC AND EU INTEGRATION CHALLENGES

Forthcoming unwinding of QE: expected impacts

The 2008 financial crisis witnessed unprecedented policy responses from the world's major central banks. Main central banks cut their policy rate to near 0%, exhausting the conventional monetary options. Then, to further ease financial conditions, they started to design a variety of unorthodox monetary policy tools commonly labeled as "unconventional monetary policies".

With the momentum in the global economy gaining strength, monetary policy normalization has come into focus. The US Federal Reserve (Fed) is well ahead of its peers on the path to policy normalization. It began normalizing the stance of monetary policy in 2014, when it ended its asset purchases. Then, in 2015, it started increasing its policy rate, and in October 2017, it embarked on its plan to shrink its $4.5 trillion balance sheet. In March 2017, the European Central Bank began reducing the pace of its asset purchases.

1. Quantitative easing has contributed to a revival of bank credit in the euro area

Since June 2014, the ECB has introduced a range of unconventional measures (negative interest rate on the deposit facility, asset purchase program of private and public sector securities, Targeted Longer-Term Refinancing Operations) alongside conventional ones, in pursuit of its price stability objective. Together, these measures have proved effective in preventing a period of disinflation from spiraling into one of severe deflation.

The easing of financing conditions has contributed to a revival of bank credit in the Eurozone and has supported domestic demand. The non-standard measures of the ECB have been particularly effective in counteracting bank funding and financial fragmentation in some jurisdictions. Indeed, the ECB decisively contributed to the rapid setting of a lower and more homogeneous interest rate pattern in the Eurozone. In such a context, whereas the outstanding bank credit to non-financial enterprises was reduced from 2012 to 2015, there has been an upward movement since 2015.

In addition, low interest rates have significantly supported public debt refinancing which has contributed to short-run political and economic stability in some countries. Furthermore, the lasting low interest rate environment has provided additional space for accommodative fiscal policy.

The more positive outlook of the global economy as well as heavy acquisitions of bonds by Central Banks have resulted in sizeable gains on the equity markets. This is healthy as long as it is in line with the fundamentals of the real economy, but can become problematic if the economies overheat.

2. However, large scale monetary stimulus also comes with significant risks

Since loose monetary policy has stimulated risk-taking in financial markets, asset prices can quickly become disconnected from real economic developments. This can create imbalances, which might become unsustainable once monetary conditions are normalized. Furthermore, market discipline could be weakened by the abundant availability of liquidity. This can distort the risk compass of investors, contribute to a misallocation of resources and dangers of a higher propensity of bubbles and episodes of financial instability.

As Governor B. Vujcic summarized in 2017[1], "the most frequently outlined critiques of QE are excessive risk-taking, the possibility of fuelling asset bubbles, the creation of asset shortages, disincentives for governments to do structural reforms because of suppressed yoelds on government debt and the further build-up of debt".

Global indebtedness remains a major problem. The world economy has massively increased its leverage since the 2007-2008 crisis. Global debt – facilitated by easy monetary policy – has increased by 58 trillion $ from 2007 to 2015 (against an increase of 36 trillion from 2000 to 2007). According to Bank for International Settlements (BIS) data, total debt of the non-financial sector (that is households, government and nonfinancial corporations) amounted to $145 trillion in the first quarter of 2017, an increase of 40 percent since the first quarter of 2007.

This big debt overhang represents a risk to the stability of the systems as monetary policy normalizes and a drag on long term growth.

The overall situation of financial markets therefore remains fragile:

- Long term interest rates are increasing;
- Equity valuations are high;
- Bonds are still very highly priced.

Over the past years, we have learnt that a monetary policy approach that takes a neutral view on the possible formation of asset price bubbles, instead focusing more on picking up the pieces after bubbles burst can be very costly. Therefore, in such an environment, monetary policy should not only focus on inflation but also target financial stability.

Moreover, inflation is also influenced by long term structural factors (e.g. oil prices, potential growth, supply constraints...). But it is not the primary job of monetary policymakers to repair the economy and bring about long-term growth. That is the job of parliaments and governments. Only governments can put the economy on a higher permanent growth path by implementing appropriate labour market, economic as well as social and tax policy reforms. The key is to find effective and synchronized policy synergies between the two.

3. How to move forward?

The expansionary balance sheets policies are in fact much easier to introduce than to abolish. Normalization seems inevitable and is proceeding in the US. For a large part, normalization of interest rates is coming from the markets themselves. After the tapering off of an active quantitative monetary policy by the Fed in 2015, markets are normalizing. The normalization process should be different from a traditional cycle of interest rate hikes. Central banks currently have a very powerful presence in markets, owing to the implementation of unconventional policy tools. As a result, policymakers face the key challenge of designing a strategy for the withdrawal of the stimulus that does not unleash disruptive market movements.

Monetary Policy in the Euro Area

Extract from the Speech of M. Draghi, Institute for Monetary and Financial Stability, Frankfurt, 14 March 2018

At present, our policy stance is made up of three main elements: the flow of net asset purchases, the stock of outstanding bonds and principal reinvestments, and our forward guidance on the future path of key policy rates. But it is evident that the relative importance of the different elements will evolve over time, in three key ways.

First, net asset purchases remain necessary for now to validate the stimulus that is already priced into key indices of financial conditions and on which the inflation path depends. Thereafter, when progress towards a sustained adjustment in the path of inflation is judged to be sufficient, net purchases will come to an end. At that point, next to our forward guidance, appropriate financial conditions will be maintained by our reinvestment policy.

Re-investments will ensure a continued presence in the market, long after net asset purchases expire. The cumulative redemptions under the asset purchase programme between March 2018 and February 2019 are expected to be around EUR 167 billion. And reinvestment amounts will remain sizeable thereafter.

Second, as regards the evolution of our policy rates beyond the end of our net purchases, we will maintain the sequencing that is currently set out in our forward guidance, namely our pledge to keep key interest rates at their current levels "well past" the end of net purchases. This time-based element of our guidance is already vital today, in particular to ensure that our policy stimulus is not weakened by premature expectations of a first rate rise, and so financial conditions remain consistent with inflation convergence.

Third, as we move forward in time, the anchor for monetary policy, and the main tool for shaping the stance, will become the path of our key policy rates and forward guidance about their likely evolution. Our forward guidance has assured in the past, and continues to assure today stability to the short-end of the curve. As such, our communication, and rate path itself, will be calibrated to ensure that inflation continues to evolve along a trajectory that is consistent with the sustained adjustment path.

Adjustments to our policy will remain predictable, and they will proceed at a measured pace that is most appropriate for inflation convergence to consolidate, taking into account continued uncertainty about the size of the output gap and the responsiveness of wages to slack.

We have proven in the past that our forward guidance is credible. This has been the case both for our guidance on rates and on our reaction function, notably when we laid out the contingencies that would justify launching an asset purchase program in response to a too-prolonged period of low inflation.

Normalization raises a big issue in the Eurozone: the one of public debt and finance. Public debt remains very high at around 90% of GDP in the euro area. Some core countries of the euro area are still running substantial primary fiscal deficits. Therefore if and when monetary policy becomes less accommodative and interest rates rise, the cost of public financing of the Eurozone will feel strong pressure as well as a significant impact on budgetary outlays.

The time provided to European Governments by the massive fall in interest rates (that has reduced to a minimum the debt service burden of these States), has not been sufficiently used to start meaningful structural reforms that are needed to achieve the reduction of excessively high public expenditures and to revitalize the supply side. In essence, the ECB's understandable interventions in the government bond markets have pari passu weakened market pressure and discipline on governments.

Here is a paradox of European Monetary Policy:

- By easing financial costs it allows deficit countries to postpone structural reforms, buy time and borrow more...
- But this makes a change to "normal" monetary policy all the more problematic since the budgetary cost of tightening of monetary policy is significant.

This also raises the issue of the independence of Central Banks. Whilst they are, de facto, massively monetizing public debt (through public bond acquisitions programmes) they become, de facto, fiscal agents of Governments.

It is clear that the Eurozone CPI recent trend is an important factor. From close to 0 at the end of 2014, the European CPI reached 2% in the early part of 2017 (1,4% in December 2017) ie closer to target. Of course oil had played a major role in this upswing of CPI before it fell more recently; therefore core inflation stands only at 1,1% by the end of February this year. In this regard, it is interesting to note that the ECB is focusing now on the relative stability and moderation of core inflation. But when inflation was falling from 2011 to 2014, the ECB was then focusing on headline inflation, not core...

4. Too much responsibility may have been put on the shoulders of Central Bankers over the years

In the old days, Central Banks used to fight against inflation by raising short term interest rates and monitoring credit expansion. Today they have become quasi responsible for the whole outcome of economic cycles.

Their core mission is to ensure maximum growth over the cycle by forcing long term rates to fall, and remain low. This has enticed the ECB into hyperactive monetary policies. Such policies – whatever their short term advantages – can bear long term costs that could be very significant, notably concerning the stability of financial markets as well as on the profitability of the banking sector. The longer the period of exceptionally low rates, the stronger the impact on interest rate margins.

The time has come to overhaul such policies and to correct the mistaken view that money creation can, by itself, resolve structural economic problems which mcan only be addressed by structural reforms. Public debt will fall much faster if growth – boosted by such reforms – is higher than the present forecasts.

5. Setting aside ammunition for any future slowdown

If the world economy were to start decelerating (which is not likely given the relatively high rate of actual growth compared with potential growth), there would not be significant margins left to policy makers.

Budgetary solvency, weakened by very high debt ratios, could be threatened by the deceleration of growth or/ and/ by higher interest rates.

As for monetary conditions, they are still pretty loose. Interest rates are presently lower than growth rates. Therefore the margins for further loosening of monetary policy are extremely limited. It is odd to have uneven nominal negative interest rates up to 6 years in the Eurozone while the economy is improving; any margin to fight against recession has in fact disappeared.

Given the possibility of a slowdown of the advanced economies in the not too distant future, have policy makers sufficiently prepared for such a turnaround? Budgetary and monetary policies should normalize in good times in order to be able to provide countercyclical cushions when economic growth weakens. ■

[1] B. Vujcic, The changing composition of balance sheets, Central Banking, August 2017.

Further developing the ESM in order to deepen the Economic and Monetary Union (EMU)

1. The euro area rescue funds

The European Financial Stability Facility (EFSF, established in 2010) and the European Stability Mechanism (ESM, established in 2012) are part of the Europe comprehensive package of measures in response to the crisis. They are the lender of last resort for sovereigns in the euro area. They provide emergency loans combined with strict conditionality to euro area countries that lose market access.

The 19 euro area Member States provided the ESM with a capital totaling €700 billion, of which €81bn is paid-in. This capital serves as security for investors and it is the reason for good credit ratings from the rating agencies. It allows the ESM to raise capital at low interest rates. The EFSF is covered by euro area Member State guarantees. The ESM and EFSF raise money from investors by issuing bonds and bills. The rescue funds are among the largest bond issuers in the euro market.

Since 2011, the EFSF and the ESM have provided a total of €279bn in loans to five countries: Greece, Ireland, Portugal, Spain and Cyprus. Today, four out of five programme countries are clear success stories, with the highest growth rates in Europe and rapidly declining unemployment. Greece is the only remaining ESM programme country. If Greece continues to implement reforms it can become the ESM's fifth success story when the programme ends in August 2018.

2 Possible new tasks for the ESM

Strengthening the ESM would help make monetary union even more robust and crisis-proof. A number of possible new tasks have been proposed and include: providing a backstop for the SRF; designing, negotiating and monitoring surveillance programmes together with the Commission; regular monitoring of euro area countries; catering for possible new fiscal facilities, and managing a sovereign debt restructuring framework.

The first of the new possible tasks would be to provide a backstop for the SRF. There is a broad consensus among euro area Member States that the ESM should assume this role.

The ESM could also play a more important role in future rescue programmes. The role of the IMF in the programmes has become much smaller since 2010 while the role of the ESM has increased. Today, the ESM has its own know-how and necessary financial firepower. The ESM has increasingly been involved in the preparation and review of the programme Greek programme. The development of adjustment programmes – their design, negotiation and monitoring – could become a joint task of the Commission and the ESM. For the ESM to be able to do this, it would need to be in regular contact with euro area Member States also outside ESM programmes. Competences in the area of economic policy coordination and surveillance assigned to the Commission in the EU Treaty must be respected. The ESM could do complementary work, focusing on proper strengths and, for example, analyse issues related to debt sustainability, financial stability and market access.

It has also been suggested that the ESM could manage new facilities such as for macroeconomic stabilisation. This could take the form of short-term ESM loans to be repaid within a business cycle and with lighter conditionality than regular ESM programmes. Other proposals on the fiscal side involve an annual budget for European public goods and a euro area budget. A euro area budget for investments or a revolving fund to provide loans to individual countries to deal with asymmetric shocks have also been proposed. Rainy day funds or a complementary unemployment insurance exist in most U.S. states. They do not lead to permanent transfers or debt mutualisation between the participants.

Such facilities could be combined with a more transparent system for burden-sharing with private creditors in case of a sovereign debt restructuring. The aim would be to create a predictable framework for debt restructuring negotiations with private creditors. The emphasis is on 'negotiation' and excludes 'automaticity' for maturity extensions, which would have a pro-cyclical effect and accelerate a crisis, which could have otherwise perhaps been avoided. The ESM with its experience in debt sustainability and activities in the market could take on the role of a neutral moderator within the context of such a predictable framework. ■

Are Eurozone public and private debts sustainable?

1. Public debt vulnerabilities remain high in Europe despite a favourable macroeconomic outlook

At the end of the third quarter of 2017, the government debt to GDP ratio in the euro area (EA19) stood at 88.1%, compared with 89.0% at the end of the second quarter of 2017. In the EU28, the ratio also decreased from 83.3% to 82.5%. Compared with the third quarter of 2016, the government debt to GDP ratio fell in both the euro area (from 89.7% to 88.1%) and the EU28 (from 82.9% to 82.5%) (Eurostat).

Public debt has overall further reduced in the EU in 2017, supported by the continuing economic recovery, very favourable financial conditions and a broadly stable fiscal outlook (a structural primary balance stable compared to 2016, at 0.8% of GDP).

However, in several countries, public debt levels have not decreased, or have done so at a slow pace, and remain close to their historical peaks. Close to 90% of GDP at the euro area aggregate level in 2017, public debt ratios linger around 100% of GDP in Belgium, Spain, France and Cyprus, and around 130% of GDP in Italy and Portugal. Several countries remain therefore exposed to unfavourable shocks.

According to the Debt Sustainability Monitor (DSM 2017) published by the EU Commission, EU and EA overall debt ratios are projected to remain in 10 years' time above their pre-crisis levels, and well above the 60% of GDP Treaty reference threshold. These remaining important debt-vulnerabilities impede the mobility of cross border capital flows within the EU and expose highly indebted Member States to unfavourable shocks, in particular to hikes in interest rates. For instance, an increase of market interest rates of 100 basis points, compared to the baseline scenario, would raise public debt ratios by around 8 pps. of GDP or more in high-debt countries. Stabilising public debt in a higher interest rate environment would thus require larger fiscal efforts.

This analysis of the EU Commission also states that ten countries are deemed at high fiscal sustainability risk in the medium-term, as a result of inherited high post-crisis debt burdens, weak projected fiscal positions in some cases, and / or sensitivity to unfavourable shocks.

This concerns Belgium, Spain, France, Croatia, Italy, Hungary, Portugal, Romania, Finland and the United-Kingdom. In five additional countries, namely Cyprus, Lithuania, Austria, Poland and Slovenia, medium-term fiscal sustainability risks are deemed medium.

2. Higher long term interest rates and a repricing of sovereign risk may reignite government debt sustainability concerns in the absence of further reforms and consolidation efforts

First, a rise in long-term interest rates may reignite pressures on more vulnerable sovereigns, thereby triggering a sovereign risk repricing. Highly indebted euro area sovereigns are more vulnerable to rising financing costs than countries with lower debt levels. Second, while bail-in and bank resolution rules have weakened the sovereign-bank nexus since the height of the euro area sovereign debt crisis, residual risks remain, not least as individual banks in some jurisdictions remain vulnerable. These short-term challenges continue to be accentuated in the medium-to-long run by vulnerabilities related to lower potential GDP growth and ageing-related costs.

Current better economic conditions should be used to re-build fiscal buffers in time to absorb new shocks when they come, not least a foreseeable rise in interest rates. At the same time, the economic outlook is still surrounded by uncertainties. Therefore, appropriate strategies need to be designed, aimed at strengthening fiscal sustainability, while not hampering the economic recovery. This requires in particular a differentiation of fiscal policy across Member States.

3. Since reaching its peak in 2009, private sector debt as percentage of GDP has been on slight downwards trend in the euro area as whole

From 147% of GDP in 2009, private sector debt fell to 139% of GDP in 2016. This relatively modest decline hides significant differences across countries. In some highly indebted countries private sector debt-to-GDP ratios have been falling significantly since their peak. The reduction in the ratio has been very marked in Spain (54 percentage points since the peak in 2009), amounting to half of the increase over the previous ten years; the reduction has also been significant in Estonia, Latvia, Lithuania, Luxembourg, Malta, Portugal and Slovenia. By contrast, other highly indebted countries (with a private sector debt-to-GDP ratio above 200%), namely Ireland, Cyprus and the Netherlands, have not shown any major decline in their ratios. Private sector debt-to-GDP ratios have been growing continuously over the past 18 years in Belgium, France, Slovakia and Finland.

4. The decomposition between debt held by households (HHs) and by nonfinancial corporations (NFCs) shows that the proportion of the latter is on average larger

There are three exceptions: Germany, where the proportion of debt held by households (HHs) is higher than that held by nonfinancial corporations (NFCs); and Greece and the Netherlands, where the proportion of debt held by each sector is approximately equal. The NFC debt-to-GDP ratio is very high in Ireland, Cyprus and Luxembourg. In these countries the value of NFC-held debt is, however, particularly affected by large cross-border intra-company loans.

5. There is a growing body of empirical literature which shows that high levels of private sector debt can have significant adverse effects on future economic outcomes

While private indebtedness, at moderate levels, helps to smooth consumption and enhance economic growth, an excessive increase in private sector debt over the medium term can affect capital accumulation and lead to lower economic growth. This occurs because investment is reduced as companies need income to repay their debt and private consumption is also reduced as overleveraged households need to increase savings to cover debt service obligations. Moreover, banks' lending suffers as high private sector indebtedness is often associated with rising non-performing loans, which tend to erode banks' capital buffers. There is also evidence that delays in dealing with debt overhangs can lead to lower firm exit rates and can significantly affect the degree of capital and labour reallocation across firms and sectors which, in the medium term, lowers aggregate productivity in the economy.

6. The deleveraging process across euro area countries has come about as a result of both nominal GDP growth and a reduction in private debt

Empirical evidence shows that a rapid and front-loaded deleveraging process tends to be associated with medium-term output gains. This also seems to be the case in the experience of the euro area, where early and swift deleveraging episodes (e.g. in Estonia, Ireland, Spain, Latvia, Lithuania and Slovenia) have been associated with subsequent higher real GDP growth per capita. In four countries (Greece, Spain, Portugal and Slovenia) the deleveraging process has occured mainly through a reduction in nominal debt, i.e. via debt repayments or write-offs. In five countries (Italy, Cyprus, Latvia, Lithuania and the Netherlands) it occurred as a result of a combination of a reduction in nominal debt and an increase in nominal GDP. In five countries (Germany, Estonia, Ireland, Malta and Austria) deleveraging was driven exclusively by nominal GDP growth. ■

European Deposit Insurance Scheme (EDIS) and Single Resolution Fund (SRF) backstop: expected benefits and success factors

1. A European deposit insurance scheme (EDIS) for bank deposits in the euro area

To ensure that deposits are truly safe everywhere across the euro area, the likelihood that a bank might fail has to be independent of the jurisdiction where it is established. And, when push comes to shove, depositors must be afforded similar protection wherever they are located.

Successive EU-level reports, including the Four Presidents' Report of 2012 and the Five Presidents' Report of 2015, have highlighted a European deposit Insurance Scheme (EDIS) as a necessary component of the Banking Union. In November 2015 the European Commission put forward a legislative proposal to establish a single European Deposit Insurance Scheme (EDIS) that would complement existing national deposit guarantee schemes and which would provide stronger and more uniform insurance cover for all retail depositors in the Banking Union regardless of their geographical location.

EU legislation already ensures that all deposits up to €100 000 are protected, through their national deposit guarantee scheme (DGS), in case of a bank failure. Through a single fund, EDIS would also ensure equal, high quality protection of all depositors across the Banking Union in case of banks' failures. It would have more resources than national deposit guarantee funds to cope with large local shocks.

Co-legislators have not yet adopted the proposal. In its Communication dated 11 October 2017, the Commission considered possible ideas in an attempt to address the diverging views and concerns that emerged during the negotiations and to steer the discussions in the European Parliament and the Council. In particular, EDIS could be introduced by the co-legislator more gradually:

- In the reinsurance phase, EDIS would provide liquidity to national Deposit Guarantee Schemes (DGS) in case of a bank failure, which would have to be paid back by the national DGS. Liquidity support is the most essential element to ensure that depositors are paid out.
- In the coinsurance phase, EDIS would also cover losses, without recouping them from the national DGS. This would further reduce the link between banks and their Member States. However, moving to this second phase would be conditional on the progress achieved in reducing the level of NPLs and other legacy assets assessed through an Asset Quality Review (AQR).

Further adjustments to the Directive on deposit guarantee schemes (DGSD) could also be considered. These national schemes have been essential in offering better protection to depositors, though differences remain from one country to the next. The harmonisation of national deposit schemes needs to progress in parallel with the establishment of EDIS. This would ensure the correct functioning of EDIS and favour the exchange of information and cooperation among national DGSs, the Single Resolution Board (SRB) and the European Banking Authority (EBA).

2. A backstop to the Banking Union

A backstop is a "safety net". In the Banking Union context, a backstop would be activated in cases when, in spite of high-quality supervision, one or more banks are in crisis, and even after imposing losses on the banks' shareholders and creditors, there is a need for further resources because the Single Resolution Fund ran out of money. This safety net is not meant to be used as a default option. Rather, it aims to instil confidence in the European banking sector in that it would be available as a last resort, should less favourable conditions materialise, and will thereby further increase the protection of taxpayers. It would enhance the financial capacity of the Single Resolution Mechanism to cope with several bank resolutions at once. Importantly, such a backstop would be fiscally-neutral as the banking industry would repay any potential disbursements over the medium term.

When the Single Resolution Mechanism was established, Member States agreed to develop a common backstop to the Single Resolution Fund. In the European Council Conclusions of December 2012, they agreed that the SRF should be fiscally neutral over the medium term as contributions would be recouped from contributions from the banking sector. The European Parliament also called "for rapid progress in the work by the Council and the Commission on a common fiscal backstop for the SRF" in its 2016 annual Banking Union report.

The SRF is funded by ex-ante contributions from the banking sector. In case those are not sufficient, extraordinary ex-post contributions can be raised. However, both ex-ante and ex-post contributions are limited. A backstop would significantly strengthen the credibility of the Banking Union by ensuring that the SRB can fully safeguard financial stability and protect taxpayers even with limited ex-ante funding.

Resolution authorities may only use the backstop as a last resort. In their resolution plans, the SRB and the National Resolution Authorities identify banks' recapitalisation and liquidity needs, and how they should be funded. In principle resources from the bank's shareholders and creditors should cover those needs. They can be supplemented by the SRF. Only in case these resources are insufficient, would the backstop come in as a last resort.

The Commission supports the ongoing work with regard to a credit line from the European Stability Mechanism (ESM). This work stream will need to be pursued and articulated with the Commission's forthcoming package of proposals for the deepening of the Economic and Monetary Union, which will include a proposal to transform the European Stability Mechanism into a European Monetary Fund, within the framework of Union law. In this context, it will also be important to ensure an efficient decision-making process that will allow for a swift deployment of the backstop, in those last resort situations where this might become necessary. ■

Review of the operation of the ESAs

In response to the financial crisis of 2007/8 and building on the recommendations of the High Level Group on financial supervision in the EU chaired by Jacques de Larosière, the Commission put forward legislative proposals to strengthen EU level financial supervision in October 2009. The three ESAs – the European Banking Authority ("EBA"), the European Insurance and Occupational Pensions Authority ("EIOPA") and the European Securities and Markets Authority ("ESMA") – became operational in January 2011.

The responsibilities of the ESAs include defining common practices and standards for the regulation and supervision of banking, market and insurance activities, and ensuring the consistent application of these measures within the single market.

In a very short period of time the ESAs have established themselves. They are now respected by market participants, Member States, the EU institutions and globally for the professional way in which they have undertaken their duties. In this way the ESAs have contributed to a smother functioning Single Market for financial services.

The objective has however only partially been achieved since the implementation of EU laws is not always consistent across the Union. There remains significant potential to enhance regulatory and supervisory convergence in the Single Market. Integrated financial markets may require more integrated supervisory arrangements to function effectively, while more centralised supervisory arrangements can, in turn, foster market integration. The ESAs can play a key role in this symbiotic relationship between market integration and supervisory convergence and can assume more direct responsibility for supervision in targeted areas.

The need to strengthen the EU supervisory framework was emphasized notably in the Five Presidents' Report on completing the EMU (Economic and Monetary Union) published in June 2015 and in a reflection paper of the EC on the deepening of the EMU which called for a completion of the CMU and Banking Union.

The decision of the UK to leave the EU is a further reason for strengthening EU supervisory arrangements, particularly those regarding ESMA, since Brexit reinforces the importance of developing financial markets within the EU in order to continue to support the EU economy and of appropriately managing interactions with third countries. Moreover it is important to preserve the ability in the future for the ESAs to be a platform of European cooperation with non-EU financial centres such as the City to the mutual benefit of both parties.

Launched by the EU Commission last year, the ESAs review provides a very timely opportunity to consider the necessary targeted reinforcement of EU supervisory arrangements. On 21 March 2017, the European Commission launched a public consultation on the operation of the ESAs. On 20 September 2017, The EU Commission presented a proposal to review the operations of the ESAs. Its objective is to further enhance regulatory and supervisory convergence in the internal market in order to support the implementation of the Capital Markets Union (CMU) and the Banking Union in particular.

The ESA review proposal includes a broad range of measures concerning the governance of the ESAs, their direct supervisory responsibilities and their interactions with National Competent Authorities (NCAs) in order to ensure a more consistent application of EU law, the enhancement of the powers of the ESAs regarding third countries to support appropriately equivalence decisions, as well as measures to ensure that ESAs benefit from sufficient funding.

Governance: the EU Commission proposes the creation of an independent Executive Board (EB) consisting of the Chairperson and a number of full-time members in charge of preparing decisions to be taken by the Board of Supervisors (BoS), preparing the ESAs' work programme and budget and making decisions in a number of areas including dispute settlements, breach of Union law and independent reviews. The EB would moreover be in charge of monitoring delegation, outsourcing and risk transfer arrangements to non-EU country entities and of decisions in relation to requests for information.

A review of the division of responsibilities between the EB and the BoS is moreover proposed: the BoS is in charge of all regulatory decisions (certain non-regulatory decisions regarding dispute settlements, breach of Union law and independent reviews will be made by the EB). Regarding decisions on situations where ESMA is due to exercise direct supervisory powers, the BoS will only be able to reject a proposal from the EB by a majority of two thirds.

General supervisory powers: the powers of the ESAs would be enhanced in a number of areas: breach of Union law, settlement of cross-border disagreements (possibility for the ESAs to trigger a settlement on their own initiative), supervisory convergence and coordination (replacement of peer reviews by independent reviews under the responsibility of the EB, supervision by the ESAs of outsourcing, delegation and risk transfer arrangements to third countries…), a coordination role for ESMA in relation to market abuse investigations including the maintenance of a data storage facility to collect and disseminate appropriate information, publication of the results of individual stress tests, preparation of equivalence decisions regarding third-countries and monitoring their enforcement on an on-going basis, direct collection of information from market participants or financial institutions.

Direct supervisory powers in targeted areas: supervisory convergence on insurance internal models by EIOPA, authorisation, registration and supervision by ESMA of three types of EU funds (ELTIF, EuVECA, EuSEF) and their managers (while the on-going supervision would be retained by the NCA), authorisation and supervision by ESMA of data reporting service providers, explicit product intervention powers (restriction or prohibition of the marketing, sale or distribution) granted to ESMA regarding UCITS and AIF funds, direct supervision by ESMA of the administrators of critical benchmarks, transfer to ESMA of the supervision of certain categories of prospectuses (prospectuses for certain wholesale non-equity securities and asset-backed securities such as securitisations; prospectuses by specialist issuers such as property companies, mineral companies, scientific research-based companies, shipping companies) and prospectuses by non-EU country issuers.

Budgetary implications: At present the ESAs are funded by general contributions from the EU General Budget (40%) and contributions from NCAs (60%). For ESMA this distribution is slightly different with supervisory fees paid by the entities directly supervised by ESMA (such as CRAs and TRs). Following the ESA review, the ESAs budget would rely on three sources of financing: annual contributions paid by financial institutions indirectly supervised by the ESAs, supervisory fees paid by entities directly supervised by the ESAs (mainly ESMA), a balancing contribution from the EU that would not exceed 40% of the overall revenues of each agency. ■

2. GLOBAL COORDINATION AND BREXIT IMPACTS

Future of global regulatory and supervisory coordination

1. International cooperation plays a crucial role in strengthening the global financial system

The financial system is truly global. Many financial institutions are active around the globe, facilitating funding and managing financial risks across many jurisdictions. Global regulatory and supervisory coordination is therefore essential to preserve a level playing field across financial markets and mitigate the risks associated with global firms and highly interconnected activities.

The global financial crisis clearly demonstrated the international interconnectedness of the financial sector and the economies they serve, and the need for an updated and enhanced international financial regulatory architecture. The post-crisis reforms have done much to ensure the safety and soundness of the global financial system by addressing previous gaps and fragilities.

Achieving the G20's objective of strong, sustainable and balance growth requires open markets, durable international capital flows, resilient financial institutions and robust sources of market based finance.

The benefits of international regulatory standards are yielded in four major areas:

1. supporting the flow of capital to investment opportunities;
2. promoting greater and more fair competition, and better pricing and services for borrowers and end-users;
3. reducing compliance costs and increasing efficiencies;
4. supporting financial stability

Ideally, international cooperation frameworks should be anchored on a framework of binding international law. As Lord Bingham stated[1] "cross-border problems call for cross-border solutions, which can only be provided by a coherent body of enforceable international rules".

Given the context of highly interconnected and cross-border financial markets, the efforts to strengthen international financial coordination should be sustained. The risks of regulatory arbitrage or a regulatory race to the bottom among jurisdictions need to be avoided;

2. Convergence in financial regulation is one of the most important components of a sustainable open economy

Finance is the most mobile production factor, and therefore the most likely to cause dangerous spillovers. We should remember that diverging financial regulation would endanger not only financial openness, but also global trade, since they are often two sides of the same coin: finance and trade are complementary in spreading knowledge and underpinning global value chains. Consequently, organisations, which exist to create convergence in financial regulation and supervision, such as the Financial Stability Board and the Basel committees, are key, in this context, to increasing trust between countries.

Banks and insurers can also achieve greater risk diversification (and therefor greater stability) if they can expand geographically and develop successful businesses in different countries and markets, taking less correlated risks than those that exist in a single country. Consistent international standards and reasonable home-host rules are essential prerequisites for institutions to achieve this diversification.

One of the key ingredients for raising productivity is openness: open trade, investment and financial flows play a key role in the diffusion of new technologies across borders that drive forward efficiency improvements. The social consensus on open markets has, however, been weakening in recent years. People are concerned about whether openness is fair, whether it is safe and whether it is equitable. Fears about fairness, safety and equity ultimately reflect a lack of trust in other countries' regulation and enforcement.

M. Draghi explained[2] that in each case, multilateral cooperation, leading to regulatory convergence, is a precondition for addressing the underlying causes of these concerns. When disaffection with openness is growing, multilateral institutions become more, not less important. They provide the best platform to address concerns about openness without sacrificing open markets.

3. Challenges to achieve international standards and cooperation

Enforcement of standards and sanctions

International financial standards today are drawn up by a patchwork of global institutions none of which have the attributes of being formal Treaty based international organisations. Their standards and recommendations are not-binding on neither their members nor the timeframes in which they should be adopted.

Implementation is left to each member and although there are weak peer-review oversight mechanisms as in the FSB case, there are no enforcement powers, no international court to appeal to or sanction mechanisms for recalcitrant or irresponsible states.

Multilateral regulatory bodies have no authority other than moral suasion, and it remains the domain of national authorities to incorporate international standards into national laws and regulations under their own due processes; enforcement is based on peer pressure, coloured diagrams and prayer; and there are no binding disputes settlement arrangements – formal or informal- for faulty or negligent implementation or to deal with cross- border disputes.. This matters because of global interconnectivity, risk propagation, contagion and the propnsity for cyclical periodic financial crises.

Dispute resolution mechanisms

There are no binding international dispute settlement mechanisms, formal or informal, in the global financial institutions to resolve faulty or inaccurate implementation of global standards or to deal with cross-border disputes. The WTO however does have a binding dispute-settlement system for WTO Contracting Parties (CPs) set up in the Uruguay Round which, ceteris paribus, has worked reasonably well.

Building strong incentives to cooperate on enforcement

In the absence of formal treaty based institutions with binding legal powers or enforceability through a court, international financial policy making only has a set of weak set of tools at its disposal – among which, peer pressure, comparability and "naming and shaming". However, there are a few soft law tools that have led to considerable successful enforcement by cleverly aligning regulatory and supervisory incentives.

The best example of this is the IOSCO Multilateral Memorandum of Understanding (MMoU) now more than ten years old. It is a Cooperation and the Exchange of Information system that standardises the process by which securities regulators who are members of IOSCO can obtain information from other members for enforcement purposes, such as tracking down market abuse or insider trading. The MMoU was used to exchange vital cross-border information in the LIBOR cases. Becoming a MMoU member requires rigorous ex-ante legal vetting by a team drawn from existing members. The examination requires proof that the candidate securities regulator complies with all aspects of the MMoU including the provision of bank and telephone records and transactions reporting. Over 110 securities regulators around the world are MMoU signatories and share essential information on over 3000 cases per year.

The beauty of the system is that it aligns incentives – everyone needs each other to get hard, verifiable evidence to bring enforcement cases before the courts. The second powerful incentive is that those outside the MMoU all want to get into the system because it is seen by international investors as a cachet of good market practice which is of considerable value. Thirdly, the more the regulators and supervisors cooperate and trust each other with sensitive information the more the system grows, as it has done exponentially. ■

[1] T. Bingham, "The Rule of Law", page 115, Penguin Books, 2011.
[2] M. Draghi, Sustaining openness in a dynamic global economy, Jackson Hole, 25 August 2017.

Brexit: what way forward less than 1 year from the Article 50 deadline?

1. Progress made in the Brexit negotiations

Following the conclusion of the first round of Brexit talks in December 2017 with an agreement on the financial conditions of the departure of Britain from the EU, a second phase of negotiations was finalized in March 2018 with an agreement on a transition period between March 2019 and December 2020. Until the end of 2020 the UK will continue to participate in the Customs Union and the Single Market and will be subject to all existing Union regulatory, supervisory, budgetary and judicial instruments and structures. However the UK will be considered as a third country as of 30 March 2019 and thus will no longer be represented in EU institutions. Moreover, this transition deal is not fully guaranteed yet and depends on the successful conclusion of a withdrawal treaty in the next 12 months, a draft of which was published in March with several significant parts remaining to be negotiated[1].

The current situation remains challenging for industry players and their customers. The risk of a cliff edge situation is eliminated in the short term by the transition

[1] Including the question of Ireland, the settlement of a future framework for trade and the dispute resolution mechanism that will be needed for future trade relations.

deal but still exists after 2020 if trade negotiations are not successful, since the current transition agreement does not include a sunset clause for its possible extension. Given the uncertainty of the final outcome of trade negotiations and the relatively tight timeframe, the Authorities are encouraging the industry to pursue their contingency planning, but many operational and legal issues remain to be addressed in order to ensure service continuity in all situations, including contract continuity and data transfer conditions.

2. EU-UK trade negotiation objectives and redlines

The negotiations on the future EU-UK trade and financial service relationships post-Brexit started in March 2018 and both sides have officially presented their initial objectives and positions. The UK and EU have both called for a continuation of a partnership as close as possible following Brexit, but have put forward strict "red lines" on which they do not wish to compromise.

The UK's red lines include putting an end to the free movement of people, to significant budgetary contributions to the EU and to the jurisdiction of the ECJ and also recovering the ability to strike its own trade deals with foreign jurisdictions. Being a rule-taker from the EU is also ruled out.

On the EU side, red lines appear to be similarly restrictive. For the EU, the four freedoms underpinning the single market of goods, capital, services and people are indivisible and cherry-picking (opting for some rules and not others or participating on a sector-by-sector basis) should not be allowed in a Union based on the adherence of all its Member States to a common set of rules (EU acquis). The EU27 leaders noted at the March EU Council, that current UK positions "limit the depth of a future partnership" and earlier in March the EU Authorities mentioned that the only possible model in those conditions would be a free trade agreement (FTA) mainly focused on goods[2].

3. Possible scenarios for the future EU-UK trading relationships in financial services

Concerning financial services, the UK is calling for the continuation of close relations in the future between the UK and the EU based on a "bespoke" trade agreement based on regulatory and supervisory cooperation. The UK is advocating a regime allowing reciprocal access to EU and UK markets based on a joint agreement, through a structured UK-EU dialogue, on the regulatory requirements for cross-border trade in financial services, assessed according to their outcomes (i.e. potentially achieved through different regulatory requirements)[3]. This partnership would also involve supervisory cooperation to ensure the achievement of consistent outcomes over time and to monitor financial stability, as well as market integrity implications. Finally any divergences in terms of outcomes would need to be bilaterally managed in a predictable and proportionate way and an independent arbitration mechanism would be put in place to resolve potential disputes[4].

EU negotiators have however so far rejected any bespoke deal on financial services on the grounds that such an approach would in effect result in "cherry picking" existing rights and obligations offered by the single market and that an ex ante recognition of equivalence goes beyond the usual scope of FTAs[5]. In the March 2018 EU guidelines for negotiation, proposals regarding trade in services are limited to allowing market access under host state rules, including regarding the right of establishment for providers, "to an extent consistent with the fact that the EU and UK will no longer share a common regulatory, supervisory, enforcement and judiciary framework".

4. Alternatives in the absence of an EU-UK agreement on financial services

If no agreement is found on financial services, EU-UK relations would have to rely on the existing third-country equivalence provisions of EU financial legislations, when these exist[6]. Current equivalence arrangements have however been repeatedly considered as insufficient for managing over the long term the type of relations that exist at present between the EU and the UK in the financial services sector. They indeed differ across EU regulations and do not cover all financial activities. They are also relatively uncertain since the EU can decide unilaterally to discontinue such arrangements at any time with a 30 day notice. In addition they are lengthy to put in place and

[2] A FTA covering all sectors and with zero tariffs on goods and also addressing services to a limited extent. Previously the EU negotiators have claimed that UK red lines, as they are stated at present, rule out all existing trade agreements negotiated by the EU Commission (i.e. EEA, Customs Union, a broad trade agreement such as the one with Switzerland…) except a free trade agreement (FTA) mostly focused on goods such as the Canada-Europe Trade Agreement (CETA).

[3] While UK financial regulations will initially be equivalent to EU ones, the UK is not ready to commit to maintaining strict equivalence with EU rules over time, since it would put the country in a rule-taking position, which raises political concerns domestically.

[4] If the ECJ is not an option for the UK after the end of the transition period, a specific process would need to be set up, provided that this is acceptable to the EU regarding the interpretation of EU law.

[5] FTAs usually have limited ambitions regarding services, when these are covered, focusing at best on a non-discriminatory approach to foreign firms wanting to establish themselves in a country compared to domestic firms, on the recognition of professional qualifications and the right for third country nationals to take temporary postings in the EU or on the definition of steps to further align regulations. The seamless provision of services on a cross-border basis (i.e. without a need for authorisation in the host country according to local rules) indeed poses specific challenges, since it requires an assessment of the equivalence of regulations by the host country, in order to ensure that cross-border services follow similar standards to domestic ones. This is particularly the case for financial services which involve risks and are highly regulated. Moreover trade in services often involves a recognition of qualifications and access of staff, at least temporarily.

[6] e.g. there are no market access provisions for third-country firms in particular in CRD IV/CRR (e.g. corporate lending), payments or in UCITS and these are limited to professional clients for MiFID and to reinsurance companies in Solvency II.

cannot be defined ex ante since they require an in-depth equivalence assessment to be made and updated on a case-by-case basis.

In areas where third-country equivalence provisions are not available in EU legislation, there would be no real alternative for UK-based companies wanting to provide services in the EU post-Brexit than establishment in the EU and full compliance with EU rules, since the international General Agreement on Trade in Services (GATS) framework is very limited regarding services[7].

A general improvement of EU equivalence arrangements could nevertheless be envisaged as a solution, given that most UK financial regulations should be equivalent to EU ones at the moment of Brexit, aiming for instance to make these arrangements more legally certain and predictable with more timely processes and possibly improving their coverage and consistency notably regarding wholesale financial services. ■

[7] Many observers consider that the GATS framework would be difficult to use in this context, given that it contains no specific approach to facilitate mutual recognition of regulations. There are on-going discussions to improve existing GATS rules for services (on-going talks among 23 WTO members on a Trade in Services Agreement (TiSA) to improve existing GATS rules for services) but these mainly focus on non-discriminatory establishment issues.

3. REDUCING FRAGMENTATION IN EU FINANCIAL MARKETS

Optimizing the Banking Union

Proposals to further integrate banking markets in order to develop private risk sharing

1. More integrated banking markets foster a more effective allocation of capital across the Eurozone and help building a stronger Economic and Monetary Union (EMU)

In response to the sovereign debt crisis, the EU institutions created a Banking Union in the Eurozone in 2012 to safeguard financial stability in the euro area (reduce financial fragmentation, break the link between banks and their national sovereigns), minimise the cost of bank failures for tax payers and create a safer banking sector.

The Single Supervisory Mechanism (SSM) was fully established in 2014 and the Single Resolution Mechanism (SRM) became operational in 2016. The Commission put forward a proposal for a European Deposit Insurance Scheme (EDIS) in November 2015 and a banking package with further risk reduction measures in November 2016. Most of these measures have been implemented, except EDIS, which is still required to achieve the financial stability objectives of the Banking Union.

Beyond the stability dimension, the Banking Union should also contribute to a strong Economic and Monetary Union. By helping to further integrate EU banking markets, the Banking Union would indeed foster a more effective allocation of capital across the Eurozone, help to achieve a better diversification of risks thus contributing to private risk sharing within the Union[1], which is essential in the absence of short term solutions to develop public risk sharing across the EU due to the insufficient economic convergence.

A safer and more integrated banking system would also better support the currency union by improving the efficiency of the transmission of the monetary policy, for which banking activities play an important role in the euro area.

2. The persistence of fragmented banking markets in the Eurozone, despite a common supervision, limits the full benefits of the Banking Union

While supervisory and resolution decisions are now taken at the Eurozone level, following the implementation of the SSM and SRM, further integration of Eurozone banking markets is needed to achieve the private risk sharing and optimised capital allocation objectives of the EMU. Banking markets within the Banking Union are much fragmented along domestic lines: corporate and retail banking markets are still essentially domestic, financial flows within the banking union have not returned to their pre-crisis level, and in many countries the links between sovereigns and domestic banks have not disappeared.

This fragmentation is mainly due to the EU regulatory framework, which does not consider trans-national banking groups structured around subsidiaries at the consolidated level, but as a sum of separate subsidiaries. This was not reviewed when the Banking Union was implemented and limits the possible benefits of developing trans-national banking activities since the management of liquidity and capital is not possible at group level:

- The CRD, CRR and BRRD adopt a solo approach for the definition of capital and liquidity requirements (LCR, NSFR, MREL, leverage…)
- The pillar II SREP (Supervisory Review and Evaluation Process) requirements for banks are also defined and calibrated for each subsidiary.

3. Concerns about the way possible banking group resolutions may be handled in the EU are the main underlying factor of this non recognition of banking groups

Many Member States, which are dependent on Eurozone banks situated in other Member States for the financing of their economies, are not inclined to move towards a more integrated management of capital and liquidity at banking group level, despite the common supervision of Eurozone banking groups.

This is because they are concerned by the impact that the possible failure of one of these financial transnational groups might have on their depositors and on their economies, and by the fact that these impacts would have to be addressed entity by entity domestically.

Three main factors explain these concerns (aggravated by the slow resolution of NPLs and persistent economic imbalances):

- The **availability of group financial support** to a failing subsidiary is not guaranteed but conditional in case of bank failure according to the rules of the BRRD
- No rule currently prevents liquidity from being **abusively removed** from a foreign subsidiary by the parent company prior to resolution.
- The treatment of bank failures across the EU is not **sufficiently harmonised, consistent and predictable**[2].

4. A more integrated approach to resolution and liquidation is needed to fully benefit from the Banking Union

Developing private risk sharing through banking activities within the euro zone requires that for each transnational group, all its liabilities (deposits, bonds…) whatever their location in the Banking Union, should contribute to the financing of all its assets (credit, financings…) in the Banking Union. Thus capital and liquidity should circulate freely within these banking groups. For this to be possible, i.e. addressing the three factors mentioned above, which explain the concerns of many Member States, these groups have to be treated in practice as a single entity from an operational, regulatory, supervisory and liquidation perspective.

Of course the current solutions for completing the Banking Union (EDIS, backstop to the Single Resolution Fund) would strengthen the credibility of the bank crisis management therefore contributing to achieving the initial financial stability objectives of the Banking Union. As the current set-up with national deposit guarantee schemes remains vulnerable to large local shocks (in particular when the sovereign and the national banking sector are perceived to be in a fragile situation), common deposit insurance would increase the resilience against future crises as mentioned in the Five President's Report: Completing Europe's Economic and Monetary Union (June 2015).

However EDIS and the SRF backstop would not address the current fragmentation issues in the EU banking markets.

Addressing this situation requires proposing additional solutions, which may improve the consistency and the predictability of transnational bank resolutions and allow the management of liquidation at the group level with no difference of treatment among creditors of the same rank within the group. This entails that all the subsidiaries of these transnational groups should benefit from an unconditional financial support of the Group.

This is already the way groups structured around branches function. This is not currently possible for the other banking groups since the solo approach prevails for banking regulation (prudential, recovery and resolution).

5. Possible solutions to increase the consistency and predictability of potential trans-national bank resolutions at the EU level

A first solution that does not require regulatory changes could be to facilitate the validation by domestic supervisory authorities of the transformation of subsidiaries into branches. This requires that the national supervisors and parliaments should receive the necessary information to understand the risks national depositors are exposed to from these branches and the possible impacts on the financing of their economies. This may require developing specific reporting instruments and processes for the local authorities to continue to be able to appropriately supervise local activities and appropriately contribute to supervisory decisions taken at the SSM level that may impact their jurisdiction. If this would not be possible, a change in the EU regulatory framework would be necessary. Different alternative regulatory solutions could be proposed for increasing the consistency and predictability of the resolution of these banking groups.

Ultimately, a new EU legal framework should be created for managing the liquidation of trans-national banking groups operating in the Banking Union that would impose consistent conditions for all banking groups in the euro area (i.e. an unconditional financial solidarity among the different entities of these groups and an equal treatment in liquidation or resolution, of all the creditors located in the Eurozone). This should go together with a review of the governance requirements for Eurozone-based banking groups (e.g. an integrated organisation and policy for monitoring risks, compliance, legal affairs and internal control).

In an interim stage however, a solution would be to extend to subsidiaries the liquidation approach currently used for branches, whereby resolution is managed under the regime of the parent company. This would allow all the subsidiaries of the Group to be treated under the same liquidation regime.

A first step forward could in addition be to define objective criteria of financial soundness that could enable the SSM to allow the circulation of cash and liquidity at group level. Strengthening the powers of the SRB in case of liquidation (e.g. decision power to trigger a liquidation or resolution, positioning the SRB as the operator of liquidations and resolutions) would also be necessary to facilitate the implementation of those solutions.

A solution is also needed to facilitate the contribution of cooperative and mutual banks to the cross border integration of EU banking markets. One possibility could be to facilitate the cooperation between regional banks on a transnational basis.

To move forward, a discussion between the main transnational banks operating in the euro area and the EU and national supervisory authorities concerned should be initiated to discuss the conditions of a possible transformation of banking subsidiaries into branches (information of local authorities, possibility for local considerations to be effectively taken into account in SSM supervisory decisions impacting their jurisdiction…) and of the possible pre requisites for adopting the proposed solutions (unconditional group support, common liquidation regime). This discussion will be initiated during the Eurofi Sofia High Level Seminar. ■

[1] Risk sharing should increase the capacity of the banking sector to absorb potential asymmetric economic shocks (or the asymmetric consequences of a common shock) affecting one or two Member States.

[2] Whether competent authorities are resolving (CRD and State Aid regulation) or liquidating (State Aid regulation) a transnational banking group, and whether the effects of a liquidation and notably its implications on public interest and critical financial functions, are assessed at EU or national levels (which apply different sets of criteria), the impacts in terms of levels of state aid and bail-ins are very different. Furthermore, in the event of a liquidation, which is handled at entity level, the creditors of the same rank of different subsidiaries may be treated differently across the Eurozone.

Resolution and liquidation of banking groups in the Banking Union (MREL & single EU liquidation regime)

Before 2008, EU supervisors lacked the tools to implement an orderly restructuring of a bank that was failing or likely to fail[1]. The Bank Recovery and Resolution Directive now requires Resolution Authorities in Europe to establish resolution plans to anticipate the restructuration needed in case of severe difficulties and set up a bail-in mechanism in which either debt is written down or liabilities are converted to equity according to a pre-defined hierarchy (equal to the insolvency hierarchy). On 16 June 2017, the EU Council agreed on the ranking of unsecured debt instruments in insolvency proceedings (bank creditor hierarchy), which introduces a new category of liabilities, the so called "senior non-preferred" liabilities in order to enhance legal certainty in the event of resolution.

The principle of these new European rules is to absorb bank losses by bailing-in shareholders and uninsured creditors. This does not mean that bail-out is fully excluded, as the new rules contain sufficient flexibility to deal with truly exceptional situations where public money may be required to stabilise the banking system.

Since the inception of the Banking Union much has been achieved and among these achievements there was the establishment of the Single Resolution Board. The Single Resolution Board is the resolution authority for significant banks and other cross-border groups within the Banking Union. The mission of the SRB is to ensure the orderly resolution of failing banks with minimum impact on the real economy and public finances of the participating Member States of the Banking Union.

On 7 June 2017, the Single Resolution Board adopted its first resolution decision, triggering the sale of Banco Popular to Banco Santander. The situation of the two small Italian banks in the Veneto region which were declared failing or likely to fail (FOLTF) by the ECB on the 23rd June was different and the two banks entered into the normal Italian insolvency proceedings. On 4 July, the Commission authorized the precautionary recapitalization of Monte dei Paschi di Siena – the first time after the BRRD entered into force.

The Commission's legislative proposal (November 2016) to integrate the international Total Loss Absorbance Capacity (TLAC) Standard of the Financial Stability Board (FSB) into the Bank Recovery and Resolution Directive (BRRD) and to create a two Pillar Minimum Requirement for Own Funds & Eligible Liabilities (MREL) system distinguishing between G-SIBs and other banks is still evolving.

Adequate levels of MREL are crucial to ensure the resolvability of banks and are a key instrument to replace bail-outs with bail-in and safeguard taxpayers' money. This the reason why a clear and stable definition of the this regulatory framework is an important step to ensure resolution authorities can determine the requirement and banks can comply with it through adequate issuance of debt or capital instruments.

Naturally, these requirements are not binding for the smallest institutions. To the extent that their failure would not have systemic repercussions, these institutions should be able to disappear from the market through regular insolvency proceedings. And for their part, the TLAC/MREL requirements should also, if correctly calibrated, not present major difficulties for more complex entities with experience issuing debt instruments in the market, although they can raise their financing costs to a certain degree.

A major issue is for the medium-sized institutions whose failure could have systemic repercussions, so that they must be subject to the new resolution framework, but whose business model – based on financing their lending activity primarily through capital and deposits – is not consistent with large issuance in the market for TLAC- or MREL-eligible instruments (such as subordinated or convertible debt). These intermediate institutions could come under significant pressure in the future.

It is thus possible that, in the long term, stringent MREL requirements may foster a restructuring of the sector into two well defined segments. First would be systemically important institutions that are able to issue on the market the liabilities required by the resolution regulations. Second would be a group of smaller institutions that would not perform essential functions themselves and could be subject to the established insolvency proceedings without generating adverse systemic effects.

Regulatory reform should also ensure that no difference of treatment should be made among the different creditors of a same group and that group support could be enforceable at European level giving thus a solid base for group solidarity. However the solo approach of the EU banking regulatory framework (CRD, CRR, BRRD) does not consider trans-national banking groups in the EU at the consolidated level, but as a sum of separate subsidiaries, and this was not reviewed when the banking Union was implemented. In other words, the EU legislation only recognizes legal entities and not banking groups. A liquidation of banking groups or part of them is therefore conducted entity by entity under domestic insolvency regimes. This situation can lead to an uneven treatment of the creditors of the group which remains dependent on the insolvency legislation of the country where the liquidated entity of the group is located.

While supervisory and resolution decisions are taken at the European level, the consequences of potential bank liquidations are still national. In such a context, national considerations continue to affect regulatory and supervisory decisions.

Therefore more regulatory reform is needed to move forward. An unconditional financial solidarity among the different entities of these banking groups has to go hand in hand with a liquidation conducted at group level and no longer entity by entity. This is the only way to achieve a situation where no difference of treatment is made among the different creditors of a same group in case of failure and to allow a trans-national group to pool its available cash and to calculate liquidity and solvency requirements at the group level (see Eurofi paper related to “Optimizing the Banking Union”). Only such a regulatory reform would make banks European not only in life but also in death, and definitively address the current fragmentation issues in the EU banking market, which impair the functioning of the Banking Union. ■

[1] Resolution occurs at the point where authorities determine that a bank is failing or likely to fail. Resolution is the restructuring of a bank by a resolution authority through the use of resolution tools in order to safeguard public interests, including the continuity of the critical functions of the bank, financial stability and minim costs to taxpayers.

MiFID II implementation opportunities and challenges

1. Objectives and scope of MiFID II

MiFID II and MiFIR[1], which were adopted following the review of MiFID I, were implemented in the EU on January 3rd 2018. The objective of this new legislative framework, usually referred to as MiFID II, is to further strengthen investor protection, improve the functioning of financial markets, making them more efficient, resilient and transparent, and also tackle some of the issues raised by MiFID I.

MiFID I indeed brought greater competition across Europe in the equity trading space, increased transparency obligations and set new conduct of business rules for providing investment services, but also demonstrated some shortcomings such as the lack of coverage of bond and derivative instruments and the development of unregulated and non-transparent trading platforms in equity markets it led to[2] (e.g. broker crossing networks, dark pools…). Some new technological developments in the market (algorithmic trading / high frequency trading (HFT)) also needed to be taken into account, as well as the implementation of the G20 post-crisis requirements to trade sufficiently standardized and liquid OTC derivatives on electronic platforms.

MiFID II covers a broad range of areas and should substantially change trading models, transaction reporting, how the buy-side sources research and distributes

[1] MiFIR covers more specifically equity and non-equity market structure and access rules as well as transparency obligations, whereas MiFID II focuses on the rules pertaining to investment firms and platforms in terms of authorisation, investor protection and order execution. Both legislations are usually referred to as MiFID II.

[2] Non-transparent platforms were considered to represent 30 to 40% of share trading before MiFID II rules were implemented.

its products, how investors interact with advisors and the information they receive and also how supervisors monitor markets.

2. Detail of MiFID II measures and possible issues

The new legislation firstly introduces trading obligations that should significantly impact EU market structure, mandating that shares and sufficiently standardized and liquid bonds and derivatives should be traded on regulated platforms and introducing a new type of multilateral platform (OTFs) for the trading of non-equity instruments[3]. Volume cap mechanisms have also been implemented to limit the volume of trading of liquid equity instruments on regulated dark pools – where prices are disclosed only after a trade has been completed – through the application of specific waivers[4]. Consequently, internal multilateral matching systems operated by banks (e.g. crossing networks) now have to be authorized as multilateral trading facilities (MTFs) and the volume executed OTC should significantly diminish. It is however still unclear where the transactions currently happening on these platforms will migrate to (i.e. to regulated multilateral venues, such as stock exchanges or MTFs, or to less strictly regulated bilateral ones such as SIs (systematic internalisers[5]).

MiFID II also introduces rules on algorithmic and HFT trading in order to ensure that investment firms engaging in these activities have appropriate systems and risk control mechanisms in place to ensure market resilience and integrity and that those pursuing a market making strategy fulfill all related obligations.

Transparency obligations have also been broadened with an extension to all traded financial instruments that are sufficiently liquid of pre and post-trading transparency requirements (i.e. the publication to the public of quotes, orders and of the size and price of trades in near real time), while maintaining some waivers notably for large in scale orders. An obligation for SIs, which execute orders bilaterally on own account, to make their quotes public on a continuous basis has also been introduced, but requirements remain lower than those of regulated markets (RMs) or MTFs.

MiFID II should also help to improve the oversight of financial markets, with obligations for investment firms to maintain more detailed trade data (including data on counterparties for example) at the disposal of the competent authorities. The objective of these different measures is to better ensure best execution and price discovery for investors and to provide supervisors with the information needed to prevent market abuse and assess counterparty risks.

MiFID II moreover aims to enhance investor protection and conduct of business rules with measures to improve the information that investors are provided with (notably on costs), additional requirements for advisors to assess the suitability and appropriateness of the investments proposed and stricter rules for those providing advice on an independent basis, as well as rules regarding the remuneration of investment firm staff. MiFID II also grants ESMA increased intervention powers in the product and distribution areas as well as in commodity markets. Additional requirements have also been introduced to unbundle the costs of services, notably with an obligation for investment firms to split out the cost of investment research from trade execution costs and do away with so-called inducements (i.e. the promise of "free" investment research by a broker if an asset manager or another investor chooses to trade through it, which regulators believe may lead to conflicts of interest and higher costs). This latter rule was criticized by many investors and issuers who claimed that it would increase the cost of research and reduce its availability, notably for SMEs. A first outcome is that most asset managers have decided to cover the costs of research themselves rather than to pass them on to end-investors, which may potentially impact their profit margins or lead to a reduction of their research budgets. The impacts of this rule on SME-focused research are currently being further assessed by the EU Commission (EC). The EC and the SEC have also settled an agreement to ensure that EU portfolio managers can continue to access research and execution services from US broker dealers.

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[3] Regulated markets (e.g. stock exchanges), MTFs or systematic internalisers or equivalent third country trading venues for shares; regulated markets, MTFs, OTFs and equivalent third country venues for derivatives. 'Multilateral trading facility' or 'MTF' means a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules; 'Organised trading facility' or 'OTF' means a multilateral system which is not a regulated market or an MTF and in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in the system.

[4] This rule imposes a double volume cap to limit the amount of trading under certain equity waivers to ensure the use of such waivers does not harm price formation for the equity instruments concerned. The main rule stipulates that if trading in dark pools in any one financial instrument covered by the rule (shares, depositary receipts, ETFs or other similar financial instruments) exceeds 8% of the total volume of trading across all EU trading venues over a 12-month period, then traders will be banned from trading that instrument in dark pools for six months. The rule also stipulates that the percentage of trading in a given financial instrument on dark pools should be limited to 4% of the total volume of trading in that financial instrument on all trading venues across the EU over a period of 12 months. If this second cap is breached the instrument will be prohibited from the dark pool concerned for 6 months. The list of instruments to which this double volume cap applies was published in March 2018 by ESMA. NCAs should suspend within two working days the use of waivers in those financial instruments where the caps are exceeded for a period of 6 months.

[5] 'Systematic internaliser' means an investment firm which, on an organised, frequent systematic and substantial basis, deals on own account when executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system.

Finally, MiFID II also introduces rules for the provision by third-country firms of investment services, following an equivalence decision, to professional clients and eligible counterparties, and for the access of third-country CCPs and trading venues to the EU market. In addition it establishes non-discriminatory access rules to trading venues and to CCPs[6], aiming to allow investment firms to freely choose where to trade and clear their transactions for all financial instruments, provided that this would not threaten the viability of the CCPs and trading venues concerned, nor decrease the liquidity and stability of financial markets. The implementation of this latter requirement regarding exchange-traded derivatives has been delayed for several exchanges until July 2020. In addition, opinions are split on the impact that these rules may have on competition in the clearing space and on CCP standards. Some other measures will apply later due to the complexity of their implementation, such as the requirement to establish and operate a non-equity consolidated tape[7] which will only apply from September 2019.

Much concern was expressed during the negotiation of the legislation regarding the burden of compliance and the related costs and complexity of the implementation of MiFID II and its potential impacts on market liquidity and market fragmentation. Some adjustments were made, but MiFID II rules now need to be assessed relatively to the benefits actually produced for investors and the EU market in general.

Some market observers also argue that MiFID II thresholds may have to be recalibrated following Brexit. Without the volumes currently handled in the UK the range of liquid instruments qualified to be subject to current pre- and post-trade transparency measures and dark pool caps may significantly diminish, thus reducing the potential reach of MiFID II. ■

[6] Non-discriminatory and transparent access rules including as regards collateral, data feeds and fees.
[7] Consolidated tape providers will need to be established to collect post-trade information published by trading venues and approved publication arrangements (APAs), consolidate them into a continuous live data stream and make the data available to the public, both for equity and non-equity products.

4. CMU IMPLEMENTATION AND SUSTAINABLE FINANCE

Further reducing fragmentation in the CMU

1. Main objectives of the Capital Markets Union

The Capital Markets Union (CMU) project was designed at the end of 2014 as an EU-wide project aimed at developing and further integrating capital markets in the EU, in order to connect savings to investment across the Union and foster growth by providing alternative sources of financing for SMEs and infrastructure projects. These objectives have become even more urgent with the decision of the UK and thus of Europe's largest financial centre to leave the EU.

The specific importance of the CMU for improving the resilience of the Eurozone has also been emphasized. Indeed an effective CMU would complement the Banking Union, leading to more "private risk-sharing" across the Euro area and thus to a more effective allocation of risks and capital across the Union and to an increased shock-absorption capacity.

The Action Plan of September 2015 set out a broad range of 33 actions necessary to put in place the building blocks of CMU by 2019. These were completed at the end of 2016, following the mid-term review of the CMU, with an additional set of priorities regarding fintech, sustainable finance and personal pensions.

2. The strategy of the European Commission for completing the CMU by 2019 is made up of three main components at the heart of which is the further integration of EU capital markets[1]

The first component is allowing all investors to take full advantage of the single market for capital with new EU-wide labels and passports for financial products and services. In this perspective new rules have been put in place to develop EuVECA funds. A label for Pan-European personal pensions (the PEPP) was put forward in June 2017 in order to help households prepare for retirement and make the most of their savings. In March 2018 a new EU regime was proposed for crowdfunding platforms, to help them operate across the single market based on a single authorization and common EU rules were also proposed to boost covered bonds as a source of long-term finance. Work is moreover underway on defining an EU green finance framework in order to support the development of sustainable finance.

The second component is to remove barriers to deeper capital markets and simplify rules for businesses, notably SMEs. Rules have already been adopted in this context namely the Prospectus Regulation, more proportionate requirements for SME IPOs and new rules for safe, transparent and standardized securitization (STS) and work has been conducted on the barriers to further integration of post-trading by the EPTF group set up by the European Commission (EC). New measures to develop the cross-border market for investment funds were also presented in March 2018, as well as rules to facilitate cross-border securities transactions by providing legal certainty on who owns a claim and clarifying which country's law applies when determining who owns a security in a cross-border transaction. Proposals have also been made in 2016 on business insolvency to promote preventive restructuring and give a second chance to viable businesses.

The third component is about achieving a more consistent supervision of EU capital markets and supporting the development of capital market ecosystems throughout the EU. Proposals were made at the end of 2017 to review the operation of the European Supervisory Agencies (ESAs). Moreover technical assistance is provided by the EC to support the development of local capital market ecosystems throughout the EU.

3. Progress made in the implementation of the CMU action plan and main remaining challenges

Progress has been made in the three areas mentioned above. Legislative proposals have been made by the EU Commission (EC) regarding many actions of the CMU Action Plan, and these are in the process of being reviewed by the co-legislators. However several challenges remain to be overcome.

Brexit is a first challenge. A Brexit deal that would not cover appropriately financial services could be a significant hindrance to the deliverability of the CMU in the short term, due to the current dependence of EU capital markets on the City. But many in the EU also see Brexit as an opportunity and an incentive for the EU27 to achieve greater financing autonomy and to accelerate the development and integration of its financial markets, building on the CMU and the Banking Union initiatives.

Building sufficient momentum around the CMU which is broad in its scope, made up of many individual initiatives and with no single action decisive enough to drive significant short term growth of EU capital markets is however challenging. The CMU is currently in a critical phase of its implementation, politically. The objective of the EC is to finalize the adoption of all the CMU-related proposals by the next European elections i.e. 2019, however, at this stage several legislative proposals on CMU are still under review or have just been just published. More fundamental questions are also raised by some commentators regarding the toolbox design of the CMU project and whether it may provide a sufficiently ambitious and concrete vision of post-Brexit EU27 capital markets and financial centres.

The interconnection of the CMU with the Banking Union is another issue to be considered. Progress on the CMU, notably regarding its integration objectives, is indeed dependent to a certain extent on a further integration of the EU banking market since banks play a key role as intermediaries, distributors and administrative agents in many capital market activities. However Eurozone banking markets (and even more so EU ones), remain very much fragmented along national lines, despite the common supervision and resolution approaches of the SSM and SRM. The potential impacts of bank (and insurance) prudential rules on the development of EU capital markets are another factor that is being addressed in the context of the CMU but may require further attention.

Finally, finding the right balance between the pan-European and the local dimensions of the development of the CMU is another challenge. Further integrating EU capital markets and improving the consistency of rules should foster their development. However, the expansion of EU capital markets also hinges on the growth of local market ecosystems, notably local SME markets, whose growth could potentially be limited by further integration if, for instance, the most successful businesses only go to the biggest financial centres for their financing and if regulatory requirements are not adapted to smaller businesses and markets in a sufficiently proportionate way. ■

[1] Source: remarks by VP Dombrovskis on the Capital Markets Union – 12 March 2018.

Developing fund cross-border distribution

1. The EU asset management sector remains fragmented despite unified EU product and distribution frameworks

The development of the asset management sector is a key driver of the Capital Markets Union (CMU). Funds, which provide portfolio diversification, are indeed an effective way to intermediate capital between securities issuers and investors and cross-border funds may also play an important role in better allocating capital and risk throughout Europe.

The development of the EU cross-border fund market is supported by the UCITS and AIFM directives, which provide a consistent set of rules for the provision of investment funds to retail and professional investors in Europe. These frameworks have been completed with more specific products (ELTIF, EuVECA, EuSEF) targeting long term investment and also with specific rules for MMFs. In addition MiFID II and PRIIPs provide unified rules for the distribution of these products and the provision of information notably to retail investors.

The EU fund sector has experienced a strong growth particularly following the 2008 crisis, since when the assets held by investment funds have doubled in the EU. The EU investment fund sector reached a total of €14,310 billion in assets under management in June 2017, of which approximately 60% is invested in UCITS and 40% in alternative investment funds (AIFs). However, the sector remains fragmented which impacts its competitiveness.

The EU fund market counts a high number of funds of a relatively small average size (compared in particular to the US[1]), which increases management costs and lowers potential investor returns. In addition the EU fund market is still predominantly organized along national lines despite UCITS and AIFMD passports, which reduces competition and choice for investors. Although about 80% of UCITS funds and 40% of AIFs benefit from a passport, the proportion of funds actively marketed across borders is significantly lower. 70% of the total AuM are held by investment funds registered for sale only in their domestic market. Moreover only 37% of UCITS and about 3% of AIFs are registered for sale in more than 3 Member States[2].

Different factors hindering the cross-border distribution of investment funds in the EU have been identified by the EU Commission: (i) specific requirements imposed by domestic authorities including marketing requirements and fees, administrative obligations regarding the location of subscription, redemption and payment services and burdensome notification processes[3]; (ii) differences in the implementation of UCITS and AIFMD rules across the EU; (iii) different national tax regimes applicable to investors and investments in funds, (iv) the prevalence of vertical or closed distribution models which mainly distribute in-house products and (v) cultural preferences for domestic products and insufficient financial literacy. Proposals made by the EU Commission target the first two sets of issues.

2. A package of measures was proposed by the EU Commission in March 2018 to tackle the main regulatory barriers hindering fund cross-border distribution

The legislative proposal made in the context of the CMU (consisting in a Directive introducing targeted amendments to the UCITS and AIFM Directives and a Regulation) aims to clarify and streamline domestic requirements affecting the cross-border distribution of funds and to improve the consistency of rules across the different EU fund frameworks.

Concerning marketing requirements, the proposal establishes a unified concept of pre-marketing which will allow asset managers registered in accordance with the AIFMD to test the appetite of specific professional investors for upcoming investment opportunities or strategies without being subject to domestic marketing requirements. The proposal also determines principles of clarity and fairness which marketing communications must fulfil and introduces obligations for the National Competent Authorities (NCAs) to publish on-line their rules, administrative provisions and procedures for marketing communication, while ESMA will maintain a dedicated central database. It moreover proposes a timeframe of a maximum of 10 days for the NCAs to decide on the compliance of marketing communications when this verification is required.

Regarding the fees charged by the NCAs in each Member State where funds are distributed, the text does not propose their harmonisation but sets common principles for determining these fees in a proportionate way to supervisory tasks and mandates the NCAs to publish and maintain on their websites central databases on the fees and charges and relevant calculation methodologies. ESMA should moreover publish and maintain online an interactive central database with these fees and charges and the calculation methodologies used by NCAs, as well as an interactive tool allowing the on-line calculation of these fees.

As for administrative obligations, the choice of how facilities to support local investors – e.g. for the subscription and redemption of shares and related payments and for the provision of information to investors – are provided (local presence, by phone or electronically) is left to the management company of the UCITS concerned.

Finally, proposals are made to further standardize and streamline the information flows between management companies and the NCAs regarding notification and de-notification procedures. ESMA is also required to enlarge its central database in order to include the information related to notifications concerning all management companies, the UCITS and AIFs they manage and where they are marketed. The conditions under which investment funds may exit a national market would also be harmonized.

3. A second EU legislative text which may impact the cross-border distribution of investment funds is the proposal to review the operation of the European Supervisory Authorities (ESAs)

The ESAs review proposal indeed proposes that ESMA should be endowed with stronger powers to tackle inconsistencies in the implementation of EU laws (e.g. with powers to handle breaches of EU laws and to conduct independent reviews of the implementation of EU laws). This should help to tackle the current inconsistencies in the implementation of UCITS and AIFMD requirements in particular, which may contribute to hinder the cross-border distribution of these funds. Secondly the proposal has been made to transfer to ESMA certain fund-related activities such as the authorization of certain new categories of funds (ELTIFs, EuVECA and EuSEFs). This proposal is strongly debated, but could open the way to further discussions about the tools or supervisory activities that could be usefully centralized at ESMA level in order to facilitate the cross-border distribution of UCITS and AIFs (e.g. common databases and IT systems, reporting tools, processes in connection with notifications…). ■

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[1] There are 58,125 funds in the EU compared to 15,415 in the US (source EFAMA and ICI fact books 2017).

[2] Source EU Commission, Proposal for a regulation on facilitating cross-border distribution of collective investment funds – 12 March 2018.

[3] Four main types of requirements are imposed to asset managers by domestic supervisors: (a) Marketing requirements which differ across the EU: significant costs can be incurred in researching each EU Member State's financial promotion and consumer protection regime, and providing appropriate materials on an on-going basis; (b) Regulatory fees imposed by home and host Member States that vary significantly in both scale and how they are calculated: the costs themselves and the need to research them are reported as acting as a barrier to cross-border distribution; (c) Administrative arrangements: Where EU funds using the marketing passport are sold to retail investors, host Member States sometimes introduce special administrative arrangements intended to make it easier for investors to subscribe, redeem and receive related payments from those funds, as well as receive tailored information to support them in doing so. These are an additional burden that may not always justified by the value added for local investors; (d) Notification processes: Where funds are marketed on a cross-border basis and there is a need for documentation to be updated or modified, asset managers are required to give written notice to the competent authority of the host Member State. This can add cost and time to the process.

EU green finance framework (taxonomy, reporting, fiduciary duties...)

1. Economic sustainability requires an unprecedented level of investment

The magnitude and diversity of sustainability investments i.e. those related to climate change mitigation and adaptation, as well as air and water pollution, resource depletion, and biodiversity loss, are unprecedented. These investments are not focused on certain economic sectors such as energy infrastructures. Rather these investments are an essential and permanent feature on the whole investment effort globally.

2. Mainstreaming long-term sustainability is essential

This why all sustainability needs to be mainstreamed and incorporated in all investment planning and related financing decisions, which have to demonstrate that they are "carbon proof" and even "sustainability proof".

The systematic provision of sustainability information will in particular help to address a huge moral hazard, notably existing in the financial sphere, by which investors, entrepreneurs and project sponsors may maintain or increase their contribution to environmental and social threats, since the cost and the consequences of those threats are at present borne by others, or by society as a whole and such risks are likely to materialise over a longer time horizon.

Indeed, this situation stems notably from the fact that those economic players with insufficient information or accountability regarding the long-term or indirect consequences of their actions, have a tendency or even the incentive to behave inappropriately from the perspective of society as a whole.

3. Progress has already been made

An increasing number of investors are already demanding systematic and structured information regarding the direct and indirect contributions of their investment to the adaptation of the economy to sustainability.

Essential contributions of the private sector have also been the definition of the Green Bond principles and the subsequent constant strengthening of Green Bond markets.

The involvement of the private sector in the definition and voluntary implementation of climate-related financial disclosures (as proposed by the Task Force on Climate-related Financial Disclosures - TFCD) released in June 2017, also demonstrates its strong commitment.

In the context of the impetus created by the Paris agreements, this market led progress has sent an explicit signal to the management of large industrial and financial groups on the strategic importance for their institutions to contribute explicitly to adaptation efforts.

4. It is however necessary to further refocus capital flows and mitigate disruption risk

However, since current levels of investment are not sufficient to support an environmentally and socially sustainable economy, policy makers have also to contemplate the ways and means to refocus capital flows toward the projects supporting a sustainability transition.

However, EU policy makers need also to make such a transition toward a more sustainable economy as smooth as possible. Indeed, unexpected or destabilising wake-up calls regarding the proximity of an occurrence of sustainability-related risk (e.g. policy makers stranding certain assets, the sudden obsolescence of a given green technology, etc.) might trigger financial disruptions and have systemic consequences.

This requires an appropriate level of transparency, an effective continuity of sustainability policies and finally structured forward guidance from public authorities. This is notably necessary in a context where these risks involve assessment approaches, which are no more based on the assumption that the future can be deduced from the observation of past events. The continuity of sustainability policies requires in particular to factor in policy decision making and public sector risk-mitigation mechanisms, the rapid obsolescence of "sustainability technologies" which results from constant innovation and cost-efficiency improvement.

5. Communication of the EU Commission – Areas for action

To make progress in these different domains, the EU Commission issued in March 2018 a Communication outlining the features of an action plan for a "Greener and Cleaner Economy" depicting its strategy for a financial system more supportive of climate and sustainable development agenda and also setting up a road map.

In order to address the unprecedented information challenge, to make more sustainable the whole financial value chain and prudential regulations and to foster investment in sustainable projects, the road map of the EU Commission outlines 10 work-streams contributing to three main areas of progress:

I. Re-orientating capital flows towards a more sustainable economy
  1. Establishing an EU classification system for sustainable activities (taxonomy)
  2. Creating standards and labels for green financial products
  3. Fostering investment in sustainable projects
  4. Incorporating sustainability when providing financial advice
  5. Developing sustainability benchmarks

II. Mainstreaming sustainability in risk management
  6. Better integrating sustainability in ratings and market research
  7. Clarifying institutional investors' and asset managers' duties
  8. Incorporating sustainability in prudential requirements (e.g. a green supporting factor)

III. Fostering transparency and long-termism
  9. Strengthening sustainability disclosure and accounting rule-making
  10. Fostering sustainable corporate governance and attenuating short-termism in capital markets

6. Regarding the timetable, the Commission lays down some deadlines:

- May 2018, proposals on the duties of institutional investors and asset managers and on the principles and scope of an EU taxonomy for sustainable activities.
- Q2 2018, the amendment of Markets in Financial Instruments Directive (MIFID II) and the Insurance Distribution Directive (IDD) delegated acts, to enhance sustainability in suitability assessment.
- Q1 2019, the publication by an expert group of a report on a taxonomy on climate change activities,
- Q2 2019 Report on a taxonomy on climate change adaptation and other environmental activities as well as a Report on green bond standards.

The Commission will create EU Ecolabels for financial products and explore possible prudential measures to incorporate climate and environmental risks after the adoption of an EU regulation on taxonomy.

- Assessment by the Commission of the fitness of EU legislations on public corporate reporting, and the amendment of non-binding guidelines on non-financial reporting. The adoption of delegated acts on a prospectus for green bond issuances and the publication of a study on sustainability ratings and research. ■

Impact of bank prudential rules (FRTB, NSFR)

On 7 December 2017, the Group of Central Bank Governors and Heads of Supervision (GHOS) endorsed the final piece of post-crisis regulatory reforms (Basel III). Among these reforms the Net Stable Funding Ratio (NSFR) and a Fundamental Review of the Trading Book.

The NSFR is already being implemented in the EU through the CRR2 proposal. On market risk, notably since the BCBS is recalibrating the FRTB and banks have faced important implementation challenges, the FRTB framework has been delayed by the GHOS to 1 January 2022.

1. An impact study is necessary to achieve appropriate calibrations and adjust the design of the frameworks

These two reforms have important negative impacts on banks and more generally on market activities.

Actually NSFR, which captures the entire balance sheet and is one of the most complex standards in the Basel III package, is expected to have a stronger impact on markets and banks' business models than the Liquidity Coverage Ratio.

Regarding the FRTB a study for AFME[1] on how banks actually respond to post-crisis regulations shows how they have been influencing banks' strategy and triggered significant deleveraging in capital markets activities. Actually related assets notably those related to rates, credit, commodities and equities, fell by 39%.

Overall annual regulatory costs on capital markets are estimated to near US$35bn while capital and leverage requirements account for 90% of the total regulatory charges. These costs are responsible for a 14 percentage point reduction in ROE before banks' mitigating actions. The study stresses that this trend is not limited to individual firms or regions.

In such a context, considering the anticipated sizeable increase of capital and liquidity requirements of trading activities, cumulative impact studies should be undertaken to enable a better calibration of forthcoming NSFR and FRTB reforms. In particular assessing the effects of regulations on products, instruments and asset classes is necessary.

In the EU it is notably relevant to understand the likely functioning of markets for less liquid asset classes which will impact the financing of SMEs as well as credit and rates/repo activities, which are essential for financial stability. In particular national authorities in the EU need to assess how structural peculiarities in their respective banking systems and markets, should be taken into account.

2. Significant adjustments are needed

These costs and burdens should be limited by addressing certain flaws regarding the design and calibration of these regulations. One could summarise AFME general related concerns[2] regarding the NSFR and FRTB by the following array.

	NSFR	FRTB
Government bonds	Asymmetric treatment of short-term transactions with financial counterparties [repo]: affects market-making on EU sovereign debt bond	The design and calibration of FRTB could provide disincentives to market-makers on government bonds
Corporate bonds	Corporate bonds RSF factors (up to 50-85%): underwriting becomes costlier (need to fund short-term inventory at long-term rates)	The design and calibration of FRTB could disincentivise market-makers from dealing in corporate bonds. Particularly concerning is the modellability criterion and its impact on smaller issuances
Covered bonds	Do not acknowledge as stable funding conditional pass-through (CPT) funding models[3]. Inappropriate definition of encumbered assets[4]	
Equity	Short-term equity positions held as hedges against equity swaps attract disproportionate RSF factors (50 or 85), which could make equity swaps unviable	The current calibration of the standardised approach, not adequately recognising hedging benefits, leads to cliff effects in terms of capital charges in case internal models cannot be used
Derivatives	Additional funding requirement for gross derivative liabilities would lead to disproportionate and risk insensitive funding requirements	The current standardised approach would lead to significant increases in capital costs for derivatives hedges and portfolios
Repo	Repo funding is not recognised as stable funding (0% ASF), while lending to financial institutions in the form of reverse repos, is subject to a stable funding requirement	Overly conservative stresses

These issues need to be addressed notably to remain in line with the CMU objectives.

The extension of the implementation dead line gives time to review the calibrations of the standardised and internal model approaches notably to ensure consistency with the Committee's original expectations

3. Effective and consistent implementation requires defining reasonable but mandatory deadlines

The extended implementation deadline to 1 January 2022 also provides banks with additional time to develop the necessary common or bank specific IT systems related to an extremely complex and data demanding new market risk framework.

However, the discussions in the Basel Committee, but also national discretion introduced in the Basel NSFR framework, create uncertainty about how it will be used by other jurisdictions.

More generally, the additional four or five years which are likely to pass before the FRTB and NSFR are implemented resulting from the complex legislative procedure by which Basel recommendations are transposed into EU law, should not undermine some more proportionate approaches, which were proposed by the Commission (CRR2) notably those regarding covered bonds.

Several European banks are concerned by the fact that there is excessive regulatory uncertainty, also due to the review by the US of the framework.

Large firms active at the global level in particular, need to know what is expected in different regions. Therefore, deadlines have to be officially set and given a legally binding character and a rigorous schedule is therefore key at the global level otherwise banks would most likely cut back their project budgets.

While the EU approach to implementing the NSFR and FRTB has to follow closely the relevant Basel frameworks, it is important to ensure that the prudential purpose of the rules and the global level playing field are not compromised. In the December 2017 agreement by GHOS, all the Basel member jurisdictions have committed to such implementation. ■

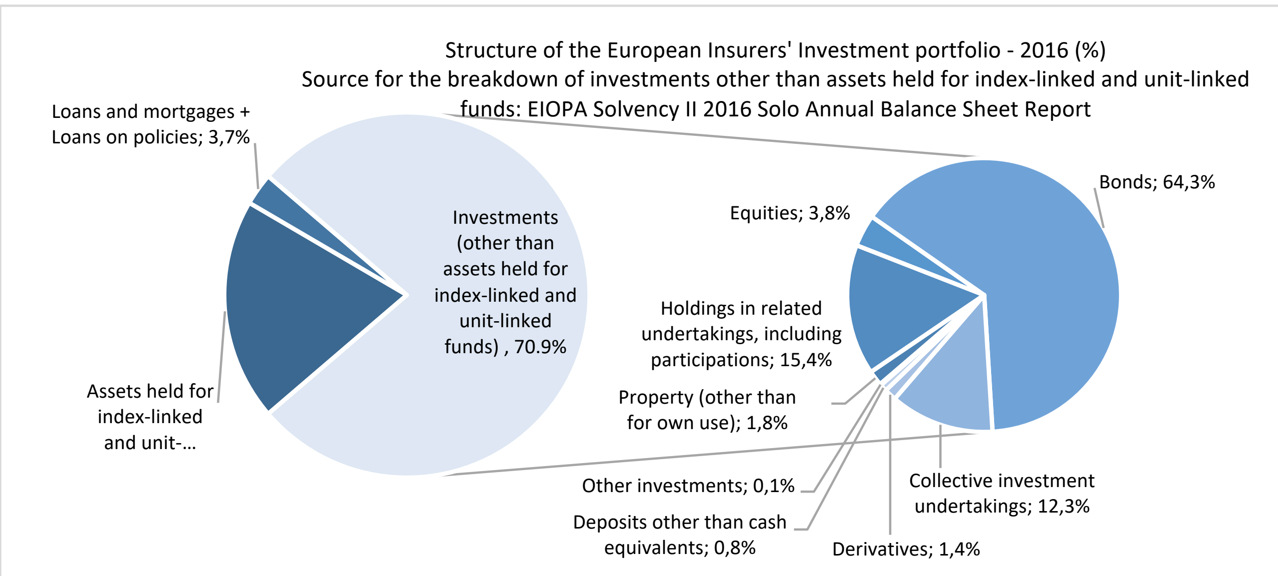
[1] For further details, see Burkhard Eckes' article in the Eurofi newsletter.
[2] https://www.afme.eu/globalassets/downloads/publications/afme-rrm-and-cmu-2017-4.pdf.
[3] Pass through covered bonds face zero NSFR obligation since no finding risk whenever assets and liabilities maturities are matched and the issuer passes through the funding from the liability into the corresponding asset. Conditional CPT should also benefit from a zero NSFR since related covered bonds are only repaid by the issuer on the basis of the inflows that are generated by the cover assets and also through the sale of such cover assets, but only when these cover assets can attract adequate prices on the market.
[4] The assets involved in over collateralisation (OC) are treated as encumbered assets and therefore subject to a 100% required stable funding requirement.

Insurance groups in the context of the CMU: regulatory and accounting challenges

In order to address the investment crunch, notably with businesses and especially small and medium-sized ones, the EU launched in 2015 the CMU initiative in order to make the EU common capital market work better. This was happening in the post-crisis context of a reduced appetite of banks to lend stemming from tougher regulations. In addition, in certain countries banks were addressing the issues posed by bad debts in their balance sheets.

The CMU project targeted various areas for progress such as securitisation, which was expected to facilitate the banks off-loading their balance sheets. It also undertook clearing obstacles to investors regarding notably insolvency and securities regimes. It tried on the issuers' side, to streamline prospectus requirements. The CMU project also took stock of the review of more than 20 pieces of EU financial legislation passed since 2009 to check for "unintended consequences" on financing.

In addition, the EIOPA notably in the context of the European Investment Plan, identified circumstances and recommended objective criteria such as financial ratios, intended to allowing to infrastructure assets the same treatment as rated debt and listed equity. In addition, EIOPA carried out an analysis of the treatment of unrated debt and unlisted equities to support improving insurers' ability to invest in private placement offerings and in private equity.



Source: Insurance Europe 2016.

In the EU insurance companies are large investors. Their 2016 investment portfolio – more than 10trillion Euros – is about 60% of the GDP. Clearly, this sector is essential for developing market finance in the EU and it has taken over a portion of bank domestic and cross-border financings in the EU.

Yet, although the insurance sector developed its holdings of corporate bonds no general information is available any regarding significant evolution regarding equity holdings, or infrastructure financing, neither on systematic or high scale purchases by the insurance sector of bank portfolios notably those of SME loans. ■

5. FINTECH AND DIGITALISATION

What can be expected from the EU fintech policy framework?

1. Fintech has the potential to foster radical change in the financial sector

Technology has been a key driver of progress in the financial sector for decades but fintech (i.e. technology-enabled innovation in financial services) based on new technologies such as cloud computing, big data analytics, artificial intelligence (AI), Distributed Ledger Technology (DLT) including blockchain, offers new opportunities that could foster radical change in the sector. Many of the practical applications of fintech being implemented or tested at present in the market are improvements of existing services / processes, but fintech can also help to build new business models and facilitates the entry of new players into the market.

On the efficiency side, DLT for example has the potential to significantly reduce costs and delays notably in areas where automation and standardization are limited[1]. Current applications however tend to focus on relatively niche processes and markets or on adding resiliency to existing processes or databases[2]. Other fintech solutions, often based on internet applications, aim to support effective interactions among key stakeholders in the financing value chain. These include loan and investment-based crowdfunding[3] and also robo-advice and data aggregation platforms for instance[4]. Finally, RegTech solutions based on fintech may also facilitate the supervision of capital markets[5].

These different services and solutions have mostly been developed by fintech start-ups but incumbent players such as banks and infrastructures are increasingly playing a role either as partners of or investors in fintechs.

2. The Fintech action plan proposed by the EU Commission aims to further support the development of fintech solutions in the EU

Harnessing the potential of fintech to transform financial business models is one of the key priorities of the Capital Markets Union (CMU) action plan reviewed at the end of 2016 and is also an integral part of the European Commission's (EC) objective to achieve a digital single market.

Some tools and measures have already been implemented at Member State level to encourage the use of fintech, such as innovation hubs[6], incubators or regulatory sandboxes[7], and specific rules have also been developed for crowdfunding platforms in some jurisdictions. Initiatives have also been launched at the EU level such as the European observatory and forum on blockchain (which aims to enable cross-border cooperation on practical use cases as well as new ideas[8]) and specific provisions to improve cyber security in the financial sector. Following a public consultation led in 2017, the EC considered that the case for a broad legislative or regulatory action at EU level regarding fintech was limited at this stage, but that a number of targeted EU initiatives were needed, building on existing experiences. Key principles that a fintech policy approach should adopt were also reinforced by the feedback of the consultation i.e. the need for a non-prescriptive approach based on technology neutrality and same activity, same risk, same rule principles.

The EC's Fintech action plan published in March 2018[9] sets out a range of measures aiming to encourage and simplify the emergence of new fintech solutions and to enable innovative business models to scale up, while increasing cyber-resilience and preserving the integrity of the financial system. These measures include:

- The establishment by the EC of an expert group to assess whether current EU financial services rules need to be adapted to the challenges posed by new technologies and whether some of them need to be made more technology-neutral, proportional or flexible. The EC moreover invites the European Supervisory Agencies (ESAs) to explore the need for guidelines on outsourcing to cloud service providers.
- The creation of an EU FinTech lab hosted by the EC, which will aim to foster a better understanding of technologies by providing training to regulators and supervisors in a non-commercial way and sharing knowledge on new technologies
- The preparation of a Report with best practices on regulatory sandboxes and fintech hubs based on guidance from the ESAs in order to encourage coordination among Member States
- A project to promote the digitization of information published by listed companies in Europe (the European Financial Transparency Gateway), using inter alia innovative technologies such as blockchain to interconnect national databases in order to facilitate cross-border investment decisions

- A continuation of the efforts already underway to monitor crypto-currency and crypto-asset developments and the emergence of initial coin offerings (ICOs), to strengthen cybersecurity guidelines (notably regarding information sharing and cyber resilience testing) and also a continuation of the actions to enhance fintech (notably blockchain) standardization and inter-operability in connection with the relevant ISO committee.

The EC has moreover proposed in the context of the ESAs review that the latter authorities should systematically consider fintech in all their supervisory activities. The GDPR (General Data Protection Regulation) which will become applicable in May 2018 also provides guidelines that will be essential for a proper use of innovative data-driven financial services.

3. In addition, the EC has proposed a new EU regulation on crowdfunding

At present investment- and lending-based crowdfunding is under-developed in the EU compared to other major economies. One of the main reasons is that crowdfunding is mainly conducted on the basis of national legislation which currently limits the expansion of these platforms across the EU.

The EC's proposal[10] is to introduce an optional EU crowdfunding regime, which will enable platforms that comply with this common set of rules to provide their services across the EU with a comprehensive passporting regime. In addition, platforms would be authorized and supervised in a common way by ESMA. Several mechanisms are also proposed to protect crowdfunding investors (e.g. improved disclosure of risks, requirement for payments to take place via entities authorized under the PSD2[11]) and to provide legal certainty as regards the applicable investor protection rules.

4. Although no specific financial stability risks from fintech have emerged at this stage, several areas where further monitoring is required have been identified by the FSB

Fintech is a priority area also at the international level with similar market developments happening in the main economies around the world. For example crowdfunding and peer-to-peer lending are significantly more developed in the Asia-Pacific region than in the EU. A number of jurisdictions have also set up fintech hubs and regulatory sandboxes[12].

Assessments of the opportunities and risks that different fintech technologies present and of on-going market trends have been conducted by IOSCO. The FSB has moreover analyzed the main financial stability implications of fintech.

Although the FSB concludes that there are no "compelling" financial stability risks from these emerging technologies at present and that many fintech activities are already covered within existing regulatory frameworks, several issues have been identified that merit further monitoring by the authorities. These include cyber-risks, operational and dependence risks from third-party service providers, as well as potential systemic issues and procyclicality emerging from a possible concentration of providers in certain market segments. Further issues identified by the FSB are the cross-jurisdictional compatibility of national legal frameworks, the possible complexity and opacity of some big data analytics models and of AI and machine learning methods, the diversity of players and the speed of change in the sector and the development through AI and machine learning of some new forms of interconnectedness and correlations, for instance if many financial institutions or platforms rely on similar data sources and algorithmic strategies. ■

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1 DLT solutions can for example be used to support capital market back office processes or procedures related to prospectus documentation. DLT may also help to improve security (through encryption) and data transparency (e.g. easier tracking of securities ownership).
2 Larger-scale applications (e.g. regarding the DVP settlement of traditional securities transactions) are still a fairly remote objective with many challenges still needing to be tackled including scalability, standardization and interoperability, legal certainty, liability and privacy issues…
3 Investment-based crowdfunding platforms for example allow SME issuers to raise capital in a cheaper or more targeted way and individuals to invest directly in SMEs. Fintech solutions can also be used in the context of existing financing processes such as factoring, supply chain finance or trade finance.
4 Robo-advice usually combined with data aggregation and financial management tools, allow a cost-effective and consistent online provision of guidance on investment decisions and automated asset allocation. Initially used as standalone services, a combination of on-line tools with human interaction may help to broaden their potential customer base. Data aggregators support the provision of standardized and consolidated information on customers' financial accounts.
5 However these developments are still at an early stage and may require an adaptation of some supervisory approaches.
6 Innovation hubs and fintech facilitators have been set up by national authorities to engage with companies that seek to place technological innovations on the market in order to facilitate fintech developments.
7 A sandbox is a safe and controlled space where companies can test innovations in the market, with or without regulatory relief.
8 The observatory and forum will report on the challenges and opportunities of crypto-assets later in 2018 and are working on a comprehensive strategy on DLT and blockchain addressing all sectors of the economy.
9 https://ec.europa.eu/info/publications/180308-action-plan-fintech_en.
10 https://ec.europa.eu/info/publications/180308-proposal-crowdfunding_en.
11 Payments for crowdfunding transactions cannot take place via entities that are not authorized as Payment Service Providers under the Payment Service Directive (PSD 2), whether the payment is provided by the platform itself or by a third-party.
12 Australia, Canada, Hong Kong and Singapore have set up fintech hubs and regulatory sandboxes and the US and Japan also have fintech hubs.

GDPR impacts, opportunities and challenges

In a context where digitalisation and the development of new technologies such as Artificial Intelligence (AI), machine learning, and Big Data, Regulators are increasingly eager to regulate how organisations store, process and share personal data. Consequently, the General Data Protection Regulation (GDPR) comes into force in May 2018 in the EU. It aims at protecting EU citizens' data, regardless of where the data are processed or stored.

In particular the article 5 of the GDPR requires that personal data shall notably be:

- processed in a transparent manner in relation to individuals
- collected for specified, explicit and legitimate purposes and not further processed in a manner that is incompatible with those purposes (...)
- kept in a form which permits the identification of data subjects for no longer than is necessary for the purposes for which the personal data are processed; (...)
- processed in a manner that ensures appropriate security of the personal data, including protection against unauthorised or unlawful processing (...)

The GDPR applies not only to 'controllers' i.e. the entities who determine the purposes and means of processing personal data but also to the entities processing personal data on behalf of a controller.

The risks of not complying are substantial. Reputational risk is important as is illustrated by the pressure faced by Facebook to explain how data collected on 50m users on the basis of a psychological survey app for research purposes, were exploited potentially for political purposes.

Financial risk is not negligible either since the regulation imposes potential fines of up to €20m or 4 per cent of annual global turnover.

However not only GDPR will transform how organisations store and manage personal data, but it is likely to impact certain business models in a context where internet and data are every day more intimately involved in the day to day life of business and citizens. Indeed, it is the collection and monetisation of data, which underpin the digital economy and are among the essential challenges posed by digital players to incumbent financial groups.

After decades during which in a highly innovative domain, practices have mostly been defined by market practitioners, this new EU regulation suggests that public decision makers have perceived the possible conflicts of interest faced by the management of big techs and also a true asymmetry between them and their customers in the perceptions of the stakes related to data. However, this raises one question, which is worth addressing at this point in time, which is whether governments must intervene in order to build trust in the area of personal data which is a promising economic sector, while preserving its capacity to innovate.

The "Cambridge Analytica" scandal also suggests assessing the magnitude of the backlash in public opinions provoked by rows of data abuses, and cyber-attacks. Interesting questions indeed are whether such a backlash produces irreversible effects on consumers and also whether the GDPR which has de facto a global reach, as such suffices or not, to address related concerns and restore the level of trust required for the economy to continue to reap the benefits of constant innovation in the digital economy.

Finally, in such a context, the financial sector the historical role of which is the security of people's assets, might have one opportunity, which is to contribute to deepening the trust in data, by developing insurance and data custody services as trusted third party. Indeed, the GDPR enables companies to access data from both competitors and players outside their industry, notably by offering better prices and services to customers who store their personal data with them. Naturally, beyond the design of data custody products, harnessing the conditions for anchoring the credibility of the financial sector regarding its ability to provide an effective protection for data, in the context of an ever increasing cybersecurity threat, would be essential. To comply with GDPR and even more to be up to the customer challenges, require from competitors notably in the financial area to address related managerial and operational challenges, and implement an effective data governance. ■

6. IMPROVING FINANCIAL STABILITY

Vulnerabilities in global and EU financial markets

Global growth has broadened and strengthened during the past 18 months but the global and EU economies face a mix of macroeconomic and long-standing vulnerabilities and newer threats that have emerged or evolved in the years.

1. Macro-economic risks

Macro-economic risks stemming from protectionism, global indebtedness, and monetary policy normalization could threaten the sustainability of the current global and EU economic expansion in the medium term.

1.1. Risk to global economy from U.S. protectionism

Trade protectionism remains a key risk that would negatively affect confidence, investment and jobs. Indeed tit-for-tat trade barriers in response to the Trump administration's tariffs on steel and aluminum threaten to pull the rug from under a strengthening global economy. The risk is obviously that the deterioration in US foreign trade could lead to an extension of these protectionist measures and to reprisals from other countries. A rise in tariffs between the US and its trading partners would snuff out the positive effects on US growth of the Trump tax cuts and threaten to damage the global economy.

1.2. Global indebtedness remains a major vulnerability of financial stability and may undermine global growth

The world economy has massively increased its leverage since the 2007-2008 crisis. Global debt – facilitated by easy monetary policy – has increased by 58 trillion $ from 2007 to 2015 (against an increase of 36 trillion from 2000 to 2007). According to the BIS annual report (June 2017), globally, debt is at record levels: in 2016, the stock of non-financial sector debt in the G20 economies stood at around 220% of GDP, almost 40 percentage points higher than in 2007. High debt might become a significant drag on demand as interest rates normalize.

In fact that there has been no deleveraging since 2008, but rather a gradual, albeit substantial, increase in global debt to GDP. This debt overhang represents a financial risk to the stability of the system as monetary policy normalizes and a drag on long term growth.

The situation of financial markets is therefore fragile:

- Long term interest rates are increasing,
- Equity values are high,
- Bonds are still very highly priced,
- Global indebtedness has never been as huge.

This creates financial vulnerabilities, especially as monetary conditions tighten. To mitigate these risks, countries should take advantage of the current momentum by building fiscal buffers – creating more room to act in the next downturn – and by making active use of macro- and microprudential policies.

An abrupt increase in risk premia (and volatility) in global financial markets leading to a tightening of financial conditions may be triggered by a number of factors. First, lower than expected economic growth may lead to higher global risk premia. Second, several central banks in advanced economies have begun preparing to withdraw policy accommodation. Potential changes in monetary policy expectations could generate greater market uncertainty. Third, geopolitical uncertainty may increase further with possible adverse repercussions on global risk premia.

1.3. The search for yield has gone too far and could lead to significant market disruptions

According to the Global Financial Stability Report of the IMF (October 2017), the low-interest-rate environment has stimulated a search for yield in markets, pushing investors beyond their traditional risk mandates. This has compressed spreads, reduced the compensation for credit and market risk in bond markets, contributed to low volatility, and facilitated the use of financial leverage.

While these supportive financial conditions have helped boost growth, as intended, they have also raised the sensitivity of the financial system to market risks. Prolonged normalization of monetary policy could extend these trends. Unless well managed, these rising medium-term vulnerabilities could lead to significant market disruptions if risk premiums and volatility decompress rapidly.

1.4. The US fiscal policy entails significant risks for the US and the major global economies

At a time when the unemployment rate is very low and the participation rate is no longer rising in the United States – i.e. the United States is close to full employment – the Trump administration is implementing a highly expansionary fiscal policy (corporate tax cut, increase in public spending on the military and on infrastructure), which will lead to a fiscal deficit higher than 5% of GDP in 2019.

An expansionary fiscal policy at full employment is risky for the United States and global financial markets for at least two main reasons. First there is a risk of a sharp rise in interest rates, due to expectations of a reaction by the Federal Reserve to the fiscal demand stimulus in a situation of full employment, and a reaction by the bond market to the fiscal deficit. Second the fiscal stimulus of demand for goods and services at full employment will drive up the fiscal deficit and the external deficit. These twin deficits are pointless in the current stage of the US cycle, and it would be better to save them for a situation of declining activity, when demand would actually need to be boosted.

1.5. Monetary policy normalization raises a big issue in the Eurozone: the one of public debt

Since 2015, the ECB's quantitative easing programme and its low interest rate policy have substantially pushed down the financial costs of the euro area countries.

However, public debt remains high, at around 90% of GDP in the euro area. Therefore, if and when monetary policy becomes less accommodative and interest rates rise, the cost of public financing of the Eurozone will feel the pressure: a rise in interest rates can have, indeed, a significant impact on budgetary outlays. Moreover, the EU has established as a rule that public debt should fall below 60% of GDP, and that countries whose debt exceeds that ceiling must reach the target within 20 years.

Some countries, like Spain, Belgium, France, Italy, Portugal, will thus have to achieve, or maintain, a primary surplus of at least 1% of GDP. But as some of these countries are now running primary deficits, they should act now in order to reduce public spending and deficits.

However, it appears that the time provided to European Governments by the massive fall in interest rates (that has reduced to a minimum the debt service burden of these States), has not been sufficiently used to start meaningful structural reforms that are needed to achieve the reduction of excessively high public expenditures and to revitalize the supply side.

1.6. Is there enough fiscal and monetary policy firepower left to deal with another crisis?

If the world economy were to start decelerating (which is not impossible given the relatively high rate of actual growth as compared with potential growth), there would not be significant margins left to policy makers.

Budgetary solvency, weakened by very high debt ratios, could be threatened by the deceleration of growth or/and/ by higher interest rates. As for monetary conditions, they are still pretty loose. Interest rates are presently lower than growth rates. Therefore the margins for further loosening of monetary policy appear extremely limited.

Given the possibility of a slowdown of the advanced economies in not too distant a future, it seems that policy makers may not have sufficiently prepared for such a turnaround. Budgetary and monetary policies should normalize in good times in order to offer countercyclical cushions when expansion weakens.

2. New risks and remaining structural vulnerabilities to financial stability

Much progress has been made since the financial crisis in mitigating systemic risks in the financial sector. However, some issues remain to be addressed notably in the capital markets area, while new threats are developing such as cyber-risk.

2.1. Cyber security incidents have become a greater concern for the financial system.

As the financial system relies more heavily on technology, the risk that significant cyber security incidents targeting this technology can prevent the financial sector from delivering services and impact financial stability increases. Cyber security incidents have the potential to disrupt operational and financial networks via three possible channels: an incident could disrupt the provision of key services, reduce confidence in firm and markets. At the same time, several factors could increase the probability of an incident: the open structure of Internet, the emergence of crypto currencies and the legal liability of software developers. In sum, Cyber attacks on banks, financial market infrastructures and service providers are a serious concern, as they negatively impact consumers and businesses, could lead to systemic risks an eventually impair economic growth.

2.2. Ongoing structural vulnerabilities

International supervisors have identified structural vulnerabilities in the financial system. These include: profitability prospects of many banks in the EU, concentrations of activities and exposures in CCPs; liquidity risks in the non-bank financial sector with potential spillovers to the broader financial system, asset management and activities; challenges to data quality; collection and sharing and financial innovation.

A number of further structural challenges continue to dampen profitability prospects for euro area banks

Euro area banks' profitability recovered somewhat in 2017, mainly driven by an increase in non-interest income, while banks' solvency continued to improve. The faster reduction of Non- Performing Loans has also contributed to the de-risking of bank balance sheets, but progress remains uneven across banks. A number of further structural challenges continue to dampen profitability prospects for euro area banks. As mentioned in the Financial Stability Review published by the ECB in November 2017, although structural challenges differ depending on banks' business models and the country they operate in, there are some common characteristics that have been hampering the profitability of a large set of banks across euro area jurisdictions. In such a context the return on equity for many banks in the EU is insufficient to cover the cost of capital, which eventually would threat financial stability.

Central Counterparties

Central counterparties (CCPs) have the potential to provide considerable benefits to financial stability by enhancing market functioning, reducing counterparty risk, and increasing transparency. These benefits require CCPs to be highly robust and resilient. However because CCPs clear a very large volume of transactions, and because of the extent to which they are interconnected with other large and interconnected financial institutions, it is essential that CCPs be robust and resilient.

Consequently authorities need to ensure that CCPs do not themselves become a new, concentrated source of too-big-to-fail risk. To coordinate international policy work on CCP resilience, recovery planning and resolvability, the BCBS, CPMI, FSB and IOSCO adopted a joint workplan in 2015. Implementation of the workplan is now largely underway in the EU in particular with the EMIR regulation and the CCP recovery and resolution framework.

Leverage risks in the non-bank financial sector with potential spillovers to the broader financial system

Leverage in the nonfinancial sector has increased since 2006 in many G20 economies amid easy financing conditions. While this has helped facilitate the recovery in aggregate demand, it has also made the nonfinancial sector more sensitive to changes in interest rates. Private sector debt service burdens have increased in several major economies as leverage has risen, despite declining borrowing costs. Debt servicing pressure could mount further if leverage continues to grow and could lead to greater credit risk in the financial system.

Asset management products and activities

Certain asset management products and activities may create potential financial stability risks particularly in the area of liquidity and redemption, leverage, operational functions, securities lending, and resolvability and transition planning. Many of these risks are mitigated by funds legislation notably in the EU.

Data Quality, Collection, and Sharing

The financial crisis revealed gaps in the data needed for the effective oversight of the financial system and internal firm risk management and reporting capabilities. Although progress has been made in filling these gaps, much work remains. In addition, some market participants continue to use legacy processes that rely on data that are not aligned to definitions from relevant consensus-based standards and do not allow for the adequate conformance and validation of structures needed for data sharing. Regulators and market participants should continue to work together to improve the coverage, quality, and accessibility of financial data, as well as data sharing between and among relevant agencies.

Financial innovation

The entry of new financial market participants and the development of new financial products and services offers benefits to firms, households, and financial institutions. Innovation allows market participants to adapt to evolving marketplace demands and regulatory constraints and offers the possibility of reducing transaction costs, increasing credit availability, improving efficiency, and allowing for the more accurate pricing of risks. But new applications of technology, as in other parts of the economy, can be disruptive and can create risks and vulnerabilities that are difficult to anticipate.

Examples of such new products and services include crypto assets, distributed ledger technologies, and marketplace lending. This is the reason why many regulators evaluate the potential effects of new financial products and services on financial stability, including operational risk. ■

Tackling vulnerabilities from asset management activities

1. The growth of the asset management sector is welcomed but raises potential financial stability concerns

The strong growth of the asset management sector over the past decade is welcomed for its capacity to diversify financing sources and improve the efficiency and resilience of the financial system, in line with CMU objectives in particular. The role of the sector is expected to increase further in an environment of low interest rates and with balance sheet constraints impacting the banking sector.

Authorities however emphasize the need to monitor potential systemic risks associated with these activities. Concern has notably been raised regarding the increasing volume of assets managed by open-ended funds that offer daily redemptions, while investing growing amounts of capital in less actively traded securities, which may create potential liquidity mismatch, contagion risks in case of fire sales and also possible 'first mover advantage' issues. Leverage used by some funds may also amplify the impact of negative market movements. In addition the interconnectedness between funds and investors may contribute to further spread risk.

2. Risks from asset management activities are addressed by the existing EU fund frameworks as well as international standards

In the EU, many of the risks associated with asset management activities, notably those related to liquidity mismatch and leverage, are already covered by EU legislations (UCITS, AIFMD, MMFR, SFTR), on which possible future policy steps should build. The strengthening of the powers of ESMA proposed in the context of the ESA review (regarding decision-making, arbitration and investigation powers) should help to improve the consistency of the implementation of these requirements.

The UCITS and AIFM directives both contain liquidity management requirements. AIFs are required to have redemption policies that are consistent with the liquidity profile of their investment strategy and to conduct regular stress tests under both normal and exceptional liquidity conditions. UCITS are also subject to detailed eligibility rules that govern the types of assets in which they are allowed to invest and must conduct stress tests where appropriate. Moreover liquidity management tools (e.g. gates, side-pockets, suspension of redemptions) are available domestically in many EU jurisdictions, but they are not standardized at the EU level. The risks associated with specific types of funds such as ETFs have also being investigated by some domestic EU authorities, who have so far concluded that they do not require specific liquidity measures.

The UCITS and AIFM directives also provide a legal basis for limiting the build-up of leverage in investment funds. The UCITS directive specifies an investment limit on the exposures of UCITS to derivative instruments[1] and a 10% temporary borrowing cap[2]. In addition the AIFMD allows national competent authorities (NCAs) to impose leverage limits or other restrictions on the management of AIFs[3]. AIFMD also provides[4] a role for ESMA in determining that the leverage employed by an alternative investment fund manager (AIFM), or by a group of AIFMs, poses a substantial risk to the stability and integrity of the financial system and ESMA may issue advice to NCAs specifying the remedial measures to be taken, including limits on the level of leverage.

At the international level, new guidelines have also been introduced to address financial stability risks from market-based finance activities, including asset management. 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 their activities. The approach regarding NBNI G-SIFI risk is however due to be finalised by 2019 once the work on residual structural vulnerabilities stemming from asset management activities has been completed.

The FSB published in January 2017 policy recommendations covering four main types of vulnerabilities that are being further elaborated by IOSCO: (i) Liquidity mismatch between fund investments and redemption terms; (ii) Leverage; (iii) Operational risk; (iv) Securities lending activities. The FSB moreover made recommendations to enhance the system-wide oversight of financial stability risks associated with market-based finance activities going forward[5].

Following these proposals, IOSCO published in February 2018 a set of recommendations for the liquidity risk management of Collective Investment Schemes (CIS) including investment funds, aiming to operationalize the recommendations made by the FSB in this area. Although different risk factors that may impact market liquidity and the behaviour of investors in stressed market conditions (such as monetary policy, regulatory and technological change and changes in market conditions) have not translated at this stage into an evident deterioration of market liquidity, there is evidence according to IOSCO of a constantly changing market environment for which asset managers must be prepared. IOSCO therefore recommends that responsible entities should include liquidity risk management processes and tools in the design of their CISs (e.g. appropriate liquidity thresholds, suitable dealing frequency, appropriate subscription and redemption arrangements…) and then monitor and evaluate the underlying portfolios of their CIS on a regular basis in order to determine whether or not and also how to possibly activate additional liquidity tools. In addition IOSCO recommends that CIS should put in place contingency plans and periodically test them.

3. Additional measures are however needed according to the ESRB to address from a macroprudential perspective, possible systemic risks stemming from asset management activities

Although the current fund regulatory framework provides for effective risk management by investment funds at the individual or microprudential level, its efficacy from a macroprudential or system-wide perspective is largely untested, according to the ESRB. This may hinder the ability of existing fund regulations to prevent the build-up of sector-wide risks.

The ESRB proposed in February 2018 five recommendations addressed to ESMA and the EU Commission[6] aimed at enhancing the EU macroprudential framework applying to the asset management sector: (A) Mandating the availability of a diverse set of liquidity management tools in all Member States (such as redemption fees, redemption gates or the ability to temporarily suspend redemptions) in order to increase the capacity of fund managers to deal with redemption pressure when market liquidity becomes stressed; (B) Requiring open-ended AIFs that hold a large proportion of their investments in less liquid assets (e.g. real estate, unlisted securities, loans and other alternative assets) to demonstrate to NCAs their capacity during and/or after approval to maintain their investment strategy under stressed market conditions; (C) Developing guidance on the practices to be followed by managers for the stress testing of liquidity risk for individual UCITS and AIFs. Guidance on fund managers' liquidity stress testing is expected to reduce the variability of existing stress tests which should help to better address liquidity risk at both investment fund and system level; (D) Establishing a unified UCITS reporting framework across the EU (in terms of frequency, UCITS covered and data reported) regarding liquidity risk and leverage from a financial stability perspective; (E) Clarifying and harmonizing the use of the macroprudential tool provided under Article 25(3) of AIFMD (i.e. whereby the AIFM shall demonstrate that the leverage limits set by it for each AIF it manages are reasonable and that it complies with those limits at all times)[7] by developing a common approach regarding the assessment of leverage risks and the design, calibration and implementation of leverage limits.

The possible downsides of using macroprudential tools for market-based finance activities have been emphasized in the past, particularly if they are applied across whole market segments, which is however not the intention of the recommendations of the ESRB. Possible issues associated with these tools include the procyclical and market distortion effects of liquidity management tools if investors are led to believe that they may be harmed by these measures and no longer invest in the funds concerned, which may undermine diversity in the market. Another issue concerns the definition of stress test guidelines. If these are too restrictive, they may reduce the possibility for stress tests to be tailored to the specificities of asset management activities and to the composition of the underlying portfolios, which plays an important part in providing meaningful results, according to many market observers. ■

[1] Article 51(3).
[2] Article 83(2)(a).
[3] Article 25(3).
[4] Article 25(7).
[5] The measures proposed include (1) establishing a systematic process for assessing financial stability risks from shadow banking and ensuring that any entities / activities that could pose material financial stability risks are brought within the regulatory perimeter; (2) addressing identified gaps in risk-related data; (3) removing impediments to cooperation and information-sharing between authorities and (4) improving information-sharing on emerging risks and data granularity on assets and liabilities and cross-border interconnectedness.
[6] These recommendations are due to be implemented by the EU Commission or ESMA. The Commission is requested to report on recommendations A, B and D by December 2020 and ESMA on recommendations C and E by June 2019.
[7] Article 25(3) of AIFMD: The AIFM shall demonstrate that the leverage limits set by it for each AIF it manages are reasonable and that it complies with those limits at all times. The competent authorities shall assess the risks that the use of leverage by an AIFM with respect to the AIFs it manages could entail, and, where deemed necessary in order to ensure the stability and integrity of the financial system, the competent authorities of the home Member State of the AIFM, after having notified ESMA, the ESRB and the competent authorities of the relevant AIF, shall impose limits to the level of leverage that an AIFM are entitled to employ or other restrictions on the management of the AIF with respect to the AIFs under its management to limit the extent to which the use of leverage contributes to the build up of systemic risk in the financial system or risks of disorderly markets. The competent authorities of the home Member State of the AIFM shall duly inform ESMA, the ESRB and the competent authorities of the AIF, of actions taken in this respect, through the procedures set out in Article 50.

Supervision of EU and third country CCPs

1. Issues raised by the current EU supervisory regime of cross-border CCPs and objectives of the EMIR review proposal

On 13 June 2017, the European Commission (EC) adopted a proposal in the context of the EMIR review for strengthening the supervision of EU and third-country (TC) CCPs operating in the EU, whose importance in the financial system is growing following the implementation of the G20 commitments. This proposal aims to further ensure the safety of these CCPs, by enhancing their supervision on a cross-border basis and also to address the implications for the EU financial stability of TC CCPs handling significant volumes of cleared products denominated in EU currencies. This latter issue will be exacerbated with the departure from the EU of the UK, where a substantial proportion of transactions denominated in Euro and other Member State currencies are currently cleared. The EMIR review proposal is currently being examined by the EU Council and EU Parliament.

EMIR[1] already provides measures for ensuring the resilience of cross-border CCPs. Under EMIR, EU CCPs are supervised by colleges comprising the different National Competent Authorities (NCAs) concerned, ESMA and relevant members of the European System of Central

[1] EMIR entered into force in 2012 and was gradually implemented from 2014 approach i.e. EMIR reporting started in Feb 2014 ; CCPs were authorized in 2014; the implementation of the clearing obligation was phased in between 2016-2019 ; bilateral margin requirements were completed in March 2017, etc.

Banks, in order to foster further supervisory convergence. These requirements are due to be completed with an EU recovery and resolution (R&R) framework for CCPs and standards have also been established at the global level to ensure the resilience of CCPs[2]. Different assessments have however shown potential shortcomings in the supervision of EU and third-country cross-border CCPs, despite these measures.

First, while supervisory colleges enable better information sharing among supervisors, the main decisions for cross-border EU CCPs[3] are still taken by the home supervisor of the CCP. This needs to be reconsidered according to the EC for CCPs which have significant cross-border activity and are highly interconnected and can therefore impact all or part of the EU. Moreover, different domestic supervisory approaches persist within the EU[4], creating potential supervisory arbitrage risks and there is a variable degree of cooperation within colleges. In addition central banks of issue (CBIs) are often at present not sufficiently involved in decision-making and risk assessment processes concerning CCPs, for them to appropriately address the issues that may have implications for EU monetary policy.

Secondly, concerning TC CCPs, the current equivalence regime of EMIR leaves only a formal recognition power to the EU authorities, who consider that they do not have the ability to monitor how these CCPs develop after recognition[5]. There is also the same insufficient involvement of EU CBIs in supervisory decisions regarding TC CCPs as for EU CCPs. As a result the current equivalence regime is very reliant on third-country supervisory authorities which may be problematic for TC CCPs of systemic relevance for the EU financial system. This limited involvement of EU supervisors and CBIs makes it indeed difficult for them to identify and address possible changes in TC CCP rules, practices or supervisory arrangements, which may have in particular financial stability or monetary policy implications for the EU[6].

2. Main proposals made by the EU Commission for improving cross-border CCP supervision

Regarding EU cross-border CCPs, the main objectives of the proposal are to develop a more European perspective and enhance the role of CBIs in the supervision of CCPs and also to foster a closer cooperation between supervisors and CBIs. In this perspective, the EMIR review proposes the establishment of a specific "CCP Executive Session" within ESMA[7] in charge of the supervision of cross-border CCPs. While NCAs would continue to exercise their current supervisory responsibilities under EMIR, the prior consent of the ESMA CCP Executive Session and when appropriate of the relevant CBIs (e.g. the ECB in the Eurozone) would be needed for decisions that may affect financial stability or the monetary policy of the Union[8].

The EMIR review also proposes to reinforce the supervisory framework for systemically important TC CCPs wishing to provide services in the EU. TC CCPs would be classified in two groups by ESMA[9]: non-systemically important ones (Tier 1) which would continue to be able to operate under the existing EMIR equivalence framework, and systemically important ones (Tier 2) which would need to comply with additional requirements[10]. ESMA would be granted new powers to recognize and supervise Tier 1 and Tier 2 CCPs under this new framework with the support of the relevant CBIs. Tier 2 CCPs would moreover have the obligation to provide ESMA with all relevant information and enable on-site inspections and a process is proposed for managing possible infringements. A new system of 'comparable compliance' would be introduced for allowing Tier 2 TC CCPs to request the possibility to continue relying on all or part of their home jurisdiction rules, if these are deemed comparable with EMIR requirements, but these would still be subject to ESMA's oversight.

In addition, a limited number of TC CCPs may be determined by ESMA and the relevant CBIs as 'substantially systemically important' for the EU or one of its Member States (according to criteria yet to be set). In this case the CCP would not be recognised by ESMA and the EC would be empowered to mandate that such a CCP should establish itself and be authorized in one of the EU Member States. The result would be the potential denial of recognition of such a CCP.

3. Main issues to be further considered concerning the supervision of EU CCPs

In the draft report of the EU Parliament published at the end of January 2018, the rapporteur was generally supportive

[2] such as the CPMI-IOSCO PFMI principles, and international principles for managing a possible CCP R&R.
[3] e.g. regarding authorization, the approval of outsourcing and interoperability arrangements.
[4] e.g. different conditions for authorisation or model validation processes, despite efforts made by ESMA to improve their consistency through guidance material and the publication of best practices.
[5] e.g. due to difficulties in accessing information from the CCPs or in conducting on-site inspections.
[6] As the volumes cleared by CCPs continue to increase, substantial volumes of trades denominated in euros will be cleared in a jurisdiction out of the reach of the EU supervisors. In addition, supervision by a third-country authority could potentially lead to level playing field issues in some circumstances.
[7] This body would be composed of permanent members (a head and two directors who would be voting and a representative of the ECB and one of the EC in a non-voting capacity – who would attend all meetings of the Executive Session and all EU CCP colleges) and of members specific to each CCP including NCAs and the relevant CBIs, who would only attend the meetings concerning their jurisdiction.
[8] A recommendation was moreover made in June 2017 by the ECB Governing Council to amend Article 22 of the ECB statutes in order to provide the ECB with a clear legal competence in the area of central clearing so that it may carry out its role as CBI under the EMIR review.
[9] based on 4 main criteria (i) nature, size and complexity of the CCP's business, (ii) impact of a possible failure on EU financial stability, (iii) clearing membership structure and (iv) interdependencies and interactions with other FMIs.
[10] i.e. on-going compliance with EMIR prudential requirements; compliance with additional requirements set by the relevant CBIs relating to e.g. collateral, haircut policies or liquidity requirements.

of the more European approach to the supervision of EU CCPs and the greater involvement of CBIs proposed by the EC. The need to "properly calibrate" the role of CBIs was however stressed in order to ensure that their involvement is focused on supervisory decisions that might have an implication for monetary policy. In addition the need to properly integrate the structure dealing with CCPs within the broader set-up of ESMA was emphasized, the preference of the rapporteur going to an "internal CCP supervisory committee" within ESMA in charge of CCP supervision. In terms of decision-making, the rapporteur suggested a process through which decisions of the supervisory committee would be subject to the non-objection of the existing ESMA Board of Supervisors.

Other comments made regarding EU CCPs include the need to further specify the roles and responsibilities of the different public authorities involved in their supervision, how decisions would be made and how possible disagreements would be managed. This should be done both for normal times and times of crisis, when effective and clear communication and decision-making are particularly important. It is also important that the responsibilities and the decision processes defined should be consistent with those adopted for the recovery and resolution of EU CCPs and with the changes proposed for ESMA in the context of the review of the European Supervisory Authorities (ESAs).

4. Main issues regarding the supervision of third-country CCPs

Concerning TC CCPs, the EU Parliament draft report supports the proportionate approach proposed by the EC, based on a classification of their systemic importance for the EU[11]. Some commentators have however stressed that the new supervisory powers granted to ESMA for Tier 2 TC CCPs and how they would work in practice are too discretionary and need further specification. Some are concerned in particular that this may lead to a de facto dual supervision of these CCPs with potential ineffectiveness (risk of diverging approaches or additional complexity and the related cost impacts). The compliance with a double set of rules should however be alleviated by the application of the new system of 'comparable compliance'. In addition the US supervisory authorities have emphasized that they would disagree with any new measures[12] that would lead to direct oversight over US CCPs by the EU authorities and that the European future regime should be applied in a more proportionate way and respect the terms and conditions of the 2016 recognition and equivalence agreement concluded between the EU and the US authorities.

The recommendation that has caused the most controversy in the EU is however the possible denial of recognition that could affect some TC CCPs deemed to be "substantially systemically important". Many stakeholders have warned that this would lead to a fragmentation of liquidity, to losses in netting[13] and a possible increase of systemic risk. Some also claim that the issues posed by these CCPs could be tackled with appropriate supervisory enhancement and cooperation, similarly to what is proposed for Tier 2 TC CCPs. Many other stakeholders are however favourable to having this tool in the EU supervisory toolbox, on the grounds that offering clearing services of systemic relevance for the EU from within the Union could allow EU CBIs and authorities to better monitor decisions by CCPs that may have an impact on EU currencies and intervene more quickly and with more certainty if needed[14], particularly in a context of crisis. Most see this as a last resort tool that may be used if other mechanisms are not sufficient. It has also been suggested, notably in the draft report of the EU Parliament, that the determination of some CCPs as 'significantly systemic' needs to be based on a fact- and evidence-based process, in order to provide sufficient objectivity[15]. Some authorities however emphasize that the possible denial of recognition should not be limited to crisis situations, but should also be considered in a preventive way. Some commentators also stress that new netting opportunities could be obtained by netting across the same currency (in addition to netting across similar products).

Some have also suggested that a possible denial of recognition should be focused on specific services or activities (rather than the whole CCP) in order to focus possible measures on the specific clearing activities that have strong implications for the EU. Another suggestion would be to have an adaptation period in order to minimise disruptions in the market due to the potential relocation of certain activities. Finally, how such a measure might affect clearing members, end-investors and counterparties and whether it may lead to different obligations for EU and non-EU entities also needs to be clarified. ■

[11] The importance of basing this classification on objective criteria and a clear decision process was however emphasised by some commentators.
[12] Following the EU-US agreement reached over EMIR equivalence.
[13] with potential impacts on costs and risk mitigation.
[14] e.g. decisions on margin requirements applicable to repo clearing potentially impacting sovereign debt.
[15] Suggestions have been made that a quantitative assessment of the impact of the location of certain clearing activities on the monetary policy and on the financing of the EU 27 economy could be useful in this regard taking into account the safeguards already provided by EMIR.

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