eurofi

REGULATORY UPDATE

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EUROFI
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1. MACRO-ECONOMIC & POLITICAL CHALLENGES

Outlook for the EU27 economy

1. Europe is doing better politically and economically

On a political level, the nationalist movements and the divisions within our societies have not disappeared, but the populist wave that was threatening to submerge Europe has been contained. Indeed, Europe has escaped a victory by Marine Le Pen or Jean-Luc Melenchon in France. On the contrary, universal suffrage approved the European commitments set out by Mr. Macron. Similarly, the far-right failed in Austria's presidential elections in autumn 2016. This trend was confirmed in March 2017 with Geert Wilders' failure in the Netherlands.

With the Brexit, we are rediscovering that Europe is in reality an economic space with collective preferences. The problems facing British decision makers are highlighting the tangible benefits of Europe, which are so obvious that we used to take them for granted: the possibilities for studying or retiring wherever you wish, the freedom to do business free from controls. So, the European citizen's sense of belonging to Europe has increased. Brexit creates challenges but also provides an opportunity to advance the Capital Market Union, thereby promoting non-bank sources of funding and increasing private risks haring. As one EU Member State leaves, others will need to pull closer together.

On the economic level, the economic expansion in the euro area seems increasingly resilient and has broadened across sectors and economies The ECB foresees annual real GDP increasing by 1,9% in 2017, by 1,8% in 2018 in the euro area. The dispersion of growth rates across countries is now at its lowest since the introduction of the euro as the IMF pointed out in its concluding statement of the 2017 Article IV Mission (June 2017). Progress is homegrown, driven by domestic demand and supported by a revival of credit – the payoff from years of balance sheet repair, accommodative policies and institution building.

The Grexit has not taken place and the single currency has survived and has been strengthened. Positive developments indeed also relate to the creation of new institutions during the crisis such as the European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM), the Single Supervisory Mechanism (SSM), the Single Resolution Board (SRB), the Single Resolution Fund (SRF). They make the EMU more resilient.

2. Despite a firm cyclical recovery, the EU faces deep-rooted structural weaknesses and imbalances

The European Union still faces serious external and internal challenges: Massive increases in migration flows, the threat of terrorism on the one hand, demographic decline, weak levels of productivity gains and economic growth, high levels of indebtedness and unemployment, major economic discrepancies notably between France and Germany, the increasing fragmentation in the single banking market on the other hand.

2.1. Europe is facing an unprecedented demographic challenge and must be prepared to deal with the looming pension crisis

The decline in population (a reduction in fertility rates, an ageing in, population) which is greater than in the United States limits the potential growth of the European Union. In 2060, for every retired person there will only be two people of working age, compared to four today. Our social and welfare systems are already coming under pressure.

2.2. Weak levels of economic growth and levels of productivity are a major drag on the performance of the EU as a whole

Europe is trailing behind. Comparing the United States with the EU's best performer, Germany shows that:

- From 1998 to 2015, on a cumulative basis, productive investment in the US increased by 20 GDP points more than in Germany
- Between 1998 and 2015, per capita productivity gains increased by 40% in the US, compared with 10% in Germany
- Research and development spending levels are also higher in the United States (3% of GDP)

What are the factors behind this?

Businesses have more freedom to work and make profits in the United States than in Europe. Less regulation, more flexible markets, stronger competition, the facility of finding financing are key factors behind America's success. In addition, tax charges are higher in Europe than in the United States. Research and development spending levels are also higher in the United States (3% of GDP) than in Europe.

Faster progress on structural reforms is the most effective way to improve the business climate, raise productivity growth and reduce unemployment. Ultra-loose monetary conditions have contributed to economic growth but their persistence increases risks for the economy and they cannot act as a substitute for structural reforms. In any case, developing ownership and incentivizing domestic reforms in particular to improve the business climate and increase the attractiveness of labour as a production factor remains a short run key priority.

A greater integration of markets in energy, transport and digital services would certainly boost productivity and contribute to allow Europe to reap the benefits of network effects, provided that Member States cooperate appropriately to favor the creation of European industrial champions so as to compete on the global stage (digital/data, defense, climate change).

2.3. The circulation of capital flows between Eurozone/ EU countries has only been partly restored

The euro area has a savings surplus of more than €200 bn a year or over 2% of GDP and at the same time, suffers from an investment deficit. Northern Europe surplus savings are not feeding into the South. In other words, the situation is not satisfactory because the Eurozone's savings are financing investments in the rest of the world, whereas there is an investment shortfall in the euro area. The inability to find sufficient opportunities for investment projects in Europe should be both a cause for concern and a source of motivation for our leaders.

2.4. Some high debt countries may face rising sovereign spreads when monetary policy accommodation is reduced

Debt levels across the Eurozone were 91.3 per cent in 2016. Although deficit ratios have declined overall, public debt ratios are very high in many euro countries: France and Spain (at around 100 % of GDP), Italy (133% of GDP in 2016).

The exit of the ECB quantitative easing and the inevitable normalisation of long term interest rates will increase the debt service burden of EU Member States and could question the sustainability of the public debt of Member States notably those who do not have a primary fiscal surplus. These high debt ratios are also an impediment to the increase of growth potential in the relevant countries. High – debt countries should take advantage of the recovery and the remaining window of accommodative monetary policy to build buffers and reduce vulnerabilities.

2.5. Major economic and fiscal discrepancies notably between Germany and France

Political support for further European integration may be eroded by the lack of economic convergence. Indeed, the convergence trends between Members States of the euro area have proved partly illusory. A comparison between Germany and other EU countries such as France, Italy and Spain shows major economic and fiscal discrepancies that need to be addressed for achieving stronger growth in these countries and restoring trust between Member States. Indeed the rules of the Stability and Growth Pact have not been enforced sufficiently vigorously. Public debt ratios are very high in many euro area countries (e.g. France, Spain, Italy) and for some are still increasing. Additionally, many euro-area countries face deep-rooted structural weaknesses and imbalances.

To stabilize and deepen the Monetary Union, it is essential that France should overcome its economic weaknesses in particular compared with Germany. The main issue is the level of public expenditure which amounts to 57% of GDP in 2016. In France compared to the average level of the euro zone (49% in 2016). This is why France urgently needs to rebalance its public accounts in order to reduce the excessive level of tax and contributions which are detrimental to the competitiveness of French companies.

A well-functionning monetary union requires a credible and sustainable fiscal framework: the euro area fiscal rules need to be more binding, less complex, predictable and effective. For instance, the practice of some countries to be satisfied by a reduction of the past trend of increases in public expenditure should not be accepted. What is needed is a reduction of these public expenses and not a lesser increase in the countries where public expenditure are significantly high.

The symmetry of economic adjustments within the euro area should also be a priority focus. Germany's considerable trade surplus is not sustainable within a balanced monetary area. Within a monetary union, there must be a symmetrical adjustment mechanism to prevent long-run excessive balance of payment surpluses or deficits.

2.6. Fragmentation in the single banking market has increased despite the implementation of the Banking Union three years ago

EU cross- border groups do not operate in a single market. Cross border operations in the banking sector have declined, and are still declining. The lack of single-jurisdiction status – or the multiple national jurisdictions – penalizes banks operating across the Eurozone and impedes greater risk diversification and cross-border consolidation. Lastly progress on reducing non-performing loans has been slow in some countries even if recent supervisory actions and the adoption of an action plan by the Ecofin Council are encouraging. ■

Challenges and conditions for a normalisation of EU monetary policy

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, alongside conventional ones, in pursuit of its price stability objective. Together, these measures have proved effective in preventing a period of disinflation from spiralling 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, while 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 grow out of sync with 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.

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). This big debt overhang represents a risk to the stability of the system 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?

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 prospect of more growth in the US, less unemployment and higher inflation can only encourage markets in this belief.

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 formidable challenge of designing a strategy for the withdrawal of the stimulus that does not unleash disruptive market movements.

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 parri 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 May) 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 0,9% by the end of April 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.

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.

Longevity and ageing : Opportunities and challenges associated with the PEPP

On 29 June 2017, the EU Commission set out a legislative proposal for a pan-European Pension Product (PEPP), a simple and cost-effective retirement plan which will be portable across EU Member States. The PEPP is designed to give hundreds of millions of savers in the EU more choice in the fragmented and uneven European market, where options are nearly non-existent in some Member States. But it would also create new opportunities for providers to tap into a European-wide single market for personal pensions estimated to grow to €2.1tn over the next decade.

The Pan European Personal Pension Product (PEPP) is a voluntary personal pension scheme that will offer consumers a new pan-European option to save for retirement. PEPP would have several features inspired by existing pension products:

- For example, PEPP would be a simple product for savers, with only up to 5 investment strategies.
- It would include a default, low-risk investment option under which savers recoup at least the capital saved, and strong rules on risk mitigation.

- It would cap the costs of switching from one provider to another.
- It would be a transparent product, with mandatory information on fees and the performance of the investment. The cornerstone of providing pre-contractual information is the PEPP key information document. Its form, content and conditions of provision are described in detail in the proposed Regulation.
- And it would be flexible, offering the possibility to change investment strategy every 5 years and choosing how benefits are paid out.

All these features would be harmonised at the EU level, and providers would only need one product authorisation to offer a PEPP across the EU. The authorisation to act as a PEPP provider would be granted by a single authority, EIOPA[1]. EIOPA would be in charge of authorising PEPPs and maintaining a central register for PEPPs across the EU. National Supervisory Authorities would remain in charge of supervising PEPP providers. In order to ensure high quality standards for the PEP label, EIOPA is empowered to withdraw public authorisation in case a provider no longer matches PEPP requirements.

1. Reasons for and objectives of the EU Proposal of the EU Commission

Europe is facing an unprecedented demographic challenge. In 2060, for every retired person there will only be two people of working age, compared to four today. Our social and welfare systems are already coming under pressure. That is why it is urgently needed to bridge the pension gap created by our ageing population.

Alongside occupational pensions, personal pension plans are part of the solution to supplement state-based pensions. But today they are underused: only 27% of Europeans between 25 and 59 years of age save towards a private pension[2].

This is linked to the underdevelopment of the personal pensions market. In many Member States, supply is limited, and savers often face limited competition, hidden fees and expensive or no switching between providers. For those providers wishing to develop EU-wide products, a patchwork of rules stands in the way.

The legislative proposal of the EU Commission aims to address this situation by contributing to a European market for personal pensions and encouraging competition between providers of the benefits of consumers. The European market for personal pensions is indeed fragmented and uneven. Offers are concentrated in a few Member States, while in some others they are nearly non-existent. In only 5 Member States (SI, DE, ES, AT, SE), more than 15% of the population has bought a personal pension product.

This variation is linked to a patchwork of rules at EU and national levels, which impede the development of a large and competitive EU-level market for personal pensions. The PEPP would provide the building blocks for the creation of a voluntary single personal pension product that can be marketed by providers on a pan-European scale.

A more developed market for personal pensions in the EU is also expected to channel more savings into long-term investment and increase the depth, liquidity and efficiency of capital markets.

2. Key benefits for savers and providers

The PEPP would allow consumers to voluntarily complement their savings for retirement, while benefitting from solid consumer protection:

- PEPP savers will have more choice from a wide range of PEPP providers and benefit from greater competition.
- Consumers would benefit from strong information requirements and distribution rules, also online. Sectorial distribution rules will apply for IDD and MiFID firms, specific rules will apply for other firms.
- The PEPP would grant savers a high level of consumer protection under a simple default investment option with mandatory risk mitigating techniques, under which savers recoup at least the capital saved.
- Savers would have the right to switch providers – both domestically and cross-border - at a capped cost every five years.
- The PEPP would be portable between Member States, i.e. PEPP savers would be able to continue contributing to their PEPP when moving to another Member State.
- PEPP providers would be able to offer different types of pay-out options- annuities, lump sums, a combination of both, or regular withdrawals. PEPP savers would have the possibility to change their preferred option once every five years under their PEPP scheme, in order to benefit from sufficient flexibility.

The regulatory framework that the Commission is proposing today shoud create opportunities for a wide range of providers (banks, insurers, asset managers, occupational pension funds, investment firms) to be active on the personal pension market: IP/17/1800

- Providers would be able to develop PEPPs across several Member States, to pool assets more effectively and to achieve economies of scale.
- PEPP providers would be able to reach out to consumers across the whole EU through electronic distribution channels. A network of branches would not be required, allowing easier market access.
- PEPP providers and savers would have different options for payments when the product reaches the end of its lifetime.
- PEPP providers would benefit from an EU passport to facilitate cross-border distribution.
- The proposed Regulation includes the possibility for PEPP providers to cover the risk of death and other biometric risks. But accumulation conditions (e.g. minimum duration of contribution, maximum age to start contributing, etc.), biometric coverage (e.g. protection against disability, death) and decumulation conditions (e.g. minimum age to receive benefits) are

not harmonised in the proposed regulation in order to preserve flexibility and so that providers can adapt to national laws and criteria for tax relief.

The proposal for the PEPP Regulation is accompanied by a Commission Recommendation on the tax treatment of personal pension products, including the PEPP. The Commission encourages Member States to grant the same tax treatment to PEPPs as is currently granted to similar existing national products, even if the PEPP does not fully match the national criteria for tax relief. Member States are also invited to exchange best practices regarding the taxation of their current personal pension products and this should foster a convergence of tax regimes.

3. Some reservations already expressed

In the Eurofi Magazine published on the occasion of the Eurofi Tallinn Forum, X. Larnaudie – Eiffel (CNP Assurances) expressed three reservations regarding the PEPP legislative proposal:

"The PEPP will only achieve its objectives if it is a true, long-term pension product. Fundamentally, this means that individuals need to be incentivized to keep saving for a long period, ideally until retirement. I welcome the EC's laudable introduction of a limitation to switching. However, a 5-year term horizon will not be sufficient either to ensure long-term saving or to allow PEPP providers to generate long-term liabilities and invest accordingly.

One key aspect of the proposal is the cross-border distribution of personal pension products to create a genuine single market. To achieve this, PEPP providers will be required to have one "national compartment" per Member State to enable PEPP purchasers to save throughout the EU. This approach raises questions, which have to be investigated in detail, but one overarching concern is that it could create a huge administrative burden, as PEPP providers will need the knowledge and resources to handle all the different languages, legal requirements, taxation frameworks and so on. The inevitable result could be that PEPPs be offered only by a handful of the largest companies, meaning in practice less, rather than more, competition.

Precisely to increase competition, the EC has introduced the possibility for the PEPP to be distributed by a broad range of providers. However, the different providers fall under different regulatory frameworks, creating the very real risk that levels of consumer protection will vary, depending on the PEPP provider. The Solvency II regulatory regime that governs insurers was specifically designed to ensure a high level of protection for customers acquiring pension products. If other financial institutions offer true personal pensions, they should be subject to a similar framework, in line with the "same risks, same rules "principle." ■

1 Existing personal pension products may be converted into PEPPs following authorisation by EIOPA, which must consult the competent supervisory authority of the financial undertaking before deciding whether to reject or approve its application.

2 According to EIOPA, 67 million individuals in the EU have a voluntary personal pension plan out of 243 million EU citizens aged 25-59 years.

Improving financing prospects for EU infrastructure projects and mid-sized enterprises

1. Investment needs remain huge in the EU

The survey completed in April 2017 by the EIB, points to a strong investment focus of EU firms on replacement investment. This corresponds to the existing investment gaps regarding the quality of the capital stock of EU firms. Indeed, firms report that only 44% of their machinery and equipment can be considered state-of-the art, and that only 40% of their building stock satisfies high energy efficiency standards. Conversely investment in new capacity is still held back by relatively low levels of capacity utilisation.

The survey stresses that uncertainty (69% of firms) and lack of skilled staff (67%) stand out as the main longer term barriers to investment. Access to finance is improving, it stands at the 6th place (43%) after labour market regulation and high energy costs (52% and 48%, respectively).

2. Further improving the financing of investments remains however essential

Indeed, there are still segments of firms heavily dependent on external funding, and which have trouble obtaining it. This applies in particular in countries which have experienced economic downswing, and to smaller or young or innovative firms.

In addition, while larger firms are able to use a wide range of financial tools, smaller firms are generally using internal financing and short term debt, which provides flexibility and requires less collateral. Furthermore, owner-managed companies are reluctant to associate external parties with their capital, and consequently favour debt over equity.

Finally, although innovation and future growth are closely related to the financing of SMEs, due to the greater risk of high-growth, innovative firms, banks are more reluctant to finance them. Achieving an effective re-balancing of the financing mix of firms towards more market-based sources, is proving as essential as challenging and requires the provision of strong incentives.

Looking beyond SMEs, one accepted explanation for growth slowly recovering since the double dip recession, is low investment. Before 2008, gross fixed capital formation in GDP as a share of GDP was around 20%. It then declined to 17% in 2013, representing an EU annual investment gap between 2 and 3% of GDP or around €300bn/annum.

However relaunching investment also requires taking into account that in many Member States although households have accumulated savings, the private sector and government have accumulated high levels of debt and have now to deleverage.

3. Various initiatives have been taken at the EU level to improve the investment in the EU

The Investment Plan for Europe (IPE), which aims to encourage investments meeting EU long-term economic needs, focuses on the mobilisation of private sources of funding (leveraging €21bn public funds), the creation of an investor friendly environment (through technical assistance in particular) and comprehensive information on project investment opportunities in the EU (project pipeline). The objectives of the IPE have recently been enhanced in order to mobilise up to €630bn in 2022.

Investment vehicles channelling savings toward investment have been or will be launched: European Long Term Investment Fund targeting unlisted companies, debt instruments for which a buyer cannot be easily identified, real assets that require significant initial investment, small and medium sized enterprises (SMEs), and the Pan European Pension Fund a voluntary personal pension label designed to give savers more choice. They should all help to channel more savings into long-term investments in the EU.

Financial institutions have also benefited from significant regulation reliefs. The Solvency 2 delegated regulation was amended to remove barriers to investment in the EU and to channelling capital into infrastructure and long-term sustainable projects. Qualifying infrastructure investments will now form a distinct asset category and benefit from a lower risk calibration. The Commission also proposed to include a new category ("infrastructure corporates") in the assets that can benefit from a lower risk calibration, as will also European Long-Term Investment Funds (ELTIFs).

Supporting factors (i.e. targeted reductions of regulatory capital charges) have been introduced to alleviate SME and infrastructure bank financing capital charges. A framework defining Simple Transparent and Standard securitisations is being agreed upon, which should facilitate the off-loading of bank balance sheets and consequently ease the financing by banks.

4. A profound evolution of the financial landscape is underway

Finally, a profound evolution of the financial landscape is underway, which is expected to reduce the role of banks and further involve Insurance undertakings, Investment and pension funds. The Commission is indeed seeking deeper and more integrated capital markets in the EU to provide businesses with a greater choice of funding at a lower cost and offer new opportunities for savers and investors notably in a context where a reduction of the involvement of banks in the financing of the economy is still considered as necessary in order to make the financial system more resilient.

However, this partial withdrawal of banks raises the concern that smaller enterprises and infrastructure project sponsors, will find it difficult to have access to new funding sources the demands of which are of a different kind (higher amount, specific maturities, greater level of remuneration, additional transparency, etc.). In this context EU and National Promotional Banks will play an increasing role in identifying financing needs throughout the EU and in contributing to supplying effectively bankable projects and investments. ■

Green and sustainable finance

The political and regulatory environment has not been disrupted by President Trump's declaration that the USA will withdraw from the Paris Agreement. All the other countries have confirmed their commitments, notably at the G20 meeting in Hamburg in July, and even within the United States, many states, major cities and private sector leaders have done the same.

The momentum for the development of green and sustainable finance is continuing to move forward, as illustrated by the increase in volumes on the green bond market and the new initiatives rolled out in the private and public sectors, including on the regulatory and supervisory side.

Two important developments are taking shape with this new public-private cooperation that EUROFI has called for since COP 21:

- Many companies worldwide have committed themselves to implementing the FSB Disclosure Task Force's recommendations;
- The High-Level Expert Group (HLEG), created by the European Commission in December 2016, published an interim report in July with a first set of recommendations submitted for consultation.

1. Positive market developments:

The green bond market is continuing to grow: after $42bn of total issues in 2015 and $80bn in 2016, it is expected to climb to over $100bn in 2017. The issuing of a €7bn green bond by France with a maturity of 22 years was an important and positive development, and confirmed the very high level of demand for green bonds, as this issue was oversubscribed; it should pave the way for other sovereign issuers, including in emerging countries, to follow. The market has also matured, with bonds from a growing number of countries (24), different types of bonds, issuers, ratings and the use of proceeds. Investors with and without a green mandate are showing interest in this market, with operations frequently oversubscribed.

Public funds are supporting the financing of projects, notably the European Fund for Strategic Investments (EFSI) managed by the European Investment Bank (EIB), which aims to unlock up to €315bn of investment in combination with private funds and which will have at least 40% of its funds contributing to Paris Agreement goals.

The World Bank and the EIB have launched new initiatives to have more investment projects and match them with finance, especially in countries that are not yet engaged in sustainable finance: the World Bank in relation to emerging and developing countries, and the European Investment Bank in Europe (which has created a specific European Investment Advisory Hub to build a pipeline of projects and provide assistance). The IFC, the arm of the World Bank focused on the private sector, and Amundi, a leading European asset manager, have created the largest dedicated green bond fund for emerging markets – a $2bn initiative that aims to deepen local markets and expand financing for climate investments.

All these developments are positive, but the total volume of green or sustainable finance is still low compared with the financing needs and the overall size of the markets. Over the next two decades, Europe needs around €180bn of additional investment annually. The amount issued on the green bond market this year will represent 1% of the total bond market worldwide.

2. Regulatory and supervisory side: disclosures

The FSB has adopted the report of the task force chaired by Michael Bloomberg, which was published in December 2016 and defined a set of recommendations for common, voluntary climate-related financial disclosures and provided guidance to help companies, particularly in the financial sector. More than 100 companies globally, with a combined market capitalisation of around $3.5tn, and financial institutions responsible for around $25tn of assets, have pledged their support. Governor Carney welcomed these developments, writing: "Climate change presents risks...but it also presents opportunities that wise chief executives and investors will capitalise on. The solution provided by the task force recommendations is by the market for the market. And by acting in their own interests, leading companies, banks and investors from across the G20 are helping society address one of the gravest challenges we face"[1].

The task force's mandate has been renewed for one year to provide assistance for companies that will implement its recommendations and to monitor disclosures.

A number of institutional investors, notably pension funds and sovereign funds, already disclose data about their portfolio and more specifically in relation to climate change and ESG (environment, social, governance) principles. These publications have enabled the WWF (World Wide Fund for Nature) to assess the equity portfolios of European funds in Nordic countries and the Netherlands with regard to a 2° strategy compatible with the Paris Agreement. This research concludes that these funds have invested well in clean energies, but not divested sufficiently from fossil energies[2].

In France, Article 173 of the 2015 Energy Transition Act requires institutional investors to disclose, for the first time at June 30, their strategy to take climate change into account in the management of their portfolios. The assessment of these first disclosures will certainly provide interesting information and input for all financial institutions and corporates.

3. European Commission High-Level Expert Group (HLEG) interim report:

In December 2016, the European Commission appointed the HLEG, chaired by Christian Thimann, who is also Vice-Chair of the FSB Disclosure Task Force. This group's mandate is to provide, by the end of 2017, recommendations for a comprehensive EU strategy on sustainable finance as part of the Capital Markets Union.

The HLEG published an interim report in July 2017 with a first set of eight recommendations and their preliminary views on other issues.

The eight recommendations are as follows:

1. A classification system for sustainable assets: an EU classification system of financial products that captures all acceptable definitions of "sustainable"; it will initially focus on climate change given the considerable progress in this area;
2. A European standard and label for green bonds and other sustainable assets, as well as a label for sustainability funds;

3. Fiduciary duty that encompasses sustainability: "the responsibility of directors and investors to manage long-term sustainability risks should be enshrined in their relevant duties, whether it is through fiduciary duty in common law or its equivalent in other legal systems"
4. Disclosures: "investors should provide forward-looking analysis on how their portfolios are aligned with the energy and environmental transition, potentially via mechanisms comparable to France's recent Energy Transition Law, Article 173"; "the 2018 review of the Non-Financial Reporting Directive represents an opportunity"; "the disclosure rules should be principle-based and leave room for flexibility and innovation across four key elements: governance, strategy, risk management, and metrics and targets";
5. A sustainability test in financial legislation to ensure that sustainability is embedded across all future EU financial regulations and policies;
6. Create "Sustainable Infrastructure Europe", a dedicated advisory and "match-making" facility between public authorities (including municipalities) and private investors, which could be housed within the EIB (the European Investment Advisory Hub is considered too small given the number of potential investment projects across the EU);
7. Position the European supervisory agencies on sustainability: "the current review of the ESA operations provides an excellent opportunity to clarify and enhance their role in assessing ESG-related risks...even without changing their current mandate".
8. Accounting standards for energy efficiency: "Eurostat's interpretation of public sector accounting standards on energy efficiency needs to be improved".

In addition to these policy recommendations, the HLEG is working on other policy areas which require further analysis and discussion, such as:

- The early definition by 2018 of the EU's 2030 and 2050 climate and energy goals;
- Improving the governance of financial institutions on sustainability matters;
- Integrating sustainability in ratings;
- Integrating sustainability more effectively in accounting standards;
- Improving the sustainability benchmarks;
- The use of green-supporting factors or brown-penalising factors for banks;
- The investigation of the possible implications of Solvency II for insurance companies;
- Increasing the "pipeline of sustainable projects for investment".

This report and its recommendations in particular have been submitted for consultation until September. A one-day hearing in Brussels in July revealed a good level of support for most of the recommendations, especially from green lobbyists and experts, but some reluctance among regulators (for instance on fiduciary duty) and private market stakeholders (for instance on classification and labels).

1 Financial Times

2 WWF Report: European asset owners: 2°C alignment and misalignment of equity portfolios, June 2017

Improving transparency to develop sustainable finance

1. Facilitating the financing of the transition towards a more sustainable economy is challenging

Indeed, investors, lenders, insurers and project sponsors need useful and understandable information notably regarding climate-related issues, in order to make informed capital allocations and financial decisions, while regulators need to understand the risks that may be building up in the financial system.

Eventually, this information will make it easier to have access to capital by increasing investors' and lenders' confidence, and extending the awareness and understanding of climate-related risks and opportunities within companies and among market participants.

This information to be effective and useful, has to constitute a real common language in order to facilitate decision making, streamline negotiation and transactions, and build a holistic view of climate-related issues.

2. Mainstreaming an effective common language

Such an effort requires notably defining systematic and standardised information regarding the financial impact of climate-related risks and opportunities on a given organisation, and the environmental impact of a given investment that an organisation is planning.

These are the respective objectives of the Task Force on Climate-Related Financial Disclosures (TCFD) and the

Green bond principles. The two related challenges faced by both initiatives, are to define an appropriate common language and to eventually mainstream it.

The Task Force on Climate-related Financial Disclosures issued in June its recommendations.

It proposed a set of disclosures on four areas: governance of climate-related risks and opportunities; actual and potential strategic business and financial impacts of climate-related risks and opportunities; processes used to identify, assess, and manage climate-related risks; the metrics and targets used to assess and manage relevant climate-related risks and opportunities.

The next step it proposes, is to define the appropriate timeframe that can successfully mainstream these disclosures. The approach envisaged is to reduce progressively the size of the corporates providing disclosures within their financial statements and filings, and to refine progressively the accuracy of the descriptions of issues specific to each of them, until these descriptions encompass the relevant metrics and anticipated impacts of the climate-related scenarios defined by the Task Force.

The final features of the mainstreaming timeframe are a holistic view of the concentration of carbon-related assets, as well as a mapping of the exposure of the financial sector to climate-related risks.

3. Green bond principles are essential to provide the necessary transparency to investors

Similarly, the Green Bond Markets (GBM) which are intended to finance not only a climate-related transition but more generally the investments required to achieve a more sustainable economy, are underpinned by Green Bond Principles (GBP), the role of which is to enable an adequate evaluation of the environmental impact of the projects financed, on the basis of common standards. By providing transparency at the level of each project financed, the green bond approach is complementary to the TCFD one, which is entity-based.

Green Bond Principles are voluntary process guidelines that enhance transparency and disclosures on environmental aspects, i.e. they help to define what is green and avoid the so called green washing. They help one in particular to refocus from a short-term consideration related to investment opportunities, toward their long-term sustainability risks and opportunities.

The challenge there, is again to mainstream such principles and standards. Indeed, Green Bond Markets need a massive increase. Today, although the development of the Green Bond Market among some sovereign issuers (France and Poland), currently green bonds represent less than 1% of total world bonds . Thus the Green bond market at this stage does not yet give full access to all the benefits expected from effectively efficient markets e. g. sustainability and cost efficiency of the asset class, optimal risk assessment, benchmarking…

4. The proposals of the HLEG regarding sustainable finance

According to the interim report of the EU High Level Expert Group on sustainable finance, to achieve such large scale effects in the EU, stock exchanges need to be further involved and the creation of green financial centres should be envisaged, which "have a key role to play in promoting the growth of sustainable finance and the disclosure of material information related to sustainability. They can also support the integrity and growth of the green bond market by encouraging the development and application of robust standards."

There the report goes further by stating that "many initiatives have moved from an initial focus on stock markets and green bonds to a more systematic approach focused on developing an ecosystem of products, services and expertise around sustainable finance." This raises also the question of the expected role notably of public EU and domestic banks, rating agencies, etc.

More generally, the interim report stresses the need of an "EU system of classification of financial products that captures all acceptable definitions of 'sustainable', taking into account existing principles established such as Green bond principles".

Furthermore, it highlights the fact that "trust in the market for sustainable financial products" requires also defining "credible EU labels and quality standards", a need that is reflected in the initiatives taken by some member states (TEEC in France…), which might go beyond the Green Bond approach, by possibly proposing to qualify, compare, etc. the relative added value of projects in terms of sustainability, in addition to the transparency provided by Green Bond principles.

Furthermore, it highlights the fact that "trust in the market for sustainable financial products" requires also defining "credible EU labels and quality standards", a need that is reflected in the initiatives taken by some member states (TEEC in France…), which might go beyond the Green Bond approach, by possibly proposing to qualify, compare, etc. the relative added value of projects in terms of sustainability, in addition to the transparency provided by Green Bond principles.

The possible need for labels and quality standards to be defined at the EU level, illustrates the fact that at this stage one appropriate issue is whether market-led initiatives would be sufficient to bring green financings to the level of development required or whether public action is required. Part of the reflexion concerns in consequence the expected role of respectively EU regulatory and market-led standard setting initiatives. These issues require political clarification and options.■

2. DIVERSIFYING THE FINANCING OF THE EU ECONOMY

Accelerating the CMU: which priorities following the mid-term review?

1. Progress made in the implementation of the CMU action plan

The Capital Markets Union (CMU) project was designed as an EU-wide project aimed at developing EU capital markets in order to connect savings to investment, enhance private risk-sharing and foster growth by providing alternative sources of financing for SMEs and infrastructure projects. The Action Plan of September 2015 set out the actions necessary to put in place the building blocks of CMU by 2019.

20 of the 33 actions of the Action Plan have been delivered by the EU Commission (EC) – i.e. the corresponding legislative frameworks have been adopted and are in the process of being implemented - including the modernization of prospectus rules, a framework for simple, transparent and standardized (STS) securitization, revised rules for venture capital fund passports, revised prudential rules for insurance companies investing in infrastructure projects, rules on preventive restructuring and second chance for entrepreneurs. The remaining actions of the 2015 Action Plan have been initiated and are due to be completed by the end of 2019. Among these, three key legislative proposals should be completed by the beginning of 2018: a proposal on a Pan-European Pension Product (PEPP) was published in June 2017, a legislative proposal specifying conflict of laws rules for third party effects of transactions in securities and claims is due to be published in Q4 2017 and an EU framework for covered bonds will be proposed in Q1 2018.

2. New priority measures defined following the mid-term review

Following the mid-term review of the CMU initiative conducted at the end of 2016, a set of new priority measures was defined with a focus on simplifying cross-border investment, developing capital market ecosystems throughout the EU and addressing additional dimensions of the development of capital markets (supervision, technology, sustainable investment…):

- Improving the effectiveness and consistency of the supervision of capital markets at the EU level through a review of the functioning of the European Supervisory Authorities
- Ensuring a more proportionate regulatory environment for IPOs for SMEs seeking to raise less than EUR 100 million on public markets
- Supporting the development of local capital market ecosystems throughout the EU (e.g. with technical assistance provided by the EC)
- Removing the regulatory barriers to the cross-border distribution of investment funds in the EU (e.g. marketing, administrative and notification requirements, regulatory fees, barriers to online distribution)
- Harnessing the potential of fintech to transform business models in asset management, investment intermediation and product distribution by proposing more proportionate licensing arrangements (e.g. for crowdfunding) and a passporting framework
- Shifting private capital towards sustainable investment through measures to improve confidence in such investments and an appropriate regulatory recognition of the risk-return performance of these assets
- Improving the functioning of secondary markets for NPLs with more predictability and transparency.

3. Main implementation challenges

A hard Brexit with no specific EU-UK trade agreement regarding financial services could be a significant challenge to the deliverability of the CMU, due to the current dependence of EU capital markets on UK-based counterparties and financial services provided by the City. It is however also an opportunity to further develop and integrate EU27 capital markets. A question in this regard is therefore whether the EU27 countries are able to coordinate their efforts towards building stronger EU capital markets and strengthening the consistency of their supervision. This is particularly important for wholesale and derivatives–related activities, which are mainly based in the UK at present and for funding sources that are essential for SMEs such as venture capital or IPO capabilities, A first issue is whether the expected transfers from the City will help to achieve a better allocation of capital market activities across the EU and whether the rules proposed by ESMA to avoid letter box entities and regulatory arbitrage across Member States will be effective. The third-country dimension of CMU-related EU regulations also needs to be considered in the Brexit perspective.

Another issue is whether the CMU action plan can be implemented fast enough and with a sufficient level of ambition to achieve CMU objectives. Although many new rules and frameworks part of the CMU action plan have been or are in the process of being adopted, actually implementing them and reaping their full benefits in the market may take time and requires strong momentum. Improving the effectiveness and consistency of the supervision of capital markets at the EU level will help, by facilitating a consistent implementation of CMU actions throughout the EU, but the success of the CMU is also very dependent on the commitment of Member States (e.g. in dismantling barriers) and of the industry (in implementing and leveraging these new measures). This is acknowledged by the EC - the technical assistance that is being proposed by the EC to an increasing number of Member States to support the development of their local and regional capital markets is an example of this and efforts made to provide tools to closely monitor the progress made with the implementation of the CMU is another illustration – but involving effectively Member States and the industry in the implementation of the CMU remains challenging. Some observers have suggested in this perspective that the CMU approach could be streamlined in order to focus it, at least in the short term, on a smaller set of key measures likely to drive significant progress (e.g. regarding the financing of SMEs and long term projects), given the potential difficulty of implementing in a timely and effective way a wide toolbox of measures.

A further issue that is currently being tackled but deserves continued attention are the unintended consequences of other regulatory requirements (e.g. banking and insurance prudential rules) that may hinder the implementation of the CMU by affecting notably market-making activities or the investment capacity of institutional entities. ■

Can the asset management industry provide new forms of financing for the EU?

The development of asset management in the EU is a key element of the Capital Markets Union (CMU) action plan. Investment 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 throughout Europe.

1. Despite significant growth of the EU asset management sector, improving its competitiveness remains a significant challenge

EU frameworks cover most investment needs. UCITS funds have been a longstanding success in Europe and internationally, both with retail and institutional investors, and AIFMD provides a consistent set of rules for the safe provision of AIFs to professional investors in Europe. These frameworks have been completed with more specific products (ELTIF, EuVECA, EuSEF) targeting long term investment and with specific rules for MMFs. Since the 2008 crisis, the assets held by investment funds have doubled in the EU. However, the competitiveness of the EU fund sector still needs improving.

The main challenge is the persistent fragmentation of the EU fund market, which counts a high number of funds of a relatively small average size (notably compared to the US). This fragmentation, which increases management costs and lowers potential investor returns, is due to multiple factors. Some issues may be tackled by stronger supervisory convergence at the EU level (i.e. differing implementation of UCITS rules across EU jurisdictions, coexistence of domestic frameworks with EU ones), but others are more structural (e.g. prevalence of closed distribution models, fiscal issues).

A second issue is making sure that the EU market evolves towards a product structure that allows an effective allocation of capital. Developing the new fund categories aiming to support long term investment and SME funding (ELTIF, EuVECA, EuSEF…) is a first objective. Prudential rules related to investment in these funds have been improved, but further investor education about their liquidity characteristics may be needed as well as tax incentives. Another question is whether the development of simpler and cheaper products should be favoured and how to achieve this.

Cheaper passive funds such as ETFs for example have been growing very rapidly in the EU over the past few years, but they still only represent a relatively limited share of the market in the EU compared to the US.

Finally, the third-country dimension of EU fund frameworks and the potential impacts of Brexit are another issue to be considered. Specific rules have been proposed by ESMA aiming to avoid letter-box entities and to mandate that sufficient substance requirements are met in the EU in the perspective of possible post-Brexit relocations. Many industry players are however concerned that an excessive application of such rules might impact the current industry structure, e.g. restricting the ability to outsource certain portfolio management activities outside the EU. Pending questions are also whether the consistency of third-country rules of UCITS and AIFMD needs improving and the possibility of third-country AIFMD passports.

2. Developing cross-border fund distribution in the EU is another key challenge being addressed in the CMU

Cross-border fund distribution is still relatively limited in the EU, despite UCITS and AIFMD passports and harmonized MiFID rules. This potentially reduces competition and choice for investors and increases their costs. Although 80% of UCITS funds benefit from a passport, the proportion of funds actively marketed across borders is significantly lower. One third of funds with a passport are only sold in one Member State in addition to their home country and another third is not sold in more than 4 Member States outside their home country.

Following a mapping of the main regulatory barriers to UCITS and AIF cross-border distribution, possible policy options (simplification and harmonisation of certain requirements, definitions or processes, centralisation of certain activities or processes at EU level, prohibition of certain specific domestic requirements…) have been identified in five main areas, with a view to considering a possible legislative proposal in Q1 2018: (i) Marketing requirements, (ii) Administrative requirements, (iii) Regulatory fees, (iv) Notification requirements, (v) Online distribution.

The existence of other barriers related to distribution model and investor confidence issues has also been emphasized.

A first issue is the prevalence in Europe of integrated or closed distribution models, primarily bank networks, which mainly distribute in-house products. A possible solution could be to facilitate the development of open architecture distribution supported by digital solutions, which involves, from a policy standpoint, notably reducing possible barriers to the development of fintech solutions across Europe (e.g. possible need for more proportionate licensing arrangements and for a specific passporting framework) and ensuring that appropriate investor protection can be ensured.

Another issue is the lack of investor confidence with regard to foreign funds resulting in a frequent bias in favour of local products. This may be addressed with appropriate information, marketing material and efficient supervision. But improving financial literacy is also essential. Some actions have been initiated (e.g. exchange of best practices on financial literacy programmes), but a stronger focus on this objective is needed, many believe, as well as a clarification of the respective roles of the public and private sectors in this regard. ■

CRD V / CRR II pending issues

1. Making EU bank rules more proportionate and less burdensome

In November 2016, the EU Commission presented a banking reform package, which aims to complement the reforms that the EU implemented in the wake of the financial crisis (the so-called Basel III). Although the bill targets many improvements in different areas e.g. further harmonisation and consistency across the EU by reducing national discretions, deepening the single market by considering cross border banks as a single entity, etc., this is primarily an almost final contribution to the implementation of Basel III in the EU.

On this occasion the EU Commission is also considering some means to make EU bank rules more proportionate and less burdensome for smaller and non-complex banks. Indeed, in the reform package the Commission undertakes to define whether there is a case to distinguish between large and small banks and drafts proportionate approaches.

In particular the Commission focuses on a reduction of the burden on smaller institutions in all the recent reform areas of the CRR/CRD, notably it has proposed a variety of relief measures and related thresholds.

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

The first – the work being done by the EU Commission - is a detail-driven approach, which introduces special exceptions or adjustments on a rule by rule basis. The other one is the creation of separate specific and dedicated regulatory frameworks for smaller or medium-sized institutions in addition to the framework specific to large multinational institutions, which would only be subject to the fully loaded Basel III requirements in the EU.

Nevertheless, there is also room for improvement in reducing the complexity of the reporting and the regulatory burden regarding larger banking groups in the EU.

2. Accounting for the specific vulnerabilities and business model of each financial player in order to facilitate the provision of the necessary funding for the economy

Another topic which raises comments is related to the evolution of the Pillar 2 of the banking regulation and stress testing regulatory approaches in particular.

Currently Pillar 2 is bank-specific and based on the bank's own assessment of its risks. In this perspective each financial institution in addition to a common scenario, defines its own stress test scenarios, in order to fit appropriately with its risk profile accounting for its specific vulnerabilities and business model. It is on this basis that the institution will define the necessary evolutions of its own funds to be envisaged. These bank-specific stress tests are also essential for the credibility of the outcome of internal risk-models.

However, notably for resolution planning reasons, pillar 2 processes and stress testing, might become more standardised. This is however often considered as threatening the consistency of the overall bank regulatory architecture.

The proposed bill of the EU Commission is also trying to address some regulatory issues reducing the ability of the EU banking institutions to provide the necessary funding for the economy and in particular for SMEs and infrastructure projects, and to facilitate trade finance generally.

Indeed, this bill comes after the publication by the EU Commission of the results of Call for Evidence on EU financial services - a public consultation looking at the cumulative effect of the new financial sector rules put in place since the crisis. Although this report, according to the Commission, confirmed that the overall framework is working well and consequently, the overall financial services framework does not need to be changed, however, "targeted follow-up actions to fine-tune the framework" were proposed, among which figured removing unnecessary regulatory constraints on financing the economy, enhancing the proportionality of rules and reducing undue regulatory burdens.

3. Banks are still expected to play a key role in sustainable financing

It is even more important that the High Level Expert Group on Sustainable Finance, has recommended in its interim report, the reforming of the EU's rules and financial policies in order to facilitate green and sustainable investment. The report considers in particular that, as the largest asset pool in the EU, banks are still expected to play a key role in sustainable lending. Yet the Expert Group stresses that there is still the perception among banks that the current capital framework charges some lending operations and long-term exposures more than is warranted by risk considerations, since intrinsic recovery values of infrastructure are higher compared with corporate debt.

4. Economic growth and financial markets' activity is a general concern which may trigger regulatory consistency issues across the regions

In the US, the Executive Order 13772 on February 2017, required the US Administration to comply with a set of explicit Core Principles to regulate the United States financial system. Among these principles feature the necessity to "prevent taxpayer-funded bailouts", the need to "foster economic growth and vibrant financial markets" and to "enable American companies to be competitive ". Finally, the US Administration has to "advance American interests in international financial regulatory negotiations and meetings".

Last, in July 2017 the FSB issued its Framework for a Post-Implementation Evaluation of the Effects of the G20 Financial Regulatory Reforms intended to guide analyses of whether these reforms are achieving their intended outcomes and help to identify any material unintended consequences. Indeed, the FSB considers that with the main elements of the post-crisis reforms agreed and the implementation of core reforms underway, an initial analysis of the effects of these reforms is becoming possible. The intention is to determine whether any additional action is required in the light of sufficient evidence.

The conceptual and methodological challenges related to such assessments are huge. Various qualitative and quantitative tools will be developed among which specific metrics will be developed to identify issues and trends pertaining to the reforms, as well as any regulatory gaps.

Particular attention will be given in addition to overall results, to the effectiveness of individual reforms and to the interaction and coherence of their consequences.

On this basis FSB evaluation reports will be approved by the FSB Plenary before consultation and before publication. The final responsibility for deciding whether and how to amend a particular standard or policy remains with the body that is responsible for issuing that standard or policy.

All in all, the multiplication of policy or regulatory regional and global initiatives redefining the objectives of the banking regulation and assessing their impacts even if they should most likely lead to targeted evolutions, raises many issues regarding the consistency of international standards going forward, the coordination of their review, and the level playing field at the global level. ■

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

In November 2016, the EU Commission presented a banking reform package, which aims to complement the reforms that the EU implemented in the wake of the financial crisis (the so-called Basel III). Although the bill targets many improvements in different areas e.g. further harmonisation and consistency across the EU by reducing national discretions, deepening the single market by considering cross border banks as a single entity, etc., this is primarily an almost final contribution to the implementation of Basel III in the EU.

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

1. FRTB: architectural and calibration issues potentially weigh on market activities

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

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

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

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

More fundamentally, the architecture of the framework – i.e. the usage of both internal models and the standardised, extensive back-testing, etc. - is proving extremely complex and costly due in particular to the need to enhance the scope, the form and the amount of data to store and process, in order to define the various sensitivities needed to feed such an approach, specially on a desk by desk basis. Such complexity seems to go against the objective of defining a framework combining simplicity, proportionality and risk sensitiveness.

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

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

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

2. NSFR: will proposed adaptations of the global framework to EU specificities, suffice to achieve adequate financing to the economy and financial stability?

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

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

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

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

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

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

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

3. Multiple initiatives globally to assess the actual impact of bank regulations

Meanwhile, in the US, the Executive Order 13772 on February 2017, required the US Administration to comply with a set of explicit Core Principles to regulate the United States' financial system.

Among these principles feature the need to "foster economic growth and vibrant financial markets" and to "enable American companies to be competitive ". Finally, the US Administration has to "advance American interests in international financial regulatory negotiations and meetings".

As a backdrop, in July 2017 the FSB issued its Framework for a Post-Implementation Evaluation of the Effects of the G20 Financial Regulatory Reforms intended to guide analyses of whether these reforms are achieving their intended outcomes and help to identify any material unintended consequences. Indeed, the FSB considers that with the main elements of the post-crisis reforms agreed and the implementation of core reforms underway, an initial analysis of the effects of these reforms is becoming possible. The intention is to determine whether any additional action is required in the light of sufficient evidence.

The conceptual and methodological challenges related to such assessments are huge. Various qualitative and quantitative tools will be developed among which specific metrics will be developed to identify issues and trends pertaining to the reforms, as well as any regulatory gaps. Particular attention will be given in addition to overall effects, to the effectiveness of individual reforms and to their interaction and coherence.

On this basis FSB evaluation reports will be approved by the FSB Plenary before consultation and before publication. The final responsibility for deciding whether and how to amend a particular standard or policy remains with the body that is responsible for issuing that standard or policy.

All in all, the multiplication of policy or regulatory regional and global initiatives redefining the objectives of the banking regulation and assessing their impacts, raises many issues regarding the consistency of international standards going forward, the coordination of their review, and the level playing field at the global level. ■

Review of Solvency II

1. Number of elements of Solvency II deserve reconsideration

In December 2016, EIOPA started the post-evaluation of Solvency II as was foreseen in the Directive and related Delegated Acts. In this perspective the EIOPA issued a consultation paper.

The objectives of this process, which focuses on the SCR standard formula and should notably account for the recent call for evidence on EU financial services published in November 2016, are to ensure further proportionate, risk-sensitive and consistent supervisory regimes for the insurance sector and, when adequate to propose possible simplifications.

Furthermore, a feed-back from the full scale test, provided by the roll out of the regulation is also very instructive and should enable one to appropriately adjust the design and calibrations, and to simplify and make consistent all the methodologies applied in each sub module.

Many answers to the consultation provided by the industry underscore a number of elements in the Solvency II package that deserve reconsideration by policymakers. Indeed, as for any sophisticated regulatory framework, a significant number of parameters and assumptions had to be agreed upon in particular in economic conditions such as the persistent low interest rates environment. In addition, certain inappropriate comparisons with the banking sector (own funds in insurance and banking sectors) have also to be withdrawn to effectively preserve a full consistency with the specificities of the insurance sector.

2. A central challenge remains how to foster longer-term orientation in finance

Yet, although the Long-Term Guarantees Measures (LTG) and Measures on Equity Risk which complemented the Solvency II framework, were supposed to be reviewed two years after the review of the Standard Formula of the solvency framework, one essential issue was raised in the interim report of the EU High Level Group on Sustainable Finance, which was whether finance needs to change to move the economy towards the desired sustainable model. The report stressed that this implies adjustments to financial regulation, as well as changes in financial market practices, norms and behaviour.

Actually, one of the central challenges in this respect is how to foster longer-term orientation in finance and the wider economy, and attenuate impatience in finance and avoid decision-making, in particular regarding investments, based on too close horizons.

In this respect the report stresses that the market-consistent evaluation of assets and liabilities is equivalent to the assumption that all the assets and liabilities of an insurance company should be available for trading at any time, and warns that this does not contribute to the long term view of the insurance sector.

Nevertheless, in the Solvency II framework, the LTG precisely aims at attenuating such volatility and pro-cyclicality, in particular in a challenging macro-economy. The EIOPA will be regularly monitoring and informing on the use and impacts of LTG and Equity Risk measures, as well as on the financial position of insurers. The results of its first report show that:

- 901 insurance and reinsurance undertakings in 24 countries with a European market share of 69 % used at least one of the measures.
- 852 undertakings with a European market share of 61% used the volatility adjustment.
- 154 undertakings with a European market share of 24% applied the transitional on technical provisions.
- 38 undertakings with a European market share of 16% used the matching adjustment.
- The transitional on risk free interest rate was used by six undertakings and the duration-based equity risk sub-module by one undertaking.

The EIOPA report concludes that the Long-Term Guarantees Measures have had a significant impact on own funds and the capital requirements of insurers. For those undertakings surveyed that used the package (69%) the ratio with these measures is 193% while the ratio without them would have been 121% i.e. removing the measures would result on average in a reduction of the Solvency Capital Requirement ratio of 73 percentage points.

In other words, in the current challenging economic context these countercyclical arrangements effectively enabled insurance companies to stabilize their investment and reduced the risk of forced asset sales.

However, in the meantime, the fact that only one undertaking used the duration-based equity risk sub-module, which is suitable for those having long - beyond 12 years - liabilities and consequently investing in equities, suggests that insurance companies are not yet involved in all long-term market based financing tools and have to be further incentivised to contribute to the Capital Market Union.

3. Improving the equilibrium of the framework between financial stability and an adequate financing of the economy

Finally, any adjustment that might be proposed to the solvency II framework, even for the mere standard formula, should not only preserve but ideally improve the equilibrium of the framework between financial stability and an adequate contribution of the insurance industry to the financing of the economy, which is the specific objective of the Capital Market Union project of the EU Commission.

This is notably why the industry is of the opinion that the key features of the interest rate sub module of the standard formula, should only be considered in the context of the revision in 2020 of the long term guarantee package, that complemented the Solvency II framework, in the context of the revision of the Omnibus II Directive. This should also be the case for the Ultimate Forward Rate (UFR) due to the very long term horizon considered in this proposed evolution.

The creation of a separate asset class under the Solvency II standard formula for debt and equity investments in infrastructure projects, which allows for a lower risk calibration, and the work started by EIOPA on investments on unrated debt and unlisted equities should also improve the capability of the insurance industry to become an essential participant in the Capital Market Union. Similarly, the urgent need to relaunch growth on the one hand, and to rapidly foster investment in sustainable assets at least to address climate-related challenges on the other hand, are raising the issue of an early revision of the LTG package.

However, the industry considers Solvency II as conservative compared to observed cash flows, in spite of the economic design of the regulatory framework. ■

3. TECHNOLOGY: OPPORTUNITIES AND CHALLENGES

Leveraging fintech in the context of the CMU

1. Fintech has the potential to foster radical change in the capital markets area

Technological innovation has been a key driver of progress in capital markets for decades but fintech solutions based on technologies such as Distributed Ledger Technology (DLT), cloud computing, big data, Artificial Intelligence... offer new opportunities that could foster radical change in the sector. Most of the practical applications of fintech being implemented or tested at present in the market are improvements of existing services / processes, but fintech may also help to build new business models and facilitates entry of new players in the market.

On the efficiency side, technology has the potential to significantly reduce costs and delays notably in areas where automation and standardization are limited. 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). So far however fintech is mainly being experimented in relatively niche processes and markets or for adding resiliency to existing processes or databases. 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... Finally, RegTech solutions based on fintech may also facilitate the supervision of capital markets, but these developments are still at an early stage and may require an adaptation of some supervisory approaches.

Other fintech solutions, often based on internet applications, aim to support effective interactions among key stakeholders in the financing value chain. 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.

Fintech solutions may also facilitate investment advice or the provision of standardized information on securities. Robo-advice usually combined with data aggregation and financial management tools is an example of this, allowing 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.

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

2. Supporting the development of fintech in capital markets is a key objective of the CMU

Achieving a connected digital single market is one of the key priorities of the Juncker Commission. Following the setting up of a fintech task force, the EC recently conducted a consultation in order to identify promising use cases for financial services (e.g. in asset management, investment intermediation and product distribution) and define the appropriate policy approach towards technological innovation. Four key policy objectives have been put forward by the EC: (1) Fostering access to financial services for consumers and businesses; (2) Bringing down operational costs and increasing efficiency for the industry; (3) Making the single market more competitive by lowering barriers to entry; and (4) Balancing greater data sharing and transparency with data security and protection needs. Three core principles have also been established in connection with fintech: technological neutrality on a 'same business, same risk, same rules' basis, proportionality and market integrity.

Other initiatives are being conducted at the EU level by the ESAs and the EU Parliament and at the global level by the FSB and IOSCO to evaluate the regulatory and supervisory framework needed for fintech. The EU Parliament in a recent report encouraged the EU Commission to present "a comprehensive Action Plan for boosting fintech in Europe", the suggested point of departure being the identification of legislative requirements that may cause uncertainties or barriers for its development.

Regarding capital markets more specifically, "harnessing the potential of fintech" is one of the new priorities of the reviewed CMU action plan. In policy terms, the main focus of the EC is on reducing barriers for fintech across Europe (i.e. assessing the need for more proportionate licensing arrangements or a specific passporting framework) in order to support the uptake of these solutions, while enhancing the integrity and security of the market. These actions could be building blocks of a broader EU approach to enable fintech, which seems appropriate to develop in addition to existing domestic initiatives (domestic supervisory approaches and frameworks such as sandboxes etc…) given the role that fintech can play in facilitating cross-border business. Fintech indeed does not need expanding physical presence and may facilitate many cross-border processes e.g. regarding the provision of information.

A continuous monitoring of emerging trends, opportunities and risks associated with fintech is also being conducted by the EC in order to maintain financial stability and preserve market confidence. So far assessments have not revealed major shortcomings in the application of existing market regulations (e.g. consumer protection) to fintech based processes, but potential risks need to be closely observed. Cyber-risk, which is likely to grow with the development of fintech, is a major challenge in this context and its mitigation will require continuous monitoring and the provision of appropriate tools, as well as a coordination of efforts at the EU and global levels. ■

Impacts of digitalisation on retail banking and payments

1. Digitalisation: the competitive landscape in the retail banking area

Technology and connectivity are enablers for accelerating the evolution of banking services. In addition, the internet and the associated software and infrastructure platforms have empowered small players – Fintechs. Indeed, technology has the potential to facilitate access to financial services and to improve their efficiency through disruptive innovation, which is the process by which a basic product or service targeting a portion of the value chain and a small consumer segment is introduced. Later on as the service becomes more popular, it gains much momentum and develops.

Against this backdrop, in addition to Fintechs, Alibaba, Tencent, Baidu, Facebook… with billions of users and customers and huge digital capabilities, are crowding into the financial area. Most of them have already obtained the status of "e-money" institutions. Amazon and PayPal for example are also in direct competition with banks targeting the small & medium enterprises (SME) sector. Their ultimate business model is to build on their ability to data mine individuals' information and sell ads thanks to it. Yet there will always be a trust barrier for them to overcome, since trusting any of the GAFA regarding elements of financial interests is something that should take some time to develop.

2. Developing the ability of incumbent banks to adapt

Incumbents have to depart from the rule that bigger is better. Current technology breakthroughs allow small players to exploit less costly modular platforms and services and to quickly build relationships with consumers.

For incumbent banks, an adaptive process would only lead to a "me too" investment, resulting in limited differentiation, favouring a progressive margin erosion. Rather, to succeed in this new context, financial institutions have to leverage technology and further differentiate products and services through significant investments in data and analytical capabilities. Indeed, this should lead them to dramatically increase customer understanding and insights in order to build and deliver tailored experience and services. The great advantage that incumbent financial institutions have in this regard is their large amount of data.

A key behaviour in this respect is to develop the internal ability to unfold a strategy supporting sustained innovation, transforming the organisation until it becomes "agile" enough to react (and ideally anticipate) swiftly and positively, to market challenges and disruption. Success will also depend on the ability of bank organisations to leverage tailored networks, which trigger lock-in through vertical integration and strategic partnerships.

In this context, the EU Commission is shaping an EU Action Plan intended to further empower consumers to switch more easily to better offers. One priority under this Action Plan, is to explore how the banking sector could make use of the eIDAS infrastructure to engage with customers from a distance, since a major step has been the Regulation of electronic identification and trust services (eIDAS) which enables consumers to be recognised via an electronic identification system and use their e-signature and other trust services across the EU Single Market. The general objectives here are to correct the high costs of some payments in Europe, to make lenders able to lend cross border, to empower consumers to switch more easily to better offers, and to tackle barriers that result from differences in national regulatory regimes…

3. New business models could lead to new risks

However new business models of financial service providers could lead to new risks related to consumer protection, regarding notably the provision of sufficient material to enable consumers to make well-informed choices. However, feedback to the Green Paper, in particular from industry, indicated that current pre-contractual disclosure requirements might not be fit for the digital world and need to be adjusted. In particular, mobile technology could enhance consumer understanding of financial products. Appropriate new solutions could help consumers gain a better understanding of financial products or services and make informed decisions. Cyber security needs are also magnified by digital disruptions.

Targeted consultations by the EU Commission would also provide feedback on the impact that new technologies are having on financial services in order to foster access to financial services, reduce operating costs and increase efficiency, lower barriers to entry and finally adequately balance data sharing, security and privacy.

Based on this public consultation, which ran until June 2017, and on the work of the FinTech Task Force, the Commission will present an EU strategy for FinTech, determining which actions are required to support the development of FinTech and a technology-driven Single Market for financial services.

4. Retail payments are leading retail banking digital transformations

In this context, the payment sector is a leader in this digital context, attracting new competition from alternative services providers. In particular demand for new payments schemes and services in a multichannel world is driving the need to be more efficient, with faster payment services. In particular instant payments are expected to facilitate the creation of innovative business models, based on speed, easier use, reliability.

The Eurosystem is intending to face up the growing demand for instant payments at the European level, and to avoid national solutions reintroducing fragmentation in Europe (instant payments are already available in Italy, the Netherlands, and Spain). It is also paving the way for consumers to make person-to-person mobile payments. Eventually it would be open to settling payments in other currencies.

The Eurosystem has launched an investigation to assess market participants' needs for instant payment settlement services with operating hours up to 24/7/365. The Eurosystem specified the user requirements for a potential new TARGET instant payment settlement service.

Instant payments are settled immediately meaning that the money is moved from the payer's account to the payee's account within seconds. Commercial banks will be able to use TIPS at a maximum price of 0.20 cents per payment for at least the first two years. Payment providers, meanwhile, will be encouraged to move towards instant settlement options from November 2017. ■

AML, KYC, data and competition challenges for digital banking

1. Leveraging digitalisation to developing innovation, further competition and consumer protection in payment and banking areas

The second Payment Services Directive (PSD2) is intended to make it easier to use internet payment services, but also to promote innovation in mobile and internet payment and information services. In this perspective, PSD2 opens the possibility that payment service providers and account information providers, can access the payment accounts of credit institutions - through application-programming interfaces (APIs) - in an objective, non-discriminatory and proportionate manner.

Since delivering these innovative services requires maintaining a satisfactory level of security, the PSD 2 imposes strong customer authentication to those providers accessing payment accounts, initiating transactions, and more generally carrying out actions through various and remote channels possibly facilitating fraud, money laundering, etc. risks. Finally, the Directive also makes any provider who fails to appropriately authenticate the initiation of any possible action, liable for related consequences.

Implementing the general Data Protection Regulation (GDPR) makes the situation even more challenging. Indeed, this regulation includes new requirements regarding the accountability, documentation, privacy reviews, and provides non-compliance fines.

Finally, the development of such innovative payment and information services, raises many challenges, risk and possible conflicts, since they create sets of possibly interfering, complex and fragmented interlinked value chains, which involve diverse service providers and institutions holding current accounts.

Nevertheless, the potential strategic impact may well go far beyond the challenges raised by the involvement of new service providers in the value-chains usually handled by incumbent banks.

2. Specific competitive strength of incumbent banks and their challengers

The implementation of PSD2 may also favour that incumbent banks and their current challengers, be actually challenged by GAFA (Google, Amazon, Facebook, and Apple) and BATX (Baidu, Alibaba, Tencent et Xiaomi) companies, with their own millions of loyal customers and related data. Data ownership is actual power. And specific and demanding regulations may eventually not be sufficient to protect the financial sphere from these powerful competitors.

Indeed, these incomers could leverage customer data to understand and target their customers better, tailor offerings and create new financial services and new business models (Uberisation) based on better anticipated demands and finally make better data-driven decisions. In particular those new financial players, could on the basis of these data, also better complete the necessary Customer Due Diligence, which enables banks to assess the extent to which a customer may expose them to a wide range of risks, including money laundering and terrorist financing.

Actually The 2017 BrandZ Top 100 Most Valuable Global Brands ranking shows Tencent, a Chinese internet group that launched one bank in 2014, ranking eighth. Alibaba, an ecommerce company that runs large money market funds and an online bank, rose four places to 14th. The four GAFA are within the first fifth, while the first banking group is fifteenth. Traditional banking groups in China are reacting. For example, the number 28 in the BrandZ ranking, ICBC, in addition to its own P2P platform, now runs an online shopping service similar to Alibaba's one.

Artificial intelligence including machine learning should enable banks to overcome many of these threats and help them to cut costs, while improving reliability and effectiveness. In addition, citizens at the moment trust traditional banks more than non-bank competitors. Last, Banks can combine physical interactions and digital experience. However, since many customers have recourse less and less to their usual digital banking services, the amount of data available to the institutions holding current accounts, might shrink progressively, reducing their ability to propose relevant services and develop new banking business models, notably those involving data valorisation. ■

Leveraging fintech in the insurance industry

1. In the insurance area, a digital transformation is also taking place

Currently, the financial area is facing a specific challenge, which is that technology is making it easier day after day to answer long-time unsatisfied customer expectations e.g. Improved customer experience, enhanced product attractiveness, personalisation, etc.

In the insurance area, digital platforms are emerging, electronic devices, vehicles etc. are starting to network through internet connections in the context of Internet of the Things (IoT), Big data and Artificial Intelligence are increasingly contributing to the further adjustment of risk profiles and prices, and favour cross selling... New products e.g. peer to peer or on demand insurance... are also emerging.

So far, across the insurance sectors these trends are apparently stronger in property and casualty, and health insurance sectors. Similarly, the impacts at this stage on the value chain are uneven: distribution and pricing are more impacted than marketing and claim processing.

Innovation involves the so-called Fintech - InsurTech in the insurance sector - since "technologically enabled financial innovation could result in new business models, applications, processes, or products with an associated material effect on financial markets and institutions and the provision of financial services" . This trend is significant though still emerging in the insurance sector. While in 2015 total global investment in Fintech amounted to USD19 billion, InsurTech only attracted USD2.5 billion.

The key success factor of InsurTech is that they have agile cultures and ways of working, they are focused on customer experience, are early adopters of new technology... Indeed, technology is an enabler only whenever an organisation is agile enough to think differently and absorb permanent innovation.

2. The digital challenges faced by incumbent insurance companies

Yet, for many reasons, technology, customer experience focus, etc. is precisely what incumbents have difficulty in managing. This is more than understandable when one considers to what extent the arrangements resulting from innovation - multichannel interactions (merchant web sites of diverse types, mobile phone, branches…), the addition of new functions (agents, aggregators, comparators, …), may question legacy IT, existing culture and possibly endanger existing organisations and stakeholders.

However, the insurance sector is actively reacting. The IAIS quotes a PwC report, which classifies the type of interactions they have with InsurTechs: incumbents are actively monitoring innovation and identifying emerging customer expectations and related risks, they often partner with start-ups and build pilot initiatives and in addition develop financing mechanisms in support of InsurTechs…

3. The insurance regulators have started their efforts to understand emerging digital issues

In any case these trends warned supervisors under the aegis of the IAIS, to start anticipating their likely consequences though they are still considered to be difficult to foresee since many technological innovations still need to demonstrate lasting and significant potential impacts and viability.

In the short term, regulators have started their efforts to understand the possible impact on emerging business models and offers ending in effective competition, risk selection and consumer choice. Similarly, a reflection appears to be necessary on data security and transferability. The increasing complexity of insurance value chains, or rather of the value chains involving insurance services, also imposes reflecting on the ability of supervisors to complete their task and the relevant definition of regulatory and supervisory perimeters. Interconnectedness and related systemic threats, are particularly important topics. ■

Addressing increasing cybersecurity risks

1. Efforts are being stepped up at the EU and global levels to tackle cyber-risks

Cyber-risks are drawing increasing attention due to their fast development, their potential operational and economic consequences and the impacts they may have on consumer trust in digital solutions. These risks are particularly acute and complex to fight in the financial sector, given the strong interconnections and interdependencies between multiple financial institutions, infrastructures and service providers.

Over the past few years the EU Commission (EC) has adopted a series of measures to raise Europe's preparedness to tackle cyber-risks. Since the adoption of the EU cybersecurity strategy in 2013 there have been significant EU investments for research and innovation in cybersecurity projects and cooperation has progressed within the EU and at the global level.

An EU wide legislation on cybersecurity, the Directive on security of networks and information systems (NIS Directive) was adopted in July 2016 in order to strengthen Europe's cyber-resilience and its cybersecurity industry. The Directive sets out principles to: (1) step up cooperation across European Member States; (2) support the emerging single market for cybersecurity products and services; (3) foster a better alignment of demand and supply for cybersecurity products and services and encourage the development of common, sector-neutral and replicable cybersecurity blocks (e.g. encrypted storage and processing, secured communication…).

The role of some EU bodies set up to foster cooperation is due to be reviewed, notably the ENISA agency which should also support EU countries in their work towards higher cybersecurity standards. The NIS Directive has moreover established coordination mechanisms among Member States regarding the exchange of information related to cyber-incidents and risks and the promotion of swift and effective operational cooperation on specific cybersecurity incidents.

Guidelines have also been defined at the global level in some areas, such as the CPMI-IOSCO guidance on cyber resilience for financial market infrastructures, which promotes sound cyber governance, the ability to resume operations quickly and safely following an attack and the implementation of effective intelligence and rigorous testing.

2. Cooperation and standardisation however need to progress further at the EU and global levels

Cyber-resilience and the interconnected nature of the financial system call for market-wide efforts and also for responses that go beyond IT and technology aspects. A first element is developing effective collaboration between market participants and the authorities concerned and also ensuring that coordinated or similar approaches are used notably in areas such as penetration testing. An appropriate balance should however be found between further standardisation and the preservation of sufficient adaptability and reactivity, which are important in such a diverse and fast-changing environment. This is why stakeholders generally support the principles-based approach of the NIS. Some however suggest that monitoring best practices at a more granular level could be helpful, as well as implementing more prescriptive requirements in some areas such as testing.

Another key component of cyber-resilience is the efficient sharing of information on threats which may be further facilitated with appropriate protocols (a common language and standards for dealing with cyber risk) and the use of automated information sharing. Information-sharing should also move beyond incident reporting towards the sharing of threat intelligence (details on the techniques used, the attackers...) and of effective responses. There is moreover a need to raise awareness within financial institutions at all management levels about cyber-risks, and also across the whole financial value chain, particularly when some activities are outsourced.

Finally, increasingly coordinated cyber-attacks at the international level such as the recent ransomware WannaCry attack and the cross-border nature of many financial activities and players emphasize the need for EU-wide and global cooperation. Some observers also advocate the setting up of a European capability to tackle rapidly attacks spreading across EU country borders, beyond the implementation of NIS principles in each Member State. A major issue in this regard is that EU countries differ in their cyber-readiness and cyber-security strategies and laws. Moreover well-resourced response teams are not available in each Member State, which makes the EU as a whole more vulnerable.

3. The impact of new technologies on cyber-resilience needs to be appropriately addressed

New technologies such as fintech, digitalisation and cloud applications are attractive because of their potential to reduce costs and bring about transformational change in the financial sector. However, digitisation and automation also contribute to extending the exposure of the sector to cyber attacks because they increase interconnectedness among actors and processes and introduce new – possibly unregulated - players into processing chains. Moreover, technology increases possibilities of direct access of customers to financial processes.

Although technology developments have not created so far significant stability problems in the financial sector, these new risks must be appropriately monitored and addressed in order to ensure that the benefits of innovation are not outweighed by additional vulnerabilities. The guidelines stated in the NIS and CPMI-IOSCO frameworks should help to address the risks related to fintech and digitalisation, although some issues might require further fine-tuning or prescription. This is the case particularly when activities are outsourced to third-parties outside the financial industry or happen in the cloud. The risks some concepts such as 'smart contracts' may pose in this context may also need further assessing. On the positive side new technologies such as artificial intelligence and big data may also support the fight against cyber-risk e.g. helping to perform an early detection of unusual behaviours. ■

4. WAY FORWARD FOR THE EUROZONE AND THE EU

Economic and financial priorities for relaunching the Eurozone and the EU

1. Fostering economic convergence in all parts of the Union for encouraging sustainable growth

Demographic decline, weak levels of productivity gains and economic growth, high levels of indebtedness and unemployment in some key Member States, major economic discrepancies among core Member States are the main impediments to the fostering of sustainable growth in Europe. The euro in itself and monetary policy cannot solve domestic structural problems. Only domestic structural reforms can solve structural weaknesses in EU countries, improve the business climate, raise output and productivity growth, reduce competitiveness problems and recourse to debt. This is also an essential precondition for attracting international investors in Europe.

In this perspective, ownership of the rules remains a key challenge in some Member States. A well-functioning monetary union needs a credible and sustainable fiscal framework. However, the policy convergence objectives between Member States have indeed proven partly illusory so far. A comparison between Germany and other EU countries such as France, Italy and Spain shows major economic and fiscal discrepancies that need to be addressed for achieving stronger growth in these countries and restoring trust between Member States. Indeed the rules of the Stability and Growth Pact have not been enforced sufficiently vigorously. They should be more binding, predictable and effective: Public debt ratios are very high in many euro area countries (e.g. France, Spain, Italy) and for some are still increasing. Additionally, many euro-area countries face deep-rooted structural weaknesses and imbalances.

The comparison between France and Germany shows major discrepancies. In France, the level of public debt compared to GDP is still increasing (almost 100% of GDP in 2016) while it is decreasing in Germany (70% in 2016). The budget is in surplus in Germany but is in deficit in France (3,3 % of GDP in 2016, 3% expected in 2017). Full employment is achieved in Germany (unemployment declined to around 5% of the labour force) while unemployment still stands at 10% in France. Industry and exports are successful in Germany but are declining in France: French export performance has deteriorated over the past 15 years. The current account balance is in deficit in France (0,2% of GDP in 2015) while the current account surplus reached in Germany 8.7 % of GDP in 2016. Real GDP growth in Germany stood at 1.9 % in 2016 while it declined to 1,1% in France in 2016. This is why France urgently needs to rebalance its public accounts in order to reduce the excessive level of tax and contributions which are detrimental to the competitiveness of French companies.

Italy, the third largest economy in the euro area is also experiencing excessive imbalances, which represent a major potential source of economic and financial spill overs for the rest of the euro area. Although some progress has been achieved by recent reforms (primary fiscal surplus, Job Act...), Italy needs to balance her efforts to increase potential output and reduce debt. A more ambitious approach to solving NPLs is also essential for encouraging recovery investment in this country.

Spain's economic recovery is one of the euro area's success stories in the recent economic crisis. Since 2012, business investment has picked up significantly and Spain's exports to its European partners have continued to grow. However political fragmentation and reform fatigue have delayed fiscal adjustment and impeded deeper structural reforms. Tackling long term unemployment (unemployment remains very high at around 19%) and labour market rigidities remain urgent priorities.

The European dimension can reinforce national efforts. Structural reforms could be coordinated at the EU level notably because several aspects of these measures have cross-border effects. Incentivizing compliance with existing rules should also be proposed and implemented for instance with a mutually-agreed contract, the costs of enforcement of which would be smoothed by financial support.

The symmetry of economic adjustments within the euro area should also be a priority focus. Germany's considerable trade surplus is not sustainable within a balanced monetary area. Within a monetary union, there must be a symmetrical adjustment mechanism in order to prevent long-run excessive balance of payment surpluses or deficits. The euro area is suffering from not having any such system in place, which creates economic and political tensions. The design of EMU presupposed that market forces would provide for fairly rapid self-adjustment. This has not materialised.

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

Once the deficit countries embark on the structural reforms needed to correct their competitiveness gap (reducing public spending in relation to GDP, reforming the job market, health systems, pensions, professional training, etc.), surplus countries would be expected to accept higher relative unit labour costs, be it through higher real wages or through higher price increases.

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

The rollout of such an economic expansion programme would benefit Germany's key trading partners provided that their industrial base could cope with this increase in demand.

2. Making the Banking Union a reality

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

To make progress, a pre-requisite is for all euro Member States to strengthen their fiscal positions and competitiveness but It is also essential to identify and address the concerns of host countries within the Banking Union if we want to improve the effectiveness of the existing pillars (SSM, SRM) of the Banking Union and complete it with an European Deposit Insurance Scheme (EDIS) and a permanent backstop to the Single Resolution Fund.

3. Leveraging savings to develop cross-border investment in the EU

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

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

In principle, in a currency area, the elimination of currency risk allows capital (savings) to flow from the countries with higher per capita capital and therefore higher labour productivity and lower marginal productivity of capital (for example Germany, the Netherlands and France) to countries with lower per capita capital, lower labour productivity and higher marginal productivity of capital (for example Spain, Italy and Portugal). The 2011-2012 sovereign debt crisis halted the circulation of capital flows between Eurozone countries and the European Union. However, during the decade from 2000 to 2010, Eurozone capital mobility funded primarily inefficient investments: budget deficits in Greece, Italy and Portugal, real estate bubbles in Spain and Ireland. In other words, the financing of sustainable cross-border investment has never properly taken place following the creation of the euro, particularly as there is no effective banking or financial integration.

Despite the success of the implementation of the Juncker plan, cross border investment flows remain limited. The return to fiscal solvency in all the EU Member States would have a decisive impact on accelerating the development of cross-border investment. Making the Banking Union a reality, encouraging cross border equity flows and more generally accelerating the implementation of the Capital Market Union are also in this perspective, of the essence.

4. Encouraging cross- border equity flows

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

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

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

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

The forthcoming revision of Solvency 2 also represents a key opportunity to suppress regulatory disincentives to long term financings. Other measures include the creation of MiFID growth markets, the review of prospectuses and the development of EU venture capital funds (EuVECA) to support the development of SME financing as well as efforts to improve investor information protection and financial literacy.

5. Brexit offers an opportunity to accelerate the implementation of the CMU

The departure of the largest non-Banking Union Member State is an opportunity for the EU27 to further develop and integrate their capital markets and increase the role they play in the financing of the EU economy. In this perspective it is essential to move towards a more efficient and consistent regulation and supervision of capital markets at the EU level which involves notably strengthening the powers of ESMA. Moreover the EU authorities have to monitor the transfer of financial activities from the City to the Continent in an appropriate way without creating financial stability or level playing field issues (e.g. avoiding letter box entities, encouraging an efficient organisation of financial markets in the EU and the Eurozone). ■

Deepening the EMU: when and how? *

2017 has seen Europe re-gain confidence both economically and politically. This favourable environment provides a window of opportunity for improving the resilience of the EU economy and tackling weaknesses in the euro area architecture, which requires completing the Banking and Capital Markets Union, making Eurozone fiscal rules more binding and creating a fiscal capacity. Monetary policy has supported growth to a certain extent but it cannot be a substitute for structural reforms, which are essential in many Member States to improve the business climate, raise potential output growth and reduce unemployment.

Despite some economic and institutional progress, the euro area still faces structural weaknesses and imbalances, which need to be addressed. A macroeconomic stabilisation and convergence function (or a limited fiscal capacity) without necessarily creating additional permanent transfers and without debt mutualisation could be envisaged in the euro area to better absorb the costs of internal adjustments of a Member State in case of an asymmetric shock and to support national structural reforms, provided that minimum and lasting economic convergence is achieved. In any case, developing ownership and incentivizing reforms remains a short run key priority.

1. Despite some economic and institutional progress, the euro area still faces structural weaknesses and imbalances, which need to be addressed

1.1. A monetary union without a sufficient degree of economic convergence is not viable

In the EMU, monetary policy is centralized but important parts of economic policy remain national. It is a genuine monetary union whose sustainability depends on the degree of convergence of economic performances, and consequently of national economic policies.

However, the introduction of the euro was never intended to solve the structural problems faced by the economies of the euro area. It was not conceived as a machine for equalizing diversified economic structures. Member States are liable for the increase of their potential output and the harnessing of their comparative advantages within the currency union. Balance of payments remain national. The Euro area is not a federal state. Countries can successfully function in a Monetary Union even with different income levels as long as they avoid excessive macroeconomic imbalances. Provided that external adjustments are not an option anymore, the correction in divergence in competitiveness can only be achieved through internal devaluation, meaning cuts in labor costs for real wages.

** This paper was written with the support of Paul-Angelo dell' Isola.*

As the no-bail out clause forbids federal transfers at the EMU level, rules of sound governance and convergence were set up as an alternative to what exists in the US (fiscal capacity to cushion asymmetric shocks and a sovereign benchmark security which is sizeable enough to maintain cross-border flows in case of asymmetric shocks). Hence, the Maastricht Treaty and the Stability and Growth Pact focused on convergence criteria as a prerequisite to make the euro area viable.

1.2. Significant progress has been made since the crisis to make the euro area more resilient

Substantial progress has been made mostly because many national governments did their homework (e.g. Baltic countries, Spain & Ireland). Initiatives at the EU level were also taken to make the rules of convergence more binding (Treaty on Stability, Coordination and Governance in the Economic and Monetary Union). They also monitor the competitiveness of Member States (Macroeconomic Imbalance Procedure) in order to deepen the Economic Pillar of the EMU.

Additionally, the EMU has been equipped with a crisis management tool (ESM). The ESM is in a certain sense an embryo of a Euro IMF. It provides financial assistance against conditionality. Progress on the integration of banking and financial markets has also been attempted with the implementation of the Banking Union and the action plan of the Capital Market Union. The 'Investment Plan for Europe' (2015) has also proved useful in encouraging a sustainable increase in investment in Member States.

1.3. However, the convergence trends between Member States have proved partly illusory

The rules of the Stability and Growth Pact have not been enforced sufficiently vigorously:

- Although deficit ratios have declined overall, public debt ratios are very high in many euro area countries (France and Spain at around 100% of GDP, Italy at 133% of GDP in 2016) and for some are still increasing. These countries may face rising sovereign spreads when monetary policy accommodation is reduced.
- Additionally, many euro-area countries face deep-rooted structural weaknesses and imbalances. For instance, a comparison between France and Germany shows major economic and fiscal discrepancies. In France, public expenditure is well above the average level of the Eurozone (56,2% of GDP in 2016 against 49% for the EU). The budget is in surplus in Germany but is in deficit in France (3,3% in GDP in 2016). Full employment is achieved in Germany while unemployment is still at 10% in France. In such a context, French export performance has deteriorated over the past 15 years while in Germany, the current account surplus reached 8,7% of GDP in 2016. The too high level of public expenditure has led to excessive levels of taxes and contributions which weakens the competitiveness of French enterprises. In the same vein, Italy urgently needs to balance efforts to reduce debt with support for growth.

1.4. The symmetry of economic adjustments should also be a priority focus

Germany's considerable trade surpluss is not sustainable within a balanced monetary area. Within a monetary union, there must be a symmetrical adjustment mechanism to prevent long-run excessive balance of payment surpluses or deficits. The euro area is suffering from not having any such system in place, which creates economic and political tensions. The design of EMU presupposed that market forces would provide for fairly rapid self-adjustment. This has not materialised.

The major differences in economic performance between the main euro area countries – for instance, budget and trade deficits in France, compared with budget and trade surpluses in Germany – are being compounded by the failure to to rebalance competitiveness between the surplus and deficit euro area Members. Once the deficit countries embark on the structural reforms needed to address their competitiveness gap (reducing public spending in relation to GDP, reforming the job market, health systems, pensions, professional training, etc.), surplus countries would be expected to accept higher relative unit labour costs, be it through higher real wages or through higher price increases.

In such scenario, Germany could embark, for instance, on a major infrastructure modernisation programme. Considering its low unemployment rate, such a programme could push up German wages and prices, reducing its surpluses. Such an effort would help adjust the competitiveness of the countries that are facing difficulties. The rollout of such an economic expansion programme would benefit Germany's key trading partners provided that their industrial base could cope with this increase in demand.

1.5. Persistent financial fragmentation is also a challenge

Capital flows between EU countries are far from pre-crisis levels. Moreover, cross-border banks operate in a fragmented market and cross-border operations in the banking sector are still declining. There is in particular significant national discretion in implementing banking rules. Cross-border banks indeed face additional liquidity, capital requirements on their subsidiaries located in the euro area. Symptomatic is the treatment of additional capital charges for systemically important banks related to cross-border a euro area exposure, which are still considered as international exposures from a regulatory perspective and which hinders cross border consolidation.

Regulatory reform should 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 given thus a solid base for group solidarity as the basis for consolidation. Indeed while supervisory decisions are taken at the European level, the consequences of potential bank failures are still predominantly national. National considerations therefore continue to affect supervisory decisions. Therefore more regulatory reform should move forward to secure the Eurozone's recognition as a single jurisdiction.

In addition, there is indeed not enough trust between Home and Host countries within the Euro-area due notably to the lack of effective convergence between the core countries of the Union and the important role of subsidiaries of cross-border banks in the financing of the economy of Host countries (see IV).

2. Lines of action currently proposed to deepen the EMU seem unrealistic as long as minimum and lasting economic convergence is not achieved

A comparison with the United States helps to understand the well-functioning of a Monetary & Economic Union.

4 COMPONENTS OF AN EMU	UNITED STATES	EUROZONE
RULES OF SOUND GOVERNANCE	✓ Adopted at the State level around 1840	✓ Not binding rules for all MS
STABILIZATION FUNCTION	✓ A flexible labor market and US federal budget including an unemployment scheme	X None
SAFE ASSET	✓ Federal debt since the 30s	X No EMU-wide safe asset
INTEGRATED BANKING & FINANCIAL MARKETS	✓ Effective single financial market: unique security rights, FDIC with backstop (Treasury support), GSEs....)	On going process (SSM, SRB, SRF) but no agreement on EDIS

- First, the United States federation benefits from rules of sound governance that have been adopted at a state level. Indeed, American states adopted balanced budget rules of varying strength during the nineteenth century after some of them went bankrupt. These rules limit debt accumulation and are equivalent to the Maastricht criteria in certain respects as their aim is to make sure that each participating nation shares solid-rock economic fundamentals and is labelled as safe when issuing sovereign debt.
- Secondly, the American States benefit from a flexible labour market and a macroeconomic stabilization function, i.e. federal budget including automatic stabilizers such as the US federal unemployment scheme (New Deal and World War II). In the Euro zone, this function and a flexible labour market do not exist.
- Third, the federal budget also fulfills its stabilizing objective through another powerful channel. It provides a large supply of bonds labelled as 'safe'. This in turn enhances a sustainable form of financial integration which fuels convergence and helps to cushion economic shocks well. In the EMU, states, which comply with the rules of the Stability and Growth Pact, are supposed to be equally safe and there is neither a mutualization of sovereign debt underwriting nor a significant federal budget as in the United States.

The rationale of deepening the Eurozone: enshrining a credible convergence process

Overall, there are 3 lines of actions whose aim is to enshrine a credible process of convergence by either implementing the rules more vigorously (1), smoothing internal adjustments of Member States with a stabilization function(2) and further breaking the sovereign-bank loop and restoring cross-border capital flows with the creation of a EU safe asset or n(3).

These three lines of actions are as follows:

- Reinforcing the fiscal and economic rules in order to make them more binding. The objective is an effective enforcement of the existing fiscal rules.
- A macroeconomic stabilization function is envisaged to better absorb the costs of internal adjustments of a Member State by protecting either public investment or social amenities in case of an asymmetric shock.
- A sovereign risk sharing mechanism (EU safe asset) is also proposed to further break the sovereign-bank loop and in order to restore cross-border capital flows.

However, strict compliance to the existing fiscal & competitiveness rules seems to be a pre-requisite to achieve a potential agreement on these proposals. Indeed, both a fiscal capacity and a sovereign risk sharing mechanism involve mutual liability, which, in a decentralized Economic Union, can create wrong incentives.

More precisely, there is a risk that mutualizing liability will increase euro-area incentive to run up debt instead of strictly complying with the existing rules. Hence, either a macroeconomic stabilization function or a sovereign risk sharing mechanism would have to be combined with more binding rules and lasting compliance with the rules before their implementation.

2.1. Achieving an enforcement of the economic & fiscal rules

- The rationale

Only domestic structural reforms can solve structural weaknesses in Member States, raise output and productivity growth and reduce competitiveness problems and recourse to debt.

Regarding this line of action, many changes have already been brought into the framework (Two Pack, Six Pack, European Semester, MIP) but there are still economic and fiscal discrepancies among Member States as competitiveness gap remain wide, despite painful post-crisis adjustments in some countries (see 1.3). These revisions added to their complexity, making them harder to understand and more difficult to communicate and considerable room for discretion has been opened up.

In addition, the implementation of the Country Specific Recommendations, for instance, remains weak. In fact, only 2% of the MIP-related 2016 Country Specific Recommendations have been fully implemented, the worst performance in MIP history[1].

- Features

The European dimension can reinforce national efforts to comply with existing rules. Structural reforms should be coordinated at the EU level notably because a number of aspects of these measures have cross-border effects. Incentivising compliance with existing rules could be done for instance with a mutually agreed contract, the costs of enforcement of which would be smoothed by financial support. According to this line of action, a federal fiscal incentive would be provided to countries that really embark on credible structural reforms: more fiscal transfers with more conditionality would be the idea.

In this line, a relevant proposal is the introduction of a 'Convergence and Competitiveness instrument' supported by the Commission in 2013. It consists in a mutually-agreed contract, the costs of enforcement of which are smoothed by financial support. It could require the creation of a 'Rainy Day Fund[2], either based on dedicated contributions (based on a Gross National Income-key) or on the proceeds of specific financial resources (Corporate Tax, VAT). One key benefit of such a proposal would be to foster the national ownership of reforms and break a political stalemate, i.e. when reforms involve near-term costs.

- Feasibility

This approach could be achievable in the short- to medium-term, as it would not necessarily require changes in the EU Treaties. It requires leadership and to take into account the limitations on further sovereignty sharing within the existing legal framework.

2.2. A macroeconomic stabilization function

A second way to deepen the EMU is to set up a macroeconomic stabilization function in the Eurozone to absorb asymmetric economic shocks across euro area countries without necessarily creating additional permanent transfers[3] and without debt mutualisation. There are two approaches:

Option 1

A macroeconomic stabilisation function (or a limited fiscal capacity) without creating additional permanent transfers and without debt mutualisation could be envisaged in order to better absorb the costs of internal adjustments of a Member State in case of an asymmetric shock. The central fiscal function would be designed to temporarily cushion economic fluctuations, and not to persistently transfer resources for re-distribution. It would not aim to correct structural differences among Member States, such as competitiveness or specialization gaps.

This project was first acknowledged as a possible way forward in the 'Four Presidents' Report' published in 2014. Its role would be to provide enhanced risk sharing without creating permanent transfers or debt mutualisation.

- Features

Different institutional set-ups have been envisaged for such macroeconomic stabilization function:

- First, the simplest way of arranging temporary transfers would be through a 'Rainy Day Fund'[4]. Such fund would collect revenues from Member States at all times and make transfers to countries when they experience negative shocks. Disbursements could be either triggered on a discretionary basis or on the basis of indicators of the position of the Member States in the business cycle. With a dedicated flow of revenues, the fund might even be able to borrow at low cost to smooth the impact of downturns throughout the union. It would not involve any devolution of spending responsibilities to the center and would provide ex-ante support, namely before the shock turns into a funding crisis.

- Another option would be to set up a Euro-wide unemployment insurance scheme[5]. This supplementary mechanism should be used to finance cyclical (and not structural) unemployment insurance expenses related to exceptional economic scocks, when the national unemployment rates exceed a threshold[6].

  This common basic benefit scheme could, for example, provides those who have been out of work for up to one year (the most cyclical component of unemployment) with benefits worth 50% of their previous wage. Financing for the scheme could be levied on a harmonized tax base, such as the total wage bill. To reduce the risk of moral hazard and incentives to reduce structural unemployment, the initial Member States' contributions could be individualized and updated periodically on past trends. In the interval between two updates, joint debt issuance to cover the potential cash requirements of the common scheme would enhance stabilization capacity. The basic benefit scheme could be topped up by a national benefit in accordance with the preferences of each Member State.

  The size of this fiscal capacity that can absorb asymmetric shocks would not overburden Member States'public finances, as 1-2% euro area GDP would constitute a sufficient buffer that could be accumulated over a number of years[7].

  It has also recently been proposed that this stabilization and convergence function must be coupled with a stronger enforcement of fiscal rules to make sure public finances remain sustainable[8].

- Limits and Feasibility

The implementation could be achievable in the short- to medium-term, as it would not necessarily require changes in the EU Treaties. The framework should be such that moral hazard and free-riding behaviour should be avoided making the proposal broadly acceptable by all parties.

An agreement on a Rainy Day Fund or on a Euro-wide unemployment insurance scheme shoud "only"require the achievement of some minimal convergence among core countries of the EU in order to restore trust between Member States.

Option 2

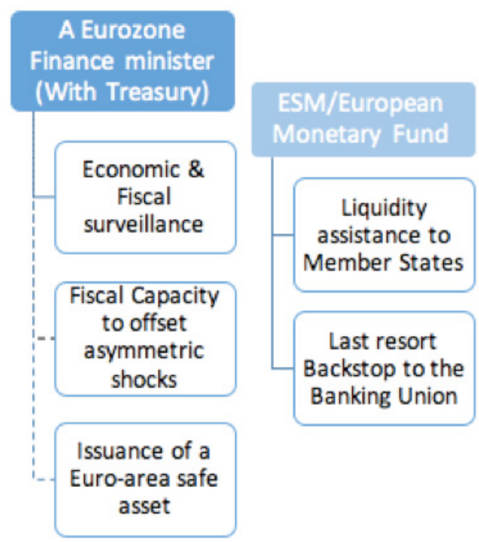
Some propose a more ambitious option: Sharing fiscal sovereignty with the appointment of a European finance minister empowered with a common budget. This Minister would chair the Eurogroup and could also chair the Economic and Financial Affairs Council (ECOFIN) according to the ideas of the EU Commission[9]. With the support of a Eurozone Treasury, he would coordinate national fiscal policies and would be empowered with a common budget. Such developments would require a change to EU treaties and abandonment of a certain degree of fiscal sovereignty.

- Rationale

The rationale is to pool some risks while sharing more economic sovereignty. In this vein, the 'finance minister of the Eurozone' could be empowered with a common budget in particular to absorb regional shocks or even offset negative effects of reforms (see (3)). He could also coordinate the issuance of a common safe asset (see (2.3.). A complementary option would be to place the European Stability Mechanism under the supervision of the 'Finance Minister'.

- Features

Such budget would necessarily entail changes in governance. A 'finance minister' would be in charge of the budget and be accountable to a Eurozone Parliament.



The budget could finance ongoing public investment expenditure and be channeled to projects offering the best socioeconomic return, with a particular emphasis on physical capital (especially infrastructure) and human capital (such as R&D, innovation and vocational training). It would therefore prevent cuts in public investments during times of crisis and improve macroeconomic stability. If chiefly aimed to catching-up countries, it could also kick-start lasting economic convergence in the euro area.

Financing for the euro zone budget could come either from the euro zone bailout fund, the wider EU budget, or from separate sources like each country contributing a share of its GDP or tax income based on 2 common consolidated tax bases (VAT and corporate tax), or from direct borrowing on the market. In case the budget is financed by a fixed percentage of a common consolidated tax base, shaving these tax rates would help to shore up the economy in a recession.

- Limits and feasibility

Such developments would require a change to the EU treaties or a new intergovernmental treaty and abandonment of a certain degree of fiscal sovereignty. With more decisions taken at the euro area level, it will also be essential to ensure greater parliamentary control of common economic, social and financial instruments and policies.

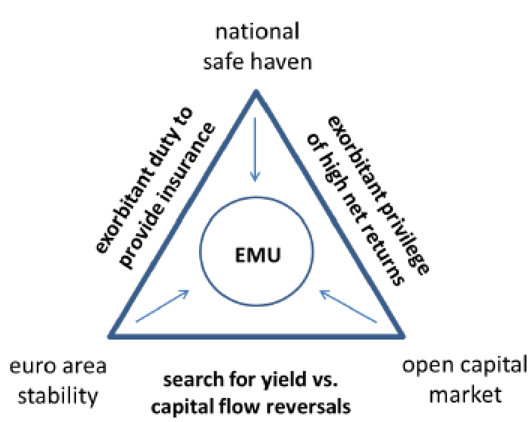
A political agreement on such mechanism seems unlikely, provided that economic and fiscal fundamental are not strong enough to avoid the risk of disproportionate support. Strict and lasting compliance with fiscal solvency is a prerequisite to progress towards a transfer union in the Eurozone. Additionally, structural differences (e.g. social security system and labor market regulations) between Member States are currently a major obstacle for the creation of such a stabilization function.

2.3. A sovereign risk sharing mechanism ('European Safe Assets')

- The rationale

Creating a common European "safe asset" would enhance the resilience of the euro area economy and promote financial integration. It would facilitate cross-border risk sharing and create a uniform benchmark risk-free rate for other assets. It could also help avoiding cross-border flights to safety. This could be a European fixed-income instrument with ample liquidity, comparable to that of the U.S. Treasury market.

The four presidents' report mentionned the need for a EU safe sovereign asset. This assessment is based on the idea that keeping a national safe asset is incompatible with having free capital mobility and maintaining economic & financial stability. This threefold tradeoff is summed up in the so-called 'Safety trilemma'.



Source: Ad Van Riet. Addressing the safety trilemma: a safe sovereign asset for the Eurozone. Working paper of the ESRB (Feb 2017)

According to the supporters of this approach, a monetary union such as the Eurozone with free capital mobility and a national 'safe haven' asset will see investors from a safe country searching for a higher yield across the risky member countries in quiet times while they will quickly return to the safety of their home country when it appears as if the negative risks could materialize. The sharp reversal of capital flows triggered by a major shift in market sentiment back to safe countries could each time cause financial fragmentation along national lines and destabilize the monetary union, as seen during the 2011-212 crisis. In the same vein, a comparison with the United States also support the supply of an area-wide safe asset on par with US Treasuries. This trilemma can be solved in 2 ways:

- Option 1: Make national debt equally safe. This requires a strong commitment of all participating countries to honor their debt and fiscal obligations. This solution is equivalent to a strict compliance with the rules of sound fiscal policy (see (1)).
- Option 2: Introduce a supranational sovereign benchmark security. A European safe asset, sizeable enough to become the benchmark for European financial markets, could create numerous benefits for financial markets and the European economy. In particular, it would help diversify the assets held by banks, and help to address the interconnection between banks and sovereigns. To some extent, however, this option is even less likely to be feasible before a sustainable trend of convergence is observed.

- Features and limits

In recent years, several proposals of 'safe assets' have been put forward with different design features – ranging from full to partial common issuance, some based on mutualization and others entailing no joint liabilities. There are 2 approaches to the provision of a European safe asset:

<u>No mutualization</u>:

Sovereign bond-backed securities (SBBS) would avoid mutualisation of liabilities among euro area Member States. The SBBS would entail issuing senior and junior claims on a pooled portfolio of euro area sovereign bonds, where the senior bond could take on the role of a common euro area-wide safe asset.

A proposal investigated by the ESRB[10] is the creation of 'Sovereign bond-backed securities' that does not entail joint liability among sovereigns. A special vehicle (either private or public) would finance a diversified portfolio of governments bonds with senior and junior claims on that portfolio. Sovereign bond-backed securities (SBSs) would be issued in tranches, with junior tranche first in line to take any losses that might arise in the event of sovereign default.

With an appropriate tranching point, senior SBBs (or 'European Safe Bonds' (ESBies)) would constitute liquid and low-risk assets with a senior claim on government bonds across Europe. In short, a Euro-area sovereign safe asset would act like federal Treasuries — but without common issuance by a joint Treasury. They would offer a way to strengthen Europe's economic and monetary union, while respecting its existing laws and treaties. Governments would indeed remain responsible for servicing their own debt instruments, which would be issued at market prices.

: Balance sheet of a special vehicle issuing SBSs

Assets	Liabilities
Diversified portfolio of sovereign bonds	Senior SBS
	Junior SBS

- Limits

SBSs would allow banks, insurers and other investors to diversify their government bond portfolios but it is arguable whether transaction costs would not be prohibitive for some countries' banks who should benefit from the proposal. Moreover, it would not mitigate the differences in sovereign risk default and banks in performing countries (e.g. Germany, Netherlands, Finland) are not likely to change their risk sentiment toward a particular country as long as fiscal consolidation has not taken place in all parts of the Eurozone and to accept risk sharing mechanisms.

More generally, the limits of such a proposal are the followngs:

First, currently German sovereigns bonds are the benchmark regarding liquidity and safety and replacing this benchmark sets a very ambitious target for SBBS. As SBBS will unlikely be perceived as having a better credit quality compared to German sovereign bonds, they would need to be significantly more liquid to be seen as the European "safe asset" by investors. However, potentially lower issuance volumes compared to the most liquid markets and the split into several tranches makes a high level of liquidity difficult to attain.

SBBS would require a common politically backed initiative of euro area countries. Generating a sizeable market for SBBS requires a strong longer-term commitment to issue this instrument, coordination among countries in generating the underlying bonds and harmonization of conditions to create a homogeneous product. Otherwise, it is difficult to see that SBBS could overcome the ramp up problem of competing with bunds. For a functioning liquid bond market, it is also important to build the related futures' market.

As part of the political initiative, a dedicated regulatory treatment would need to be devised for SBBS to make them comparable to government bonds and attractive for banks, pension funds, insurance companies and other investors. SBBS would otherwise be treated as securitised products in the current framework, which imposes a higher regulatory cost in many cases compared to government bonds.

However, since SBBS issuers would buy sovereign bonds, their introduction might reduce the depth and liquidity in national bond markets. Should investors prefer SBBS versus domestic sovereign bonds, this might further impact the demand on the remaining traded sovereign debt, causing increased liquidity risks and funding costs. This is a high price to pay for some sovereigns and is therefore an impediment to a joint political initiative.

Second, since national sovereign bonds and SBBS would coexist, there are doubts whether SBBS can address flight to safety and help stabilise the Eurozone in stressed times. The dynamics of flight to safety would only be transformed to some extent, depending on what share of sovereign debt would be financed by means of SBBS. The SBBS cannot prevent destabilizing flows from more risky to safer sovereigns as long as national bond markets co-exist. In an environment of flight to safety, investors might prefer the senior SBBS tranche, but in case of bigger or systemic shock, even the senior tranche could come under pressure.

This problem would be exacerbated for the junior tranche. The SBBS issuer would have difficulties finding investors for the junior tranche in times of stress, increasing the required yield. This would drive up financing costs and limit overall issuance including that of safe tranches. The issuer of sovereign-backed securities would therefore not be able to support the stressed sovereign by increasing demand in bad times. This would reduce the depth of national debt markets and the high risk of the junior tranche even further.

Third, technical aspects regarding the liquidity management of the issuing vehicle need to be discussed in more detail. Cash flow mismatches between the SBBS and the portfolio of sovereign bonds backing them create costs and liquidity risks, which must be managed.

In sum, at the time when it is most needed, issuance of the safe asset would be reduced. In contrast, an example of a safe asset that does exactly the opposite are ESM and EFSF bonds, which are safe bonds, issued in bad times to support a risky sovereign that needs to issue more than markets can take.

Partial joint debt issuance:

Other proposals for union-wide safe assets engender some form of joint liability, rendering them susceptible to political problems and incentive issues. In contrast to the previous option (SBSs), an important benefit would be for Member States to share the safety premium of risk-free sovereign bonds for part or all their debt.

- 'Eurobills[11]': The Eurobill proposal envisages a permanent common issuance of short term notes by a euro area Debt Management Office (DMO). Member States would give up their right to issue short term debt. The Euro-area DMO would conduct auctions to satisfy the needs of all Eurozone countries, subject to the constraint that no country can have more than 10% of its GDP in Eurobills outstanding at any point in time. Additionally, participation in Eurobills emissions would be conditional on satisfying criteria of economic governance and budgetary discipline.
- 'Blue debt/red debt[12]': According to the Blue bond proposal, sovereign debt in euro area countries would be split into two parts. The first part, the senior tranche (or 'Blue debt') of the amount of public debt up to 60% of GDP, would be pooled among participating countries and jointly and severally guaranteed. The 60% GDP limit would be a safeguard to guarantee the quality (AAA) of the Blue Bond.
- The second part, the junior tranche (or 'Red debt'), would keep public debt in excess of 60% of GDP a purely national responsibility. The annual allocation of Blue bonds would be proposed by an independent stability council staffed by members who would enjoy a similar degree of professional independence to the board members of the European Central Bank (ECB). This allocation would then be voted on by the national parliaments of participating countries, having the ultimate budgetary authority required to issue the Blue bond mutual guarantees. Entry to the system would be conditional upon enhanced fiscal credibility.
- Debt Redemption Fund[13,14]': The Debt Redemption Fund would allow Member States to offload a certain portion of its public debt (debt exceeding 60% of GDP for instance). The fund would issue bonds above a maturity of 2 years so that national debt can be rolled over into medium-to long-term euro area debt. It would receive earmarked revenues from Member States to repay their European debt. Once the repayment has been accomplished, the Fund would expire. Its two years maturity bonds would still be, for a while, a Euro-area safe asset.
- 'Eurobonds[15]': The most 'extreme' option is to fully mutualize the underwriting of sovereign debt.

- *Limits of joint debt issuance:*

As the EU Commission pointed out in its paper[16], this "raises a number of legal, political and institutional questions that would need to be explored in greater detail".

More importantly, performing countries (e.g. Germany, Netherlands, Finland) are not likely to absorb higher borrowing costs because of states who do not meet their fiscal liabilities to the other euro-area member states. Members of the Monetary Union will never accept financing current public deficits generated in other euro area Members that do not follow the rules. Mutualizing part of sovereign risk requires fiscal solvency and compliance with the fiscal rules in the first place. Indeed, sharing sovereign risk doesn't eliminate the different sovereign risks. Virtuous countries are not likely to accept either higher borrowing costs or riskier sovereign bonds in their bank's balance sheet. Therefore, an agreement at the EU level seems difficult to achieve as long as core countries (e.g. France, Italy, Spain) do not meet their liabilities to the other euro-area Member States. The mutualization of public liabilities requires a relationship of trust among Member States, based on a much stronger fiscal framework.

It is also important to point out that legally, the mutualization of debt through joint & several guarantees requires an EU Treaty change and changes in Member States constitutions.

3. Developing ownership and incentivizing reforms is a short run key priority

Respect for the fiscal rules remains a key challenge in some Member States:

So far, there is a lack of consensus concerning the EU rules which has resulted in their complexification. Decision makers too often forget that these rules are designed in the interest of Member States in the first place. Compliance with the existing rules should be obvious, regardless of the near-term costs of enforcement.

In such a context, what can be done at the European level? The Commission can only build or revive the consensus concerning the soundness of the rules.

A well-functionning monetary union requires a credible and sustainable fiscal framework: the euro area fiscal rules need to be more binding, less complex, predictable and effective. For instance, the practice of some countries to be satisfied by a reduction of the past trend of increases in public expenditure should not be accepted. What is needed is a reduction of these public expenses and not a lesser increase in the countries where public expenditure are significantly high.

The EU Commission can also provide a diagnosis of the common challenges of the European countries (demographic decline, unsustainability of social systems, sluggish productivity growth) and propose specific solutions for each Member-State.

Mechanisms to incentivize structural reforms should also be enhanced. For instance, a regular dialogue looking at competitiveness gaps and divergent trends between euro area members could be established between Europe's institutions and euro area Member States to encourage ownership. This approach should make it possible to reinforce the level of engagement among national parliaments, social partners and the civil society for structural reform programs. The euro itself and ultra-loose monetary conditions cannot solve structural weaknesses of Member States. This is why implementing structural reforms remain of the essence.

The European dimension can reinforce national efforts. Structural reforms should be coordinated at the EU level notably because a number of aspects of these measures have cross-border effects. Incentivising compliance with existing rules could be done for instance with a mutually-agreed contract, the costs of enforcement of which would be smoothed by financial support (as proposed in 2.1).

Moreover, a greater integration of markets in energy, transport and digital services would certainly boost productivity, provided that Member States cooperate appropriately to favor the creation of European industrial champions so as to compete on the global stage (digital/data, defense, climate change).

4. Responding to host countries' concerns is a key priority in order to improve the effectiveness of the Banking Union's existing pillars (SSM, SRM)

Ultimately, the single currency is embedded in an incomplete single market and only a partial Banking Union. Enhancing private risk sharing in the euro area, especially through the completion of the Banking Union and a true Capital Markets Union remains a key policy priority. Well-functioning and integrated banking and financial systems would indeed mitigate the propagation of financial shocks to the real economy.

In this perspective, it is essential to identify and address the concerns of host countries within the Banking Union if we want to improve the effectiveness of the Banking Union's existing pillars (SSM, SRM).

For financing their national economies, the vast majority of the Member States (Belgium, Luxembourg, Baltic States, Slovakia, Poland, Hungary, etc.) are essentially dependent on subsidiaries of banks whose headquarters are located in other countries within the Banking Union (Austria, France, Italy, Finland, etc.) or the EU (Sweden, Denmark). These local subsidiaries have a central and essential position for financing their economies.

Political leaders in these host countries are concerned that if one of these local banks was to leave or one of these banking groups was to experience difficulties, this might penalise their national economy or cause difficulties for their deposit guarantee system. In this respect, these countries are concerned about the slow pace that characterises the resolution of non-performing loans in certain Union countries and that makes them doubt the effectiveness of the EU crisis management framework.

These host countries are also concerned about the lack of economic convergence between Germany on the one hand and certain leading Union countries (France, Italy, Spain) and the strengthening of the sovereign bank links that can be seen in many Banking Union countries. These weaknesses are compounding the risk of banking groups withdrawing from these host countries and encouraging these states to set up local regulatory constraints (e.g. capital, liquidity, internal MREL, macro-prudential framework based on national decisions).

These concerns are worth clarifying, but seem to explain the host countries' attitude to the ECOFIN Council (see discussions underway regarding CRR/CRD, BRRD, etc.). Indeed, they refuse to accept that the regulatory constraints for banking groups can be defined essentially at a consolidated level, while calling for a series of regulatory constraints to be set at a local level for primary legislation.

Once all these concerns expressed by the host countries have been clarified and understood, European leaders will need to respond to them by adjusting the roles and missions of the national authorities responsible for supervising cross-border groups in order to provide a guarantee for each Member State that none of the supervisors will favour their own banking system and their own depositors. This is expected to result in an increasingly European framework for the operations and governance of European authorities (SSM, SRB, and European Supervisory Authorities), similar to what is already in place for the Monetary Union and the ECB.

Such an alignment will also need to be considered for home supervisors located outside the Banking Union.

These developments will lead to the creation of the EDIS and form a permanent backstop for the Single Resolution Fund.

5. Brexit offers an opportunity to accelerate the implementation of the CMU

The departure of the largest non-Banking Union Member State is an opportunity for the EU27 to further develop and integrate their capital markets and increase the role they play in the financing of the EU economy. In this perspective, it is essential to move towards a more efficient and consistent regulation and supervision of capital markets at the EU level, which involves notably strengthening the powers of ESMA. Moreover the EU authorities have to monitor the transfer of financial activities from the City to the Continent in an appropriate way without creating financial stability or level playing field issues (e.g. avoiding letter box entities, encouraging an efficient organisation of financial markets in the EU and the Eurozone).

More generally, enhancing supervisory convergence and consistency in the implementation of financial rules across the EU is essential, which requires reviewing the powers, operations and governance of the European Supervisory Authorities (ESAs).

In sum, achieving economic convergence in all parts of the Union remains a key priority in the short term.

More than anything else, the Euro Area needs economic reforms and prudent fiscal housekeeping at the national level. Economic and fiscal policies remain in the competence of the Member States. "The EU cannot make the hard policy choices for the Member States, nor can it be accountable for them to the people. It is the Member States that need to take ownership of economic and fiscal policies and the responsibility of their consequences. The EU can advise and assist, but the ultimate responsibility should not be blurred[17].

Deepening the EMU, -either through sovereign risk sharing mechanisms or a fiscal capacity-, cannot be achieved as long as sovereign risk is not mitigated and excessive imbalances and rigidities are corrected. Concerns about the weakening of incentives for sound national policies will not disappear before any progress is observed. In other words, an effective economic convergence and vigorous enforcement of the rules among all Member States would facilitate an agreement to create either a macroeconomic stabilization function and/or a sovereign risk sharing mechanism. It would also enhance the resilience of the euro area, restore trust between the Member States, restore cross-border investments in the euro area and accelerate private risk sharing within the EU. Therefore, some Member States urgently need to commit to convergence to further deepen the Eurozone.

Provided that fiscal rules are still not followed by all core countries, an adverse scenario has even been envisaged and aims to make the no bail-out clause more credible. As opposed to the common idea of pooling risks while complying to the rules, a proposal was made to reinforce the corrective effect of financial markets which is currently weakened by an accommodative monetary policy. The ESM/EMF[18] would decide on a declaration of sovereign default and conduct negotiations between insolvent sovereigns and creditors so as to restore the sustainability of public finances. Such mechanism is meant to re evaluate risk premiums on countries who do not comply with the solvency criteria and provide a framework for sovereign debt default. In a certain sense, this is an amicable divorce as it does not involve any risk pooling and goes against the deepening of the EMU, provided that compliance with the rules seems unachievable. The question that arises is then: Is an 'amicable divorce' (decentralized approach) what we want for Europe?

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Europe is at the crossroads. Structural reforms at the national level are necessary and remain the priority to improve sustainable growth and employment. In this perspective, existing rules need to be enhanced and the governance of the euro area be reinforced since the existing coordination framework was unable to prevent public finances from worsening and economic imbalances from buiding up. In addition, more integration appears to be the most straightforward solution to restore confidence in the euro area. To that end, euro area Member States should clearly have to allow a comprehensive sharing of sovereignty and powers at the European level which in turn would require greater democratic accountability. It is up to politicians to design this new framework, which needs to balance liability and control.

But if we want to achieve a viable longer solution more solidarity will have to appear. As long as structural reforms and lasting fiscal discipline take place, some form of mutualisation of certain expenditures of the system must not be discarded systematically. ■

[1] Implementation of the 2016 Country Specific Recommendations. EU Parliament (March 2017)

[2] A rainy day or rainy day fund is a reserved amount of money to be used in times when regular income is disrupted or decreased in order for typical operations to continue.

[3] While the EU budget is small, the poorer EU countries receive up to 3% of EU GDP every year, which is already significant also in view of absoption capacity.

[4] Report of the Padoa-Schioppa group (2012)

[5] French Treasury (June 2014)

[6] M. Centeno: Prioritizing EMU advancement domains to increase convergence and well-being, Eurofi Magazine, Tallinn, September 2017

[7] K. Regling:"A window of opportunity to strengthen economic and monetary Union further", Eurofi Magazine, Tallinn,; September 2017

[8] B. Le Maire: " Three steps to strengthen the euro area, Eurofi Magazine, Tallinn, September 2017

[9] EU Commission, Reflection paper on the deepening of the Economic and Monetary UInion, May 2017.

[10] Brunnermeier, Garicano, Lane, Pagano, Reis, Santos, Thesmar, Van Nieuwerburgh & Vayanos (2011); Working paper of the ESRB (2016)

[11] Philippon, T. & Hellwig, C. (2011). Eurobills, not eurobonds. Vox-EU

[12] Von Weizsacker, J. & Delpla, J. (2010). The Blue Bond proposal. Policy Brief 3, Bruegel.

[13] German Council of Economic Experts (2012). After the euro area summit: Time to implement long-term solutions. Special Report.

[14] Expert Group on Debt redemption and Eurobills (2014). Final Report.

[15] European Commission (2011). Green paper on stability bonds.

[16] Recent EU Commission paper on the deepening of the Economic & Monetary Union (May 2017).

[17] P. Orpo, "Member States need to take responsibility for reforms", Eurofi Magazine, Tallinn, September 2017

[18] The idea of turning the ESM into an EMF to provide a Euro-area resolution framework in case of a sovereign default has been first developed by economists Thomas Mayer and Daniel Gros. In case a Member States become insolvent, the EMF would decide on a declaration of sovereign default and conduct negotiations between insolvent sovereigns and creditorsin order to restore the sustainability of public finances. This proposal could lead to a re-evaluation of the risk premiums of the country whose public debt does not comply with the solvency criteria. The declaration of sovereign insolvency could be done either through a rules-based mechanism (when outstanding sovereign debt exceeds a certain level) or through the appointment of a 'finance minister' who would interfere in a country's fiscal sovereignty to make it comply with European rules and decide when it is no longer solvent.

Banking Union: how to make existing pillars more effective?

1. The benefits of a single banking market

The euro area needs an institutional framework that allows banks to thrive as euro area banks in order to reap the benefits of a genuine single banking market. In the context of a monetary union, a single banking market would also improve what economists call allocation – that is credit allocated efficiently and without reference to location. Moreover a single banking market would improve private risk sharing – that is if banking markets are integrated in such a way as to help companies and households cushion domestic bank shocks.

Reversing fragmentation would be an additional expected benefit from the single market potential. This "de-fragmentation" would contribute to breaking the 'vicious circle' between banks and sovereigns, and improve the resolution of banks, which would therefore reduce the risk of taxpayers' money being involved in bail outs.

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

2. EU cross-border banking groups operate in a fragmented banking market

Major steps have been taken at unprecedented speed over the past years to establish the Banking Union in order to break the vicious circle between banks and sovereigns and reverse the fragmentation of financial markets. After a comprehensive assessment of all significant credit institutions in the Banking Union, the Single Supervisory Mechanism (SSM) was fully established in 2014 and the Single Resolution Mechanism (SRM) became operational in 2016.

However, despite the elimination of more than 100 National Optional Discretions (NOD) by the SSM, the single banking market remains fragmented. There is still significant national discretion in implementing rules. Liquidity remains national (cross-border groups are submitted to liquidity requirements in each of their subsidiaries located in the euro area). Capital buffers are still used by national authorities notably to address macro prudential risks. And the lack of single-jurisdiction status – or the multiple national jurisdictions - may impose additional capital charges on euro area banks. Symptomatic is the treatment of additional capital charges for systemically important banks related to cross-border a euro area exposure, which are still considered as international exposures from a regulatory perspective and which hinders cross border consolidation. This discretion increases banks 'cost of capital and funding and subsequently reduce private investors' appetite to invest in euro area banks.

According to certain observers, this home bias within the EU regulatory and supervisory framework is encouraged by the fact that the role played by national supervisory authorities in terms of governance for the SSM, SRB and EBA is too important. It will no doubt be necessary to consider modifying the mandate for local supervisors (currently focused in particular on protection for local depositors and not groups) and developing the European focus for the governance of these European authorities (considered to be undermined by an imbalance favouring national interests) in order to reduce the regulatory fragmentation that characterises the single banking market.

Regulatory reform should 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 given thus a solid base for group solidarity as the basis for consolidation. Indeed while supervisory decisions are taken at the European level, the consequences of potential bank failures are still predominantly national. Insolvency law in particular remains national, which leaves the consequences of a failure still partly dependent on the country where the institution is established. National considerations therefore continue to affect supervisory decisions. Therefore more regulatory reform should move forward to secure the Eurozone's recognition as a single jurisdiction.

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

In such a context, cross-border banking remains the exception rather than the rule and banks have a much stronger home bias than before the crisis[1]. Finally, many banks in the EU continue to receive a significant exposure to their domestic sovereigns. According to a study of the European Systemic Risk Board (ESRB), in almost all euro area countries, bank exposure to their domestic sovereigns (in relation to total assets) followed a declining trend between the end of the 1990s and September 2008, when the Lehman default occurred. This date coincides with a reversal of this trend: the home country bias increased until it stabilised in 2014. For banks in non-stressed countries, the increase was less marked . In general, banks in stressed euro area countries increased their exposure to domestic sovereign debt in response to increases in its yield. This response may have been motivated by different factors, including the banks' search for yield by engaging in carry trades that take into account redenomination risk, the desire to increase holdings of liquid assets, moral suasion exerted by sovereigns, or the banks' attempts to preserve the stability of their respective countries.

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

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

4. To make progress towards the completion of the Banking Union, a pre-requisite is for all euro Member States to strengthen their fiscal positions and competitiveness

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

5. Responding to host countries' concerns for improving the effectiveness of the Banking Union's existing pillars (SSM, SRM)

It is also essential to identify and address the concerns of host countries within the Banking Union if we want to improve the effectiveness of the Banking Union's existing pillars (SSM, SRM).

For financing their national economies, the vast majority of the Member States (Belgium, Luxembourg, Baltic States, Slovakia, Poland, Hungary, etc.) are essentially dependent on subsidiaries of banks whose headquarters are located in other countries within the Banking Union (Austria, France, Italy, Finland, etc.) or the EU (Sweden, Denmark). These local subsidiaries have a central and essential position for financing their economies.

Political leaders in these host countries are concerned that if one of these local banks was to leave or one of these banking groups was to experience difficulties, this might penalise their national economy or cause difficulties for their deposit guarantee system. In this respect, these countries are concerned about the slow pace that characterises the resolution of non-performing loans in certain Union countries and that makes them doubt the effectiveness of the EU crisis management framework.

These host countries are also concerned about the lack of economic convergence between Germany on the one hand and certain leading Union countries (France, Italy, Spain) and the strengthening of the sovereign bank links that can be seen in many Banking Union countries. These weaknesses are compounding the risk of banking groups withdrawing from these host countries and encouraging these states to set up local regulatory constraints (capital, liquidity, pillar 2 requirements, internal MREL).

These concerns are worth clarifying, but seem to explain the host countries' attitude to the ECOFIN Council (see discussions underway regarding CRR/CRD, BRRD, etc.). Indeed, they refuse to accept that the regulatory constraints for banking groups can be defined essentially at a consolidated level, while calling for a series of regulatory constraints to be set at a local level for primary legislation.

6. Adjusting the governance of EU and National Supervisory Authorities (SSM, SRB, ESAs...)

Once all these concerns expressed by the host countries have been clarified and understood, European leaders will need to respond to them by adjusting the roles and missions of the national authorities responsible for supervising cross-border groups in order to provide a guarantee for each Member State that none of the supervisors will favour their own banking system and their own depositors. This is expected to result in an increasingly European framework for the operations and governance of European authorities, similar to what is already in place for the Monetary Union and the ECB. Such an alignment will also need to be considered for home supervisors located outside the Banking Union. These developments will lead to the creation of the EDIS and form a permanent backstop for the Single Resolution Fund. ■

[1] The Financial Integration Report of the ECB (May 2017) pointed out that "The obstacles to cross-border M&As give rise to a number of targeted financial sector (...). This would include removing ONDs in European banking regulation; allowing the euro area to be considered as a single jurisdiction for calculating the Basel surcharges for systemic institutions; harmonising taxation, insolvency laws and consumer protection; and streamlining supervisory merger review procedures, harmonising their legal and regulatory basis and coordinating them with competition reviews".

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

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

Review of the operations of the European Supervisory Authorities (ESAs)

1. Context

Since their establishment in 2011 in response to the financial crisis which exposed significant failures in financial supervision, the three European supervisory authorities (ESMA, EBA, EIOPA) have carried out remarkable work contributing to the building of the Single Rulebook, to ensure a robust financial framework for the Single Market and to underpin the building of the Banking Union as part of the EMU. They have succeeded through the quality of their staff and the leadership of their management in becoming a major center of competence recognized worldwide. The three agencies have been instrumental in achieving a single rule book for banks, insurance companies and market activities.

However further progress in relation to especially supervisory convergence is needed to promote the CMU, integration within the EU's internal market for financial services and to safeguard financial stability. Moreover, it will be important to also capture the ever growing benefits from technological developments such as FinTech, whilst addressing any possible risks arising in this context. ESAs have an important role to play in this respect. The departure of the United Kingdom from the Single Market reinforces the need for a thorough reflection on how to further improve the supervisory capacities of the EU27 to promote an efficient, competitive and integrated financial system underpinned by financial stability and strong supervision.

A reflection is therefore needed on what possible changes to the current legal framework are needed to optimise the rules within which the ESAs operate in order to increase their ability to deliver on their mandates. This also corresponds to the approach taken in the de Larosière report on Financial Supervision in the European Union published in February 2009, which laid down the basis for the establishment of the three ESAs.

On 21 March 2017, the European Commission launched a public consultation on the operations of the European Supervisory Authorities (ESAs). The consultation was designed to gather evidence from all interested parties on the operations of the ESAs, focusing on a number of issues in the following four broad areas:

- Tasks and powers;
- Governance
- Supervisory architecture and
- Funding.

The results of this consultation should provide a basis for concrete and coherent action by way of a legislative initiative if required.

2. Challenges and new developments

Several major issues need to be addressed if we want to achieve a more efficient European System of Financial System.

2.1. Review the membership of Boards

Detailed regulations should be carried out by regulators and not exclusively by supervisors. Something odd has crept into the functioning of ESAs: only national supervisors sit on the boards of ESAs but not national regulators (finance ministries).

Supervisors are not supposed to write rules but to apply them. Furthermore they are not inclined to change their own habits as supervisors. So the current situation is a recipe for inertia. Therefore both regulators and supervisors should participate in ESAs Boards.

2.2. Addressing the governance issues of Boards featuring national representatives while seeking an EU objective

Of course, the present setting gives national representatives the prevailing influence in the governance of ESAs. This is normal. Nonetheless, this should not be an opportunity for National Competent Authorities (NCA) to adapt unilaterally rules or add local requirements with the objective of protecting their domestic depositors, savers or policy holders without any negotiation at the EU level. This is creating significant fragmentation and weakening the financial single market as well as the Banking Union.

It has been observed that in some circumstances the ESAs have not been able to obtain a consistent implementation of some technical rules.

Providing the ESAs with some effective powers of sanction seems a necessary measure. Indeed, although the ESAs have the possibility to detect and investigate breaches to Union laws, gold plating, or shortcomings in the mitigation of systemic risks, they cannot act upon them effectively at present because they have no power of sanction if the NCAs concerned do not take the necessary correcting measures. And until now peer pressure appears to not have been sufficient and is not the recipe to move forward. Addressing this issue is essential for effectively implementing the Banking Union and the CMU. In this respect, binding mediation and the settlement of disagreements between competent authorities (as they may also be raised by industry players) should be resorted to more actively. In such a context, a sanction power should be delegated by the Commission to the ESAs.

In order to promote the European general interest, it could also be envisaged that the Management Boards of the ESAs be transformed into Executive Boards with independent permanent members not coming from the National Authorities.

This Executive Board could have its own decision process in certain areas such as binding mediation, on site inspectors. Its members could have a seat in the Board of Supervisors. Overall these changes would render the decision making process more efficient and in particular more European.

2.3. Further possible improvements

Other changes, possibly more ambitious, have been proposed by some stakeholders. These include centralizing at the EU level certain supervisory functions that concern cross-border entities or activities: e.g. the registration of cross-border products, reporting processes.

Another option would be to extend the scope of direct or shared supervision performed by ESMA and EIOPA in some specific areas taking into account issues raised by the Meroni doctrine. EIOPA, for instance, could be tasked with a centralised oversight role in the on-going monitoring of internal models provided a competent staff be in place.

More delegation of technical details to the Authorities seems also required. Indeed a large amount of the technical details of the new banking rules for instance are in the primary legislation. The ESAs have proved their ability to interact with the Parliament, with the Council, with the Commission on these issues. We can go further in delegating rulemaking to the Authorities.

Less ambitious but practically important would be to allow the ESAs to dialogue with financial institutions and access directly to information if needed. This could only improve notably the stress test work.

Increasing the role and mandate of the Chairperson and the Management Board could also be envisaged. It would be a good idea to give the chairman of the board of ESAS a decisive vote in cases where there is a split vote.

2.4. A revision of the existing funding model of the ESAs should be envisaged

Many consider the current funding arrangements not commensurate to their increasing tasks and responsibilities. Given EU and national budgetary constraints, the Commission should consider a revision of the existing funding model so that the ESAs can fulfill their mandate while taking into account budgetary constraints. A partly industry funded model might be appropriate taking into account the respective size of each member state financial industry if and when ESAs are involved in direct supervision and provided the contributors have a say on the way their money is used.

3. The Brexit challenge

Brexit is a challenge but also an additional opportunity to review the functioning of the ESAs.

The UK is indeed the main financial market in Europe concentrating a significant part of EU capital market activities. With Brexit, the EU27 jurisdictions need to further strengthen their capital markets. This involves in particular curtailing the current fragmentation of EU capital markets which reduce economies of scale and network effects within the EU27 region. The EU27 might also need to beef up its supervisory capacities to a certain extent if the transfers of financial activities that are expected from the UK (about 20 to 30%) materialize.

A first step could be to provide the USAs with the right to oppose the granting of licences or authorisations by NCAs if they think that European standards are not met.

The Brexit does not change the fundamental relevance of ESMA. On the contrary Europe needs such an authority especially for delivering the CMU and protecting investors. This requires a significant increase of its powers and governance as mentioned above.

For the future, negotiations with the UK will determine what sort of relationship will be appropriate with the United Kingdom. Given the importance of the London financial markets, it will be in the interest of all to use ESMA as a platform of future cooperation. In his intervention at the ECON Commission of the European Parliament on 3rd May 2017, Jacques de Larosière stressed that "the UK market regulator should eventually be associated to the EU decision making in the framework of the ESAs. An observership status could be envisaged in this regard. This would give both the EU and the UK the opportunity to work together in a coordinated way on these important issues. If we want to achieve a truly relevant worldwide market authority in Europe (the equivalent of an equivalent EU SEC), we should not miss this opportunity. Of course, reciprocity should be the name of the game (ESMA and other ESAS would also sit on the UK Boards), the priority being to strengthen the functioning of the ESAs in EU27."

Concerning the EBA, the upcoming immediate changes are of a different nature. Brexit has a direct impact on the EBA with a legal requirement to relocate the Authority in another country of the EU 27 and also the need to adapt the decision making rules, amended in 2013 following a request by the UK, leading to a system of majority of votes between participating and non-participating members to the Banking Union which is too complex. ■

5. IMPROVING FINANCIAL STABILITY

Improving the supervision of EU and third-country CCPs

1. Progress made and potential shortcomings regarding the supervision of cross-border CCPs

The implementation of EMIR requirements in 2015 has led to a rapid expansion in the scale and scope of central clearing in the EU and this trend is likely to continue. At the same time the CCP market remains very concentrated and CCPs are highly interconnected with other market participants, making it essential to ensure the safety of these infrastructures.

EMIR provides measures for ensuring the resilience of CCPs and has fostered stronger supervisory convergence with the establishment of supervisory colleges for CCPs authorized in the EU and with the recognition by ESMA of third-country CCPs allowed to provide their services across the EU. These requirements are due to be completed with a recovery and resolution (R&R) framework for CCPs recently proposed by the EU Commission (EC). Significant progress is therefore being made regarding the mitigation of systemic risks associated with CCPs, but different assessments have however shown potential shortcomings notably in the supervision of EU and third-country cross-border CCPs.

First, while supervisory colleges enable information sharing among the different supervisors concerned by a given CCP, main decisions are ultimately taken by the national supervisory authority where the CCP is established, which raises issues in a cross-border context. Moreover, experience has shown that differences across domestic supervisory approaches persist and that CCP supervisory processes, which involve a wide range of authorities (market authorities, central banks, bank supervisors), are complex to manage in the current set-up. In addition central banks may be insufficiently involved in decision-making and risk assessment processes at present concerning CCPs, notably for them to be able to manage all the implications of CCP actions with regard to monetary policy.

Secondly, while a significant volume of financial instruments denominated in EU currencies are cleared by recognized CCPs based in non-EU countries, the current arrangements do not allow the EU authorities to monitor the related risks appropriately after recognition. If third-country CCP rules or supervisory arrangements change, there is at present no mechanism to ensure that EU authorities are informed automatically and can take appropriate measures if this affects the resilience of the CCPs concerned. These problems 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. This change creates potential uncertainty and has made it necessary for the EU authorities to reconsider CCP supervisory arrangements.

2. Main proposals of the EMIR review regarding the supervision of EU and third-country CCPs

The objective of the EC proposal, which is currently being discussed in the EU Parliament and Council in parallel with the CCP R&R framework, is to ensure the safety of cross-border CCPs operating in the EU and to avoid third-country CCPs having adverse impacts on the EU's currencies.

Regarding EU cross-border CCPs, the EMIR review proposes a more pan-European approach to their supervision with the establishment of a so-called "CCP Executive Session" within ESMA responsible for chairing existing CCP colleges, with the objective of improving the consistency of supervision and further streamlining it. This approach also aims to foster a closer cooperation between supervisory authorities and central banks issuing EU currencies and would provide the ECB and relevant central banks of issue with binding decision powers. A recommendation was moreover made in June by the ECB Governing Council to amend ECB statutes in order to allow it to carry out its role as central bank of issue under the EMIR review proposal.

The EMIR review also proposes to reinforce the supervisory framework for systemically important third-country CCPs wishing to provide services in the EU. Third-country CCPs would be classified in two groups: 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 be subject to stricter requirements (i.e. compliance with EMIR prudential requirements; collateral or liquidity requirements set by the relevant EU central banks) while taking into account their compliance with the comparable third-country rules. Tier 2 CCPs would moreover have the obligation to provide ESMA with all relevant information and enable on-site inspections resulting in their de facto dual supervision by both the EU and the home authorities.

In addition, a limited number of third-country CCPs may be defined as 'substantially systemically important CCPs' for the EU or one of its Member States (according to criteria that are yet to be set). In this case the CCP would not be recognized and would have to establish itself and be authorized in the EU.

3. Potential impacts and issues to be further considered

The possible practical difficulty of a dual supervision of systemically important third-country CCPs (risk of diverging approaches or additional complexity…) and related cost impacts have been stressed. The fact that supervision alone cannot guarantee the resilience of a CCP and that additional mechanisms are needed for the appropriate enforcement of regulatory and prudential requirements has also been pointed out.

The criteria that may be used for determining the systemicity of third-country CCPs in a sufficiently objective way is another area where clarification is called for, as well as the decision-making process that could be used and the role that different EU authorities should play in this regard.

The recommendation that however causes the most controversy is the possible obligation to locate in the EU some third-country CCPs that would be deemed "substantially systemically important". Many observers indeed warn that such a requirement could lead to a fragmentation of liquidity and to losses in margin efficiencies, potentially reducing the benefit of central clearing and increasing costs for users, and that it could open the door to further "currency nationalization". The operational risks entailed by the possible relocation of CCP activities have also been stressed. Some moreover suggest that the concerns raised by euro-denominated clearing happening outside the EU could be appropriately addressed by effective dual-supervision and the enforcement of common standards, similarly to the approach used e.g. for CCPs clearing large volumes of US-dollar and AUS-dollar transactions outside their home country. ■

Are market-based finance risks under control?

1. Many policies address potential stability risks associated with market based finance

Since the financial crisis, additional policies have been introduced at the international and regional levels to address financial stability risks from shadow banking and transform it into "resilient market-based finance" as defined by the FSB. Steps have been taken to address banks' involvement in shadow banking activities (e.g. bank prudential and consolidation rules). Measures to address liquidity, maturity mismatch and leverage risks related to market-based finance activities have been completed e.g. with MMF and SFT regulations. Rules have also been adopted notably in the EU to enhance the transparency and standardization of securitization products. Monitoring and oversight frameworks to assess financial stability risks have moreover been established.

In terms of volumes several shadow banking activities have shrunk significantly since the crisis according to the FSB (e.g. broker dealers' intermediation dependent on short term financing, securitization-based credit intermediation…), while assets held by collective investment vehicles "with features making them susceptible to runs" (e.g. fixed income and mixed investment funds, MMFs, credit hedge funds…) have grown significantly and constitute 2/3 of the so-called "narrow measure of shadow banking" up from 1/3 immediately before the crisis.

2. The main focus at present is on asset management activities and strengthening system-wide oversight

The strong growth of the asset management sector is welcomed for its capacity to diversify financing sources, in line with CMU objectives. 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 in less actively traded securities, creating potential liquidity and contagion risks.

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 vulnerabilities at the activities level. 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.

In Europe, many of these issues, notably related to liquidity mismatch and leverage, are already covered in EU legislations (UCITS, AIFMD, MMFR, SFTR), on which possible future policy steps should build. Moreover liquidity management tools (e.g. gates, side-pockets, suspension of redemptions) are available in many EU jurisdictions and on-going supervisory convergence efforts by ESMA should help to ensure their broad consistency.

The FSB has not identified other new financial stability risks from market-based finance that would warrant additional regulatory action but has made recommendations to enhance system-wide oversight going forward which 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.

Some new areas are also being investigated by the authorities. ETFs are one of them due to their exponential growth and the increasing variety of fund ranges. Risks potentially raised by ETFs have been assessed (liquidity transformation, possible difficulties to track ownership and understand pricing…) but the need for specific policy measures has not been identified so far except close monitoring particularly in periods of market stress. In the EU the vast majority of ETFs are indeed structured as UCITS and they still represent a limited share of open-ended mutual fund assets (around 5%).

Loan funds, which have been allowed in certain EU jurisdictions, are also being assessed. In some cases they are subject to specific rules but generally regulators consider that existing fund rules are sufficient for monitoring the risks they pose, due to their limited development so far.

3. The use of macroprudential policies and tools is also being considered

The lack of systemic perspective in many market-based finance rules, possibly hindering their ability to prevent the build-up of sector-wide risks, has been pointed out by regulators. Enhanced information on liquidity in stressed conditions and on leverage would help to better monitor risks. Proposals are also being made to improve stress testing with the establishment of guidelines by some domestic regulators for the testing of individual funds and plans by ESMA to develop an EU approach to investment fund stress testing. Industry players however stress that these requirements should be tailored to the specificities of asset management activities, notably concerning unlevered funds.

The use of wider macro-prudential policies (i.e. tools designed to anticipate and mitigate systemic risks for a wide scope of vehicles e.g. investment funds, pension funds, insurance companies and the related asset owners), is being considered. This however raises several issues that need to be clarified in terms of data availability, behaviour modelling of diverse market players and clients and differentiation between market risks and systemic risks. Moreover the possible shortcomings of limiting system-wide stress testing to a subset of the market where data is more readily accessible have also been emphasized (e.g. mutual funds which only represent around 30% of investable assets and are not a homogeneous sector).

Macro-prudential tools such as leverage and liquidity requirements applied as “blanket policies” across market sectors or multiple players are also being considered. Although the use of some of these tools in exceptional circumstances is already possible in many EU jurisdictions and regulations, they have generally not been designed in a macro-prudential perspective, according to the ESRB. Some industry representatives however stress the potential procyclical and market distortion effects of these tools, advocating instead risk management and regulation at the fund and activities level. ■

Accelerating the resolution of NPL challenges

1. Size and scope of the problem

Nine years after the start of Europe’s financial crisis, the legacy of the high stock of non-performing loans (NPLs) on the balance sheets of some EU banks continues to be an important cause of concern for policymakers. Although high NPL ratios only affect a number of EU countries, the problem of persistent high NPL ratios is an issue for Europe because they pose system-wide risks of spill-overs to other EU countries, can generate negative externalities, and undermine common efforts to achieve sustainable growth.

The stock of NPLs in the EU banking sectors was around €1.0 trillion at end-2016, which amounted to 5.1% of total loans or roughly 6.7% of EU GDP, while the net amount, taking into account provisions, stood at EUR 548.7 billion. NPLs ratios are very unevenly distributed across

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

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

The recent cases (resolution of Banco Popular, precautionary recapitalization of Monte Paschi di Siena and winding down of two Veneto banks) stressed that, although the decisions differed, the four banks shared a common denominator that added to their precarious situations: the four banks suffered under the weight of NPLs. While the forecasted economic upturn in Europe will certainly contribute to the improvement of balance sheets, authorities must find ways to swiftly address this issue.

2. Resolving the NPL problem requires a broad strategy and a wide range of actions

A recent report of the ESRB[1] stressed that there are three main types of impediments to the resolution of NPLs relating to the supply side (banks), demand side (prospective investors) and to structural issues (all stakeholders).

Supply-side issues are related to weak incentives to dispose of NPLs owing to low opportunity cost, partly induced by accounting rules, tax issues, and to a coordination issue giving rise to a first-mover disadvantage and to current capital constraints.

Demand for NPLs is inhibited, inter alia, by the lack of a deep and liquid secondary market for impaired assets and the remaining structural impediments that widen the gap between bid and ask prices[2]. Structural rigidities, such as inefficient, lengthy and costly debt recovery processes affect both sides of the market, creating a deadweight cost.

2.1. The SSM has issued in March 2017 guidance to improve bank capabilities in working out NPLs

The guidance is a non-binding instrument; however, deviations should be explained by banks and substantiated upon supervisory request. The guidance will serve the supervisor as a basis for evaluating banks' handling of NPLs, as part of the regular supervisory dialogue and in the case of non-compliance, may trigger supervisory measures, including adjusting the pillar 2 requirement of the bank. It is said to be qualitative at this stage, as the supervisor does not set out quantitative requirements in the guidance on targets for NPL disposals, provisioning requirements or haircuts on collateral valuations.

The guidance provides notably short-term and long-term options on viable forbearance solutions with the aim of returning the exposure to a situation of sustainable repayment following an affordability assessment for the borrower, thus avoiding "extend and pretend" arrangements. It guides banks on how to measure impairment and write-offs in line with international recommendations.

However, numerous credit institutions lack a proactive NPL management strategy. This is the reason why the SSM guidance on NPL should be swiftly extended to non-SSM banks while giving consideration to the possibility to set NPL reduction targets on a case by case basis. We also need to make sure that, in every jurisdiction supervisors have the right instruments to enforce timely recognition and provisioning of NPL. But this alone is unlikely to be a game-changer.

If supervisory pressure on NPL management is to be increased, we need to ensure that the work out process is a swift and efficient one, as Corso Bavagnoli explained in the Eurofi Magazine published for the Eurofi Tallinn Forum. He stressed that "to this extent, structural reforms of insolvency and debt recovery frameworks is an important field of action: inefficient and poorly predictable insolvency and debt recovery frameworks weigh on NPL recovery value and set the wrong incentives for NPL resolution. National policies are primarily at stake here. But action is also possible at the European level, for instance by fostering a European approach on information standards and the regimes applicable to collateral enforcement and secured creditor protection".

The ECOFIN Council has recently invited the Commission to develop, by summer 2018, European approach to foster the development of secondary markets for NPLs, in particular to remove impediments to the transfer of NPLs by banks to non-banks and to their ownership by non-banks, while safeguarding consumers' rights, as well as to simplify and potentially harmonise the licensing requirements for third-party loan servicers and to take legislative initiative in this respect, as appropriate.

The ECOFIN Council has also asked the EBA, the ECB and the Commission, to propose by the end of 2017, initiatives to strengthen the data infrastructure with uniform and standardised data for NPLs and consider the setting-up of NPL transaction platforms in order to stimulate the development of this secondary market.

These corrective actions are necessary to address market failures and revive a well-functioning secondary market. As A. Enria recently pointed out[3], "NPL transactions are almost a textbook example of market failure. First, the absence of easily accessible, comparable data on loan, debtor and collateral characteristics generates asymmetric information. Second, an inter-temporal pricing problem occurs since, at present, markets are illiquid and shallow. There is, therefore, a first mover disadvantage to sell into such a market.

Forcing banks to write-off or dispose non-performing loans in a very short period of time in the absence of a deep and liquid secondary market for impaired assets and with remaining structural impediments may lead to an inefficient spread between bid and ask prices. In such conditions, and in the absence of efficient market clearing prices, system-wide NPL sales may create financial stability concerns amidst questions about the viability of the sector as a whole. This could also imply a redistribution of value from banks to the few specialised investors operating in the market".

2.2. The ECOFIN Council has also asked the Commission to develop, by the end of 2017, a "blueprint" for the potential set-up of national asset management companies (AMCs)

This blueprint will be established in cooperation with all relevant institutions and bodies and taking into account successful national experiences so far, which would set out common principles for the relevant asset and participation perimeters, asset-size thresholds, asset valuation rules, appropriate capital structures, the governance and operational features, both private and public.

Asset management companies (AMCs) may aid in correcting the market failure. They can swiftly clean up NPLs from bank balance sheets, and resolve them over a longer period of time. Acquisition of assets at their long-term economic value, instead of market value which is depressed by low liquidity and high uncertainty, minimises fire sale losses. Sweden, Germany, Ireland, Spain, Slovenia and Korea, for example, used these tools to manage their banking crises, often with a focus on loans backed by real estate. There is one common feature in this type of AMC: state support. By putting capital and funding guarantees at stake, governments can signal their commitment to the structural reforms and bring forward the related benefits. A similar role may be played by securitisation schemes.

Regrettably, Member States have been reluctant to enter European schemes when they did not perceive their national banks to be particularly affected by the problem of the moment. Even putting national schemes under a common European umbrella, without any form of mutualisation, has not been considered a viable option by the Members of the Ecofin Council.

The EU AMC proposed by the EBA would have represented a truly EU solution to a EU problem. This solution could also create technical challenges but an EU response would have ensured credibility, also by removing execution risk due to possible local interference, offer considerable advantages of economies of scale and attract significantly reduced funding costs, which would not materialise with various national approaches.

The superior speed of reaction and effectiveness of the policy response to the banking crisis in the US rested on the federal nature of their programme, the TARP, and on the close correspondence between the boundaries of the domestic market, the jurisdiction of the authorities responsible for supervision and resolution, and the scope of the safety net and support measures. The uneven distribution of bank fragilities and the lack of economic convergence between the core countries of the euro area have probably hindered a common solution in Europe... ■

[1] European Systemeic Risk Board : "Resolving Non- Performing Loans in Europe", July 2017

[2] Lack of high quality data for the assets in question, ineffective legal frameworks governing debt recovery and collateral enforcement, asymmetric information arisen from banks 'cherry picking of assets...

[3] See A. Enria, where there is a will there is a way: completing the repair of the banking sector in Europe, Lisbon, June2017

Systemic risks and resolution in the insurance sector

1. The role of non-bank financial intermediation requires addressing related specific financial stability issues

Non-bank financial intermediation, including that by insurance companies and pension funds, has grown in several advanced economies (particularly in Europe) and developing economies since the crisis, and now represents more than 40% of total financial system assets. Growth was more rapid in developing economies, but mostly from a low base given often bank-centric pre-existing systems. This underscores the importance of addressing appropriately financial stability issues potentially posed by the insurance sector.

Nevertheless, since 2010, the IAIS has been developing a process to identify globally active insurance groups the distress, or failure of which, because of their size, complexity and interconnectedness would cause significant disruption to the global financial system and economic activity (the so called globally systemically important insurers (G-SIIs)).

In addition, the IAIS has developed a framework - in line with the Financial Stability Board (FSB) framework - for addressing related systemic and moral hazard risks. This framework seeks more intensive and co-ordinated supervision, higher loss absorbency (HLA) capacities in particular in order to internalise some of the costs to the financial system and the overall economy of their potential failure. From 2019, G-SIIs will be expected to hold regulatory capital that is not less than the total required by the sum of the BCR and HLA requirements.

2. An activities-based approach for assessing the systemicity of the insurance sector will complement the regulatory approach

Two important factors, which are Non Traditional Non Insurance (NTNI) activities and Interconnectedness, have long been considered by the IAIS for assessing the systemic importance of insurers. However, the IAIS recognised that there is some overlap between these two categories. Consequently, the IAIS decided to discontinue using the NTNI product approach, and to replace it with an assessment of insurance product features, which may lead them to expose insurer companies and possibly the insurance sector, to substantial macroeconomic or liquidity risks, and even to asset liquidation transmission channels.

Consequently, as a complement to the methodology for designating individual firms as global systemically important insurers (G-SII), as part of the three-year review cycle which is scheduled to conclude in 2019 the IAIS is currently developing an activities-based approach for assessing the systemicity of the insurance sector. A consultation regarding the activities-based approach is expected in the second half of 2017.

3. Effective resolution approaches specific to the insurance sector are essential to preserve financial stability

Meanwhile, the FSB is also seeking to facilitate orderly resolution i.e. without destabilising the financial system or exposing taxpayers to the risk of loss. In this perspective in June 2016, the FSB released an ambitious paper “Developing Effective Resolution Strategies and Plans for Systemically Important Insurers” which provides the relevant guidance required to implement the recovery and resolution planning requirements under the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, which complements notably Annexe 2 of the Key Attributes II (Resolution of Insurers).

The Guidance issued by the FSB defines the general guide lines and objectives to be determined – based on a strategic analysis of business segments, critical functions - for a given insurance group, the preferred resolution strategy which notably identifies relevant points of entry into resolution, in order to reduce the cost and impact of the resolution and to achieve the operational continuity for possibly shared services. These resolution strategies have to take into account the nature and location of loss absorbing capacities, the liquidity of the group and its funding sources, and possibly existing policyholder protection schemes.

Naturally specific attention is paid to the cross-border dimensions of a resolution in order to define the appropriate forms of cooperation that the relevant resolution tools would require. These mean establishing Crisis Management Groups with precise objectives and processes for cooperation – e.g. roles and responsibilities, specific processes for information-sharing before and during a crisis, which providing the ability to access to relevant information and data - and formalizing firm specific Cooperation Agreements (CoAgs).

4. Defining such resolution approaches poses many challenges

One of them is the balancing of two different objectives. These are the protection of policyholders together with financial stability. In this respect, although an insurer is not considered as systemically important it could have a wider impact on some parts of the economy and, particularly, on the affected policyholders if it failed. This would be compounded if a number of insurers in a given market were to fail simultaneously.

One essential question is also the appropriateness of limiting the scope of resolution arrangement and frameworks only to systemic relevant insurers. Another is question of the potential systemic threat of reinsurers, the size of which is reduced compared with that of the insurance market. They operate bilaterally with no inter insurance market similar to the interbank market, and are able to create material contagion channels.

Such questions will also be raised by the actual developments related to the so-called activity based approach which will remind us again of the specificities of the insurance sector which are notably encouraged by prudential regulations not only to avoid maturity transformation but rather to match assets and liabilities. This explains why supervisors permanently monitor, and require from insurance undertakings prompt corrective actions when they have to face financial deterioration. This also explains why in most cases a run on an insurer is not likely and why run-offs and portfolio transfers are the most preferred and frequent options for resolving insurance failures.

Establishing the point of viability of an insurer, which is linked to the decision as to when a resolution authority should act, is also a difficulty to be addressed, notably because this might be constrained by national legislation.

More generally, making all these frameworks – assessment methodology, Basic core requirements, HLA, Key Attributes, etc. not mentioning the ISDA 2015 Universal Resolution Stay Protocol, which enables parties to amend the terms of their Protocol Covered Agreements to contractually recognize the cross-border application of special resolution regimes applicable to certain financial companies. Consistency and avoiding unintended regulatory piling ups and overlaps, also constitute a challenge.

Finally, making these preferred resolution strategies operational, will require significant efforts from both the profession and supervisors. Currently, according to the FSB, the implementation of international resolution provisions is less advanced in the insurance sector. The Stability Board considers notably that while CMGs have been established and recovery plans adopted for most G-SIIs, the absence of insurance resolution regimes with a broad range of powers and tools in several G-SII home jurisdictions remains an important impediment to resolvability. ■

Notes

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