SUMMARY

THE **EUROFI** FINANCIAL FORUM 2018

VIENNA | 5, 6 & 7 SEPTEMBER

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

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EDITORIAL

The Eurofi Financial Forum 2018 was organised in Vienna in September in association with the Austrian EU Council Presidency. More than 900 participants from the EU and international public authorities and the financial sector attended this three-day event.

Over 200 speakers contributed to the 35 sessions of this international Forum, covering the main regulatory and supervisory developments and macroeconomic trends impacting the financial sector. How to further integrate and develop EU financial markets in order to enhance risk sharing and improve capital allocation throughout the Union was a major topic of the discussions, as well as the prospects of digitalisation and sustainable finance. The financial stability challenges that the sector is still facing 10 years after the Lehman crisis and the potential implications of Brexit in the short and longer term were also major elements of the agenda. How to address increasing financial fragmentation at the global level was also discussed in several sessions of this event.

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

We hope you will enjoy reading this report which provides an extensive account of the discussions that took place in Vienna.

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SUMMARIES OF THE SESSIONS

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EUROZONE AND EU INTEGRATION CHALLENGES

Ensuring a viable EMU: are we on the right track?

1. 10 years on from the crisis, a great deal has been achieved, and progress is possible by the end of this year

1.1. Improvements have been made Europe-wide and in individual Member States

With some delay and after a lost decade of divergence, significant improvement was seen in the euro area as of 2010. The fiscal position of most Eurozone countries improved in 2017. All Member States, except Spain, have exited the Excessive Deficit Procedure (EDP), compared to 24 Members in in EDP 2011. The public deficit of the euro area Member States is now forecast to fall to 0.7% of GDP in 2018 and 0.6% in 2019.

Current transaction balances, which give an idea of relative competitiveness, now appear more consistent in the euro area. Since the crisis, the disparities in competitiveness have been significantly reduced. In 2016-2017, all countries in the Monetary Union except France were in fact able to achieve a balance or surplus of their current accounts.

An official noted that Europe's structures and progress towards monetary union are much better than they were 10 years ago. At the time of the fall of Lehman Brothers, Europe had a monetary union, but did not have the basis for real economic and fiscal policy co-ordination. Europe now has created the European Stability Mechanism and a much tighter co-ordination system; it has almost finished building the Banking Union, and has a more co-ordinated supervisory system and a more solid regulatory system.

Another official added that Europe has made good progress: EU legislators have advanced in their work on reducing risks in the banking sector, made some progress towards strengthening the role and functionality of the ESM and reached an important agreement on the common backstop to the Single Resolution Fund. However European countries keep exporting their domestic problems and political quarrels, holding hostage the necessary progress in order to look good in the eyes of domestic audiences. All present know that the architecture of monetary union in Europe is not complete. However Europe has delivered a number of institutional fixes and tools, designed during the crisis, and ought to be proud of that.

1.2. A window of opportunity for improving the resilience of the EU economy and tackling weaknesses in the euro area architecture has opened

After a decade of poor economic performance and increased divergence, economic fortunes have improved significantly in recent years. The euro area is enjoying a sustained expansion with growth well exceeding potential, albeit moderating, increasingly supported by vigorous investment and improving job creation. This favourable environment provides a unique window of opportunity for improving the resilience of the EU economy and tackling weaknesses in the euro area architecture.

However, an official noted that the process is not complete, and now is a good opportunity to make progress; Europe should not wait until the next crisis to realise what it should have done. The official's country is engaged with a number of other Member States to achieve a breakthrough by the end of the year.

Another official stated that he has been waiting impatiently for a Franco-German consensus about how Europe can go further in many areas. Every quarter, the official's country has repeated its message about fiscal capacity and fiscal rules, and the completion of the Banking Union. All these issues are very important, especially the Banking Union, and Europe needs to be honest about whether it can go further, or whether it needs to wait for another political cycle.

2. Priority areas for further ensuring the viability of the Economic and Monetary Union

2.1. The importance of Member States doing their homework

Reducing vulnerabilities whilst enhancing the capacity to absorb shocks and reallocate resources will require comprehensive structural reforms. Implementing structural reforms at the domestic level with a view to achieving a steady convergence towards resilient economies is fundamental for improving the functioning of the EMU. These internal adjustment efforts in the Eurozone become even more urgent with the long-term drag of ageing populations and higher projected pension expenditure. However, in one official's view, European countries shy away from reforms. This official noted that they often repeat a message about the importance of countries doing their 'homework' and being fiscally disciplined. Their own country has growth of 4% and record unemployment. This country is nonetheless fully committed to the rules of the Eurozone.

2.2. A Monetary Union cannot work without fiscal discipline

It is difficult to make progress towards a fiscal union as long as existing rules have not been met by all Member States. An official noted that Europe's agenda is already set: it needs to complete the Banking Union, strengthen the ESM, and build a credible stabilisation function that can help to tackle asymmetric shocks. Politics, however, are holding back progress: Europe does not have a political union, and aiming for an economic union without a political one means that it is difficult to accept basic economic truths such as spill-overs and asymmetric shocks.

Europe's finance ministers are now working on their budgets for next year; it will not be easy for them to convince their cabinet and coalition colleagues of the importance of achieving a balanced budget and decreasing debt, particularly in the context of the political cycle. However, it remains important to enforce agreed EU rules, although where there is widespread dissatisfaction with the rules, or with issues such as the output gap, it is important to change them, rather than just talking about doing so.

2.3. Completing the Banking Union

The Chair notes that improving and completing the Banking Union would foster a more effective allocation

of resources across the Eurozone, help to achieve a better diversification of risks thus contributing to private risk sharing across the EU. An official stated that Europe needs to develop a common deposit insurance system and a solid European Stability Mechanism. Europe has been working on some of these issues for years, and it should be possible to reach a compromise and an agreement on them by the end of this year. Agreeing on a date for the backstop, and possibly bringing this forward, would represent good progress.

Another official added that they are reasonably sure that Europe will be able to complete the Banking Union, although the Austrian Presidency will need to be clever in reconciling the proposal from the European Commission with all of the pillars of the Franco-German paper.

2.4. Correcting the current disequilibrium in the monetary union

The Chair explained that the pattern of euro area rebalancing that predominantly relies on 'adjustment in weaker countries' is not sustainable either politically or economically. The symmetry of economic adjustments should also be a priority focus. Lack of solidarity and an unjustified mistrust towards countries with lower productivity will indeed feed populism in Europe and undermine the cohesion of the euro area. In addition, lasting and excessive current account surpluses are not sustainable within a monetary union because they result in effect in creating currency advantages for the best performing countries. This is true also at the international level, as illustrated by the recent complaints of the US administration. Symmetric economic adjustment both in deficit and surplus countries is therefore a prerequisite for a durable rebalancing in the euro area. He asked the ministers if there must be a symmetrical adjustment mechanism to prevent a long-run excessive balance of payment surpluses or deficits.

An official noted that there will inevitably be another crisis, but Europeans should not adopt the mind set that they are never in a good phase; the present time is a positive moment. Building the monetary union or the European project in general should not be seen as a means of shying away from national obligations. Countries need to carry out structural reforms, ensure fiscal stability and address their system imbalances, although it will be impossible for all countries to have a zero current account deficit, a zero current account surplus, or zero public deficit. However, these different cyclical moments should not be magnified to the point at which they become a source of instability. The official noted that her country has seen real wages fall, child poverty return and inequalities grow, and any country that can avoid going through a similar process in future, by avoiding high deficits and imbalances, should do so.

Another official added that their country went through a very painful experience in the 1990s, involving hundreds of thousands of people being fired and structural losses in the labour market. However, that painful period is now over, and the official's country remains committed to the enforcement of agreed rules.

Responding to a question from a participant regarding whether the central issue is not imbalances between countries, but rather imbalances between rural and urban areas and the service and manufacturing sectors, an official stated that it is always necessary to begin analysing Europe-wide imbalances on a national level. In this official's country, private household debt has reached double digits over the past two to three years, and their central bank has recently introduced macroprudential measures to deal with this dynamic, which is another example of countries 'doing their homework'. Individual countries are responsible for themselves, and need to deliver at the national level before doing anything else.

Another official agreed that the issue of imbalances within countries is an important one; in particular, the difference between the countryside and cities is noteworthy, and politically significant, in most of the countries of Europe. Although Europe takes the regional level into account to some extent, it is important to look at this issue more, as well as the individual level. It should be borne in mind that, the more equal societies are, the more stable their growth.

2.5. A central fiscal capacity for macro-economic stabilisation

2.5.1. The current proposal of an embryonic fiscal capacity is a positive development

The EU Commission has proposed that a European Investment Stabilisation Function linked to the EU budget would complement existing instruments at national and European levels to absorb large asymmetric macroeconomic shocks in the euro area and countries participating in the European Exchange Rate Mechanism (ERM II). It would represent an embryonic Central Fiscal capacity. The EU budget would guarantee back-to-back loans of up to €30 billion (about 0.2% of euro area GDP in 2021). The loans would be available to Member States experiencing a large asymmetric shock and complying with strict eligibility criteria for sound fiscal and macroeconomic policies.

Responding to a question from a participant about how officials regard this proposal, one official stated that their country supports embryonic efforts to create a fiscal capacity. It is better to make progress than to reject a good proposal because it falls short of perfection. Another official stated that their country feels the same way about the Commission's proposal.

2.5.2. A Europe-wide unemployment insurance scheme is an attractive option

An official stated that they would not want to make clear their preferred option for how fiscal capacity should be dealt with; expressing a preference might make it difficult to reach an agreement. It is unacceptable to take the view that, for instance, a 15% unemployment rate represents the equilibrium rate of unemployment; it is extremely important to increase output and GDP growth, and reduce the rate of unemployment. In the official's country, one of the most important fiscal automatic stabilisers is unemployment insurance, as it has a very high unemployment rate and unemployment has been a major source of imbalance through expansionary and recessionary phases. If Europe aims to increase its stabilising capacity, unemployment insurance is an obvious means of doing so.

An official added that certain preconditions need to be met before these types of transfers can take place, including commitments to rules, fiscal discipline and responsibility; in this way, the threat of moral hazard can be mitigated. However, the nations of Europe should not forget that asymmetric shocks exist, or that countries have promised their citizens that the 2008 crisis will not be repeated. Fiscal capacity will inevitably form part of the architecture for delivering on this promise.

Restoring capital mobility in the euro area

During the decade from 2000 to 2010, there was a high level of capital mobility within the Eurozone but it mostly resulted from inter bank funding which supported the financing of inefficient investments (e.g. in real estate bubbles, sub optimal business ventures and infrastructure projects notably in Spain, Italy, Portugal, Ireland and Greece) and which contributed to massive current account deficits. The 2011-2013 sovereign debt crisis halted the circulation of capital flows around Eurozone and EU countries.

Since then, financial flows between the Eurozone countries have declined; there has been a fall in cross-border loans in the euro area. The share of the government bonds held by non-residents has dropped. Investors' and banks' portfolios have increasingly become national following the sovereign debt crisis. Member States with excess savings (Germany and the Netherlands in particular) no longer finance investment projects in lower per-capita-capital countries (Spain, Italy, Portugal, Greece). Indeed the euro area exhibits from a savings surplus of more than €300 billion or 3.5% of GDP in 2017, which is no longer being lent to the other euro-area countries but to the rest of the world excluding the euro area.

Developing cross-border financial flows within the euro area is essential. The true objective of a currency area is that savings should flow to finance the most productive investments throughout the currency area. Indeed in a monetary union, the elimination of currency risk allows savings from the countries that have a high level of per capita capital (Germany, Netherlands, France) to finance investment in the countries with lower per capita capital and higher marginal productivity of capital (for example Spain, Italy, Portugal). Income convergence therefore normally stems from the transfer of savings from high per capita income countries to low per capita income countries. But, as mentioned above, these transfers have been considerably reduced in 2008-2010.

To restore the capital mobility between the Eurozone countries, the confidence of the countries with savings surpluses in the solvency of the other countries 'governments and banks must be restored. The prerequisite for reducing regulatory barriers to capital flows is that legacy issues, including high levels of NPLs in some individual banks, must be addressed and the risk reduction legislative package must be adopted, including an NPL prudential backstop to prevent the future accumulation of excessive NPL stocks as problems like this hold back the political trust required to move forward quickly. To address this point, Europe must trust and strengthen its institutions such as SSM and SRB and empower them further to continue their programmes. Since it is understandable that some national authorities are concerned about the possible financial stability implications of for example future waivers for capital, such concerns need to be addressed.

1. Asymmetric imbalances between euro area countries are unsustainable

1.1. Asymmetric adjustments in countries with persistent and large current account imbalances hinder capital mobility in the euro area

An official underlined how the euro area has been characterised by very large and persistent competitiveness gaps between countries, which is one of the main obstacles to overcome. Since the crisis, the recent history of Europe has featured 'not very good adjustment', which means that not all countries have adjusted. More countries are now running surpluses, but the adjustment in Europe has not been appropriate because the countries with large deficits have adjusted their current accounts by reducing domestic absorption; essentially, they have undergone output contractions, labour shedding or higher unemployment. There has been less change in the large surplus countries. In terms of how adjustment should ideally work, within a currency union there must be periodic real exchange rate realignments.

These real exchange rate realignments are not happening in the correct way in the currency union. There are ways to do real exchange rate realignments. One is by differential inflation rates or differential wage growths. This means seeing higher inflation and higher nominal wage growth in the countries which are performing well. One helpful aspect is the ECB's very accommodative policy. In particular, the ECB is focused on its euro area price stability objective and is not overly concerned about inflation developments in specific countries. That is very important, because it allows real exchange rate alignment through nominal differential inflation rates. However, most of this adjustment must come from the real side and emerges from real factors. The ECB's inflation objective cannot achieve the real exchange rate realignment the euro area needs. In terms of these real factors, labour productivity has a lasting effect on competitiveness adjustments. Labour shedding and wage reductions should not be used to perform adjustments in the future. To give one example, these competitiveness gaps are widening further. Productivity in German manufacturing has grown by over 30% since 2000, but in Italy it grew by only 8%. With similar wage growth in Italian and German manufacturing, German competitiveness has far outpaced Italy's. Unfortunately, the structural reforms essential to raising productivity have actually slowed in many of the economies which need them.

A public representative highlighted an important macroeconomic issue. Implicitly, many governments in Europe are favouring export led growth over growth based on domestic demand. The current tensions between the EU and the US demonstrate that this might cause backlashes.

1.2. Capital flows are not going inside the south of the euro area

An official suggested that one of the most striking observations about capital flows in Europe since the advent of the euro is that foreign direct investment emanating from the northern European countries has gone east rather than south. Competitive gaps are only one explanation, however. The lack of structural reforms and low investment is reflected in one very worrying measurement: before the advent of the euro, per capita income levels between the original 12 members were converging but since then they have essentially diverged. Real income levels per capita are not converging, which is quite worrying. As a result of the fact that the newer Member States which have joined the euro subsequently are characterised by fewer structural rigidities, per capita incomes in these countries are rising and converging with the incomes of other countries, even though the process has been slow. The official wondered whether they were focusing disproportionately on countries with lower per capita incomes in the south of the euro area, noting however the existence of the Macroeconomic Imbalance

Procedure. This framework encourages countries like Germany to address their excessive fiscal or domestic surpluses. However, it does not have much force and it has not been applied very often, but there is some mechanism for symmetric adjustment.

There are two issues with capital flows. First, if Germany or any other of the surplus countries did more to rebalance its policy-mix and raise their domestic demand, the question arises whether this would benefit the south of the euro area. The IMF doubted this, because there is no way to show definitively that these positive spill overs are stable, robust and always flow in one direction. More importantly for capital mobility, the counterpart of the German current account surplus is its exports of domestic savings. There is no way to engineer an outcome which mandates that Germany's domestic savings being exported must go to the south of the euro area. This is the real challenge: to relate adjustment in the currency union to capital mobility. In fact, if Germany's current account surplus were to adjust to a lower level, it would necessarily lead to lower capital outflows from Germany, which would not help the south either.

The official queried whether the Banking Union has facilitated more capital mobility. Unfortunately, cross-border banking flows in the euro area have declined. In 2008, cross-border banking flows within the euro area amounted to approximately €2 trillion. In 2017, this figure was €1.3 trillion. The creation of the SSM and the SRM has not reversed this decline. By contrast, capital flows in the form of portfolio equity and bond flows within the euro area declined during the financial crisis and have now stabilised, but they have not declined as much as banking flows. Risk sharing fosters both stability and convergence within monetary unions. And without that, it becomes much harder to make high rates of growth sustainable.

2. Despite the implementation of the Banking Union, the banking markets remain highly fragmented; in addition, the Capital Markets Union project fails to deliver on its promises

2.1. The national ring-fencing policies of capital and liquidity clearly fragment the banking markets and keep retail banking integration low

An industry representative felt that Europe went through a difficult crisis in 2008 and 2009. Many of the participants at Eurofi had shared a dream, which was to make the eurozone stronger, more resilient, and quicker to react to shocks and finance rebounds. This dream was especially shared by those in the banking sector. The industry thought that Ministers, the ECB and the European Commission would make this dream a reality through the development of the Banking Union. So far, a substantial amount has been achieved, including the creation of the SSM and the SRF. At an earlier panel at the conference, potential risks were discussed, including a potential slowdown in the economy, a potential crisis, political tensions, populism and anti European sentiments. Two very serious opportunities have been missed, however. First, the system remains massively fragmented, and there is increasing support for fragmentation. There is a fragmentation of capital, liquidity and bail-in instruments. The industry representative expressed surprise that it is possible to speak of 'internal MREL' in the euro area. The SRB must surely be against this notion. There should not be any fragmentation of bail in able liabilities. To some EU Institutions, this is apparently normal, however. This idea seems to contradict the European ideas of private risk sharing with this and the efficient allocation of resources and capital. The shared dream of Europe has not been implemented, and the eurozone is not sufficiently strong because of this fact.

The industry speaker felt it is extremely difficult to reallocate assets when the situation in Europe is so fragmented. In Europe, this is a 'chicken and egg' question. Europe is not like the US in terms of the role of capital markets. In Europe, the banking industry has a key role in allocating resources across businesses and territories. The promise of the euro is to do this at the level of the eurozone. Fragmentation happens endlessly, because there is national bias. When there is national bias, choices are made in different ways. Europe should reduce fragmentation and avoid this outcome; then capital will be allocated in a better way. The other very important aspect here is trust, namely blind trust, especially between home and host supervisors. However, trust among supervisors is very important for the future. If there is trust in Europe, measures will be developed and decisions made on a step–by–step basis. This area does not need excessive regulations; it requires more decision making.

The time has come for political leaders to trust the institutions they have created. The time has come to trust the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). European nations should not act at the national level, adding constraints to their common institutions. This would not be difficult and should be done, not next year but now. Ms Nouy of the SSM has indicated that moving for transnational banking groups to a branch based model over a subsidiary model could reduce fragmentation, but this demonstrates how Europe has reached a point at which it is having this kind of debate and is not able to fix it. It is important to solve these problems before the elections to the European Parliament.

2.2. The level of securitisation in Europe is lower than before the crisis due to an inappropriate regulatory framework

An industry speaker underlined that securitisation is very important. Some of Europe's savings should go to securitisation and reduce the pressure on banks' capital to allow them to fund the real economy. In the US, the capacity to sell assets and use capital in fresh ways lies at the core of the US banking sector's capacity to rebound. There are plenty of buyers of assets in the US, but this does not work in Europe. The level of securitisation in Europe today is lower than before the crisis. The industry representative expressed incredulity at how this is possible. If there were a crisis, banks would not have the capacity to inject more capital to support the economy. If there were a crisis, the industry speaker felt that the industry would suggest that regulations are overly tough and ask regulators to relax them. The US did this, but it did this during a period of growth. In any event, regulations are a positive factor. The problem here is in fact the lack of securitisation. The industry representative questioned whether regulators and supervisors would prefer to face a political debate about relaxing regulations or simply establish an efficient and well functioning securitisation system.

2.3. Legacy issues, including high levels of NPLs in some banks, must be addressed and the risk reduction legislative package should be rapidly adopted

An official felt it is important to consider what is happening in both the Banking Union and the Capital Markets Union. Europe has been very slow to overcome the banking crisis. 10 years after the crisis, there are still countries and banks with high levels of NPLs. The total number of NPLs in the system is not an issue, however; the capital numbers for the system are high. The problem exists in a fairly small number of banks, but this holds back the political trust

required to move forward quickly. To address this point, Europe has created the SSM and the SRB, which is a huge step forward. Europe must trust these institutions and, if necessary, empower them further to continue their programme. These projects will only move forward if strong European institutions drive them.

Secondly, it is essential to finalise the legislation which is already being developed in order to reduce risks. Ideally in December, and undoubtedly before the next set of European elections, Europe must drive forward the banking package currently in the trialogue: the NPL package, the agreement on the introduction of the common backstop for the Single Resolution Fund and the agreement to bring it forward before 2024. It is a short period of time, but the EU has a very able Presidency, so all industry participants should focus on closing these issues by the end of the year.

2.4. Too little progress on building the Capital Markets Union

An official suggested that the most difficult part of this debate is connected to the need to move forward on the Capital Markets Union. This is the prestige project of the Commission. There has been little progress in legislation and very little progress in actual activities in the markets. For instance, according the report of the ECB on financial integration, only around 30% of debt securities and 20% of equities are held by investors in other countries.

After the Banking Union dossiers have been closed in December, prior to the start of the next Commission, all industry participants must think about what must be done on the CMU. An official noted that according to the long perspective the elements to work on should also include difficult issues such as insolvency issues beyond bank insolvency law and tax. Only after one year of consultations France and Germany agreed on a common position paper on the CCTB-Directive-proposal. This demonstrates that considerable progress is possible. More cooperation in this area could become a nucleus to illustrate a way forward on how to tackle the more difficult issues.

2.5. The misallocation of capital is a result of the policy environment

A public decision maker felt it is important to address the supply side of the economy, rather than what is seen today in terms of the focus on the construction sector and other relatively unproductive sectors. This question concerns the allocation of capital. The misallocation of capital is a result of the policy environment. This official queried why more capital is invested in real estate than infrastructure, as an example. Additionally, in relation to Capital Markets Union this question raises the question of contributing to standardisation. Infrastructure finance is a good example of this. Many investors and firms want to put money into the green economy, but it is very difficult because it is not standardised. There can be an asymmetry of information and substantial governance problems. Yet a considerable amount of money in savings flows into real estate. The industry seeks to standardise and create new asset classes. This problem is not caused because there is a demand for this from savers. The capital markets also drive efficiency by the creation of new categories and through providing information on governance and similar topics. It is curious that so much money is in real estate, which will probably be the source of the next crisis.

3. Potential solutions to restore capital mobility within the euro area

3.1. Achieving symmetric adjustments in countries with large current account imbalances

An official returned to the comments made by another official about how adjustment would function in an economy with full employment such as Germany's. As a full employment economy, Germany cannot increase its imbalances by spending even more money. The official noted that the necessary changes are happening. The problem of rebalancing Germany in favour of domestic demand is being addressed, but capital is flowing into construction and other sectors of the economy which are not necessarily the most productive. Europe's overall productivity issues are well known, but this issue also exists in Germany in areas such as services, infrastructure and energy. Another official shared the observation made by a previous official that the quantum and the speed of structural reform in Europe are insufficient. Additionally, this official agreed that it is unclear whether raising demand in Germany would benefit the countries within the eurozone that need this. Considering current wage growth in Germany, the basis for change is there. However, there is a lack of sufficiently deep and fast moving structural reform in all parts of the eurozone, which is also true for Germany. On infrastructure, the official advised that one key constraint is a lack of sufficient government planning capacity to deploy capital.

A public representative explained how this question involves the decisions of people or firms to invest in particular countries. The majority of the problem is not a lack of investments in some countries within the European Union; it is a lack of capital. There is a problem of demand in investment. Credible demand for investments can be undermined by non functioning labour markets, insufficient skills bases, an absence of infrastructure and general mistrust in the stability of the economy. These are the key elements that must be improved and restored. If the situation improves in the countries showing this kind of deficiencies, even if local financial systems do not function perfectly, people will find a way to bring capital. The only way to reach a more balanced situation is through structural reforms which will improve the competitiveness of the economy. An official agreed with the Central Bank official's central point. In a full employment economy such as Germany's, there is a strong opportunity for reforms. It is essential to expand the potential for growth. This can be achieved via things such as increasing female labour force participation, which the German government is already addressing, or by conducting infrastructure investment. The official reiterated that it is hard to identify whether positive spill overs would occur to southern Europe or the rest of the euro area.

3.2. Completing financial integration

3.2.1. Creating an enabling environment for pan European banks in the Banking Union

A public decision maker outlined several obstacles that hinder the fungibility of capital and the liquidity of banking groups. First, a number of national options and discretions are hindering the practical application of cross-border liquidity waivers within the Union. While such waivers are explicitly allowed by the CRR, and already contain prudential safeguards, so far the ECB has received almost no application for their use from the banks it supervises. An important reason for this lack of applications is the existence of national large exposure limits on intragroup exposures in several European countries. These limits prevent institutions in these countries from transferring liquidity within the group in a flexible manner and thus represent practical obstacles to the use of liquidity waivers. Effectively, they are hindering the free flow of liquidity in the Banking Union and should be harmonised further.

Second, the proposal to have cross-border capital waivers within the EU was not taken forward in the on-

going review of the CRR, which is a missed opportunity. Such waivers would be consistent with the establishment of the SSM and the Banking Union and help to support the free flow of capital across the Union. On the one hand, it is understandable that some national authorities are concerned about the possible financial stability implications of the proposal. On the other hand, such concerns could be addressed in the future by making the waivers subject to additional prudential safeguards, and by putting in place appropriate transition arrangements subject to the planned further progress on the Banking Union.

Third, the major progress we have made in our Banking Union needs to be recognised also in the international regulatory framework. For example, the G-SIB framework currently penalises cross-border transactions within the Banking Union by attaching a higher systemic risk score to banks with more of such transactions. This goes against the very rationale of the Banking Union, as it reduces the incentives for cross-border transactions and risk diversification. The international regulatory framework should recognise the progress that has been made in the Banking Union and exclude intra Banking Union positions from the cross-jurisdictional indicators in the G-SIB methodology.

Fourth, there are also some resolution related aspects that warrant further consideration. In particular, the allocation of internal MREL has turned out to be an area of tension between national jurisdictions. Jurisdictions with a foreign bank subsidiary prefer to have a high pre-positioning of internal MREL to ensure an orderly resolution of its local subsidiary. However, this implies a certain degree of ring-fencing to the detriment of the foreign parent bank. The compromise reached by Member States in the Council only allows internal MREL to be waived if the resolution entity and the subsidiary are located in the same Member State, neglecting the fact that so much has been achieved in terms of joint supervision and resolution among euro area countries. Therefore, it should also be possible to use guarantees to replace internal MREL and allow for more flexibility in the allocation of resources within the Banking Union. Of course, to install confidence it will be important to have adequate safeguards in place, including there being no legal or practical impediments to the provision of support by the parent to the subsidiary, in particular when a resolution action is taken.

3.2.2. A common liquidation regime for pan-European banking groups

An official considered that, in comparison with the banking system in the United States, there is one key element missing in Europe: a unified code of insolvency. Europe cannot wait until insolvency law is harmonised. Europe must focus on the elements of bank insolvency law which have a close, if not direct, connection with resolution, where further harmonisation is necessary. That is a very important element not only for the management of groups and facilitating resolution but also for addressing the waiver issue.

3.2.3. Finding a compromise between speed and ambition

Considering the range of possible solutions, the public representative felt that many things could be done. In many cases, it is possible to find a compromise between speed and ambition. While achieving a Banking Union and CMU are within Europe's reach, the public representative opined that these may exceed Europe's grasp. It is important for Europe to understand what the purpose of restoring capital mobility is. Europe should not be happy with simply restoring an active interbank market. In fact, this issue is about divergence between the countries within the European Union. Even in a fully functioning market, not all banks are the same.

Conclusion

The public representative felt there are three important things for Europe to focus on. First, policymakers, representatives from public authorities and industry figures should 'do their homework' in respect of national politics and structural reforms. Secondly, trust must be restored not only between supervisors but between top level policymakers and the people within countries, because trust is disappearing. Finally, Europe is not working cooperatively. Many different types of institution are operating in this area and hoping that everything will simply work out. Different participants must trust each other, be more cooperative and do their homework. An official noted that this demonstrates what an industry speaker indicated: defragmentation is possible, but without major changes it will not be well allocated.

Enhancing cross-border risk sharing and capital allocation in the Eurozone

In an effective Banking Union, there should no longer be any distinction between home and host supervisors for banks operating across borders. The possibility of 'national bias' playing a part in regulation or supervision should be eliminated.

However, the EU legislative prudential framework does not recognise transnational groups at the consolidated level, but as a sum of separate subsidiaries, notably due to the insufficient trust of Member States vis-à-vis the institutional setup of the Banking Union. Consequently, the Banking Union represents a source of costs for the significant supervised entities in terms of contribution to the Single Resolution Fund, local prudential requirements and additional compliance costs. Although these costs are to a large extent results of the higher prudential requirements for banking - including cross-border activities as a consequence of the financial crisis - they have produced only limited beneficial effects on banking integration, notably due to the national ring-fencing policies of capital, liquidity and bail-in instruments that - while addressing justified concerns by host Member States - clearly fragment the banking markets and impede the restructuring of the banking sector.

An official opened the discussion and underlined the general agreement in the sector that greater investment is required in Europe, that savings should be used in the best possible way across the borders, and that financial stability would increase with some private risk sharing. There is currently more fragmentation in the banking market than was the case before the financial crisis. This is not merely a regulatory problem but is also a matter of trust. There are significant differences across the borders within the European Union, the single market and the Banking Union with the distinction between home and host supervisors.

1. The deepening fragmentation of EU banking markets is worrisome

1.1. The domestic bias of the EU banking regulatory framework and the absence of a common insolvency regime impact the profitability of EU banks

An industry representative expressed disappointment at the fact that the fragmentation of the financial system in Europe has not been addressed, and noted that the fragmentation is not due to banking regulation, but rather due to highly political elements. The profitability of the banks within the Eurozone is damaged by the fact that liquidity, subordinated debt and capital are still fragmented and that a great deal of energy is being expended to locate these fragmentations and to argue the case for a consolidated approach. The resistance to consolidation seen in many host countries is not easy to understand with the resolution mechanism now in place under the aegis of a single institution as well as the establishment of the colleges of supervisors and the principle of 'no creditor worse off'.

An official cited the lack of a pan European business model as being a key issue of concern. This is exemplified by the German banking sector where the post-crisis reaction has been to retreat very substantially to its domestic market. The German market has a substantial external surplus that translates into an excess of savings. From a macro-economic perspective, a banking sector that is very domestic will always have a "passive überhang", which is a great deal of deposits that are very earnings-challenged on the asset side. As such, the aggregate return on equity (ROE) in the German banking system is not ideal. There is a growing realisation that, in a country like Germany that is global and export-oriented and that has a very strong and demanding corporate sector in terms of the financing capabilities that it requires, it is not beneficial to have a banking sector that is earnings challenged and that struggles to build a business model that can allow the finance sector to be more expansive and to grow at a pan-European level. Then the speaker described some examples to illustrate the current fragmentation in the banking area.

An example of a regulatory obstacle, which goes some way to explaining the current fragmentation, is in relation to the G-SIB (global systemically important banks) score. When a French bank acquires an Austrian or Belgian bank, for example, it is treated very similarly in its capital charges as if it were buying a bank in Kazakhstan or Colombia. The current banking package attempts to address this issue but much more needs to be done. Moreover local capital and liquidity constraints are very serious issues and must be addressed very strategically, particularly in light of the need for a level playing field between America and Europe.

A significant obstacle to the unification of the resolution mechanism exists in the form of differing insolvency regimes between Member States, which undoubtedly leads to very plausible and credible concerns in the host countries. The concept of 'no creditor worse off' is plausible and strong, but applying it to a plethora of national insolvency regimes where many Member States are still resisting harmonisation will lead to great difficulty in fostering real unified capital and liquidity mobility.

The official also noted a particular issue whereby banks are willing to act 'European' when things are working well but become very domestic during moments of crisis. This essentially means that the banks are withdrawing financing precisely when that financing is required.

Another public decision maker noted that greater political will and compromise is key in order to find the necessary solutions to these issues. Ministers of Finance, as opposed to Ministers of Justice, should be involved in fostering the harmonisation of the insolvency regime at the EU level.

1.2. Addressing the home/host issues in the context of the completion of a fully fledged Banking Union

A speaker emphasised that the completion of the Banking Union will solve the fragmentation issue at the European level and will facilitate better cross-border consolidation. A particular issue in this regard is the European Deposit Insurance Scheme (EDIS), which is crucial for host countries in substantially reducing the risk of local taxpayers being exposed to losses when a consolidated transnational bank fails and the host country has to compensate the depositors of its domestic subsidiary. It is also necessary to remove the present risks of transforming subsidiaries into branches. Both home and host countries face downside financial stability risks in this regard. With large banks, the home country may be unable to cover deposit claims in other Member States, especially when a large entity has headquarters in a small home jurisdiction.

An industry representative stressed, however, that addressing the home/host issue should not be postponed until the completion of a fully-fledged banking union as it could take 'centuries' to wholly harmonise models and legal systems across Europe. He continued by saying that consideration needs to be given to defining the minimum political package that would be needed to overcome the question of confidence between host countries and banks as well as, to a certain extent, between countries and the European institutions. Ultimately, however, this is not a question for the private sector.

In terms of the political landscape, an official encouraged Germany and France, in particular, to develop quickly a consensus on the issues raised above as history shows that, when Germany and France agree on something, there is a chance that the rest of Europe will follow suit. Steps have already been taken in this regard, for example concerning: the German position on the common backstop, where there has been no demand for any kind of automatic sovereign debt restructuring; the Meseberg paper that was signed with France; and the decisions that were made both at the Economic and Financial Affairs Council (ECOFIN) Eurogroup and the head of state level in terms of fast-tracking the common backstop, which is a very significant step towards addressing the sovereign bank nexus.

2. Two possible solutions exist to moving forward: an unconditional financial solidarity among the different entities of transnational EU banks and the transformation of subsidiaries into branches

There are two possible optional solutions to moving forward. One is a branchification approach and the other is a banking group support approach.

The branchification approach arises from the fact that the current European legislative framework allows transnational banking groups to transform their subsidiaries into branches. This approach would create 'de facto' unconditional group support for branches and would ensure equality of treatment of creditors of the same ranking regardless of geographic situation. In addition, it would not require any prior harmonisation of multiple national insolvency laws since the Directive of 4 April 2001 has established a common liquidation regime whereby the liquidation of bank branches is managed under the regime of the parent company.

The banking group support approach is predicated upon the notion that the level of own funds and the

creation of MRELs have considerably increased the solvency of EU banking groups, which means that they should be able to deal with any difficulties that their subsidiaries run into within the Eurozone. This outright group support should be based on EU law and enforced by EU authorities. This commitment is the key condition for the banking groups who wish to define prudential requirements at the consolidated level.

2.1. Nordea Bank: a successful example of branchification

An industry representative outlined the experience of Nordea Bank in its approach to branchification. As of 1 October 2018, Nordea's headquarters will move to Helsinki, which will mean that the bank will operate within the Banking Union. It is the largest bank in the Nordic region, with a balance sheet of approximately €600 billion, and is the result of a merger of Norwegian, Finnish, Swedish and Danish champions that took place roughly 20 years ago. It is therefore not a single country bank that has expanded but rather a creation of four countries coming together, all of which are small liberal market economies with a disproportionate number of large multi-national companies and each with a different position in the single market.

The bank was created 20 years ago because of the realisation that these small open-market economies would need a strong bank that could not only support these societies but, in particular, support the large multi-nationals when they expand and become more global. Nordea's vision has always been to operate as one bank with one operating model, which requires an appropriate legal structure that reflects the business, and a business model and that can help implement new regulatory requirements.

As a result, Nordea branchified the bank in January 2017. Sweden remained the parent territory with Finland, Denmark and Norway becoming significantly sized branches of the Swedish bank. It was then recognised that, as far as the Banking Union is concerned, Nordea would only be able to remain competitive if the regulations that it implemented were stable, predictable and fostered a level playing field, and that a single country regulator would never be able to fully respond to a multi-national, cross-border bank of Nordea's size. It therefore made the decision last September to move its headquarters from Stockholm to Helsinki, which essentially means that Sweden becomes a branch and Finland becomes the parent bank. This will reduce the bureaucracy that would otherwise arise with multi-jurisdiction subsidiaries and will help drive a single operating model to implement forthcoming regulation. It is hoped that Nordea will now achieve what it initially sought: predictability, stability and a level playing field to enable competition.

2.2. Unconditional group support as another possible way forward

An industry representative highlighted that branchification is difficult for a variety of reasons, notably in the countries in which there is a desire to associate local partners. An alternative, therefore, that could be further investigated, might be found in support within the banking group that wishes to operate in an integrated way. This being said, the industry representative stated that it would be highly unlikely for a bank in the Eurozone to allow one of its subsidiaries in another participating Member State to fail. As an example, Crédit Agricole recapitalised its subsidiary, Emporiki, during the Greek crisis six years ago. Crédit Agricole took this measure because it was considered to be the bank's 'duty' to do so.

An official considered whether the sector needs to go beyond the 'solo approach' in the Banking Union and perhaps invent some guarantees and some more predictability in the way that a bank can help a subsidiary based in another country. Another official acknowledged that guarantees from a bank's headquarters would help to eliminate the uncertainty but noted that those guarantees should be based on EU law and should be universal. While 'soft law' can be important in this regard, it is not enough when it comes to the issue of trust, which instead requires strict legal frameworks. This point was also emphasized by a public decision maker.

Conclusion: rebuilding trust

It is essential to consider transnational banking groups of the euro area as unique entities from an operational, regulatory and supervisory perspective, and not as a sum of separate subsidiaries if the fragmentation of the banking markets in Europe is to be addressed.

To ensure such an objective, it is necessary to tackle the root cause of domestic ring-fencing practices which, in general, lies in the concern that, should a banking group face difficulties, the parent company would repatriate liquidity and capital to the detriment of subsidiaries in other jurisdictions. This lack of trust between national authorities is one of the most damaging legacies of the recent financial and sovereign debt crises. Measures such as the Meseberg paper may present a significant step forward from a technical point of view but there is still the question of how many people in the street actually understand, for example, what MREL is. To rebuild trust in Europe, the sector has to go beyond the technical questions. Acceleration is required in order to convince citizens that change is coming, as opposed to getting bogged down in negotiating approaches between different countries.

Optimising the Banking Union

1. Not completing the Banking union would be a great mistake

A public decision maker stated that an analytical argument not to complete the Banking Union would be difficult to make. There should be quick agreement among the panel that, following the enormous growth of the financial sector since the Economic and Monetary Union (EMU) came into being in 1999, it was a conclusion of the crisis that a genuine Banking Union was a missing element in the EMU. Steps have been taken to the extent that there is a Single Resolution Mechanism (SRM) and the Single Supervisory Mechanism (SSM), but it is incomplete, which begs the question of how and when the Banking Union can be appropriately finished.

1.1. The euro area economy and the European banking industry are resilient

An official advised that asking why the Banking Union is necessary is important to keep the broader picture in mind. First, the Banking Union is a core part and an essential element of the EMU, which is still unfinished

business. Financial stability was the neglected child in the Maastricht talks of 1990-91 and this will be corrected by completing the Banking Union. That is the main reason why the European Commission suggested pushing forward with the Banking Union in 2010-12 and why an agreement was made by the Member States and the European Parliament in the summer of 2012. Significant progress has already been made since it was agreed in 2012. The Single Supervisory Mechanism, established under the auspices of the ECB, has successfully unified and overhauled the supervision of euro area banks. The Single Resolution Mechanism has given the authorities improved powers to intervene in failing banks.

Second, the economic starting point for euro-area reforms is relatively benign and positive. There is a more political genesis, but the economic context is benign. Growth is strong and solid, and the economy has been in recovery mode since 2013. The ECB's policies have contributed to the turnaround. Reforms in euro-area Member States and better economic and financial governance at the EU level have made the euro-area economy more resilient. There is no return to the unsustainable old normal pre-2008 economic and monetary policy; instead, there is a progression to a new normal equilibrium, characterised by stronger regulation, the utilisation of macroprudential policies and a substantial evolution of monetary policy. Such a context should favour further a strengthening of the institutional basis of the Banking Union, particularly in the areas of banking resolution and deposit insurance.

An industry representative noted that the European banking industry is more resilient than it was 10 years ago and the Core Tier 1 ratio is around 11% on average. The SSM and SRM are in place, although elements are still missing. In order to solve the current stalemate, it is necessary to look at the European banking structure and at questions that cannot be solved by the European Insurance Deposit Scheme (EDIS) proposal such as ring-fencing policies across cross-border business which include the free flow of capital and liquidity.

1.2. Where the Banking Union stands following the Council's conclusions on a roadmap to complete the Banking Union (June 2016)

A public decision maker noted that there is a question about where the Banking Union stands following the 2016 Council Conclusions on a roadmap to complete the Banking Union. The banking package is in the trialogue. At the same time, that differences remain became clear from the European Council's discussions in June on the desired degree of risk reduction necessary before moving to EDIS. This is nothing special in Europe. The division of responsibilities to decide on which level certain competences, correct powers and forms of risk-sharing should be brought exists in federal societies such as Europe and in the US. It comes back to striking the right balance between liability and control. The jurisdictional level that bears the consequences of decisions will want a say in discussions.

1.3. Safeguarding the credibility of EU institutions is essential

An official turned to the current situation as perceived from an outside rather than an inward-looking perspective. Banks are in global competition and are strategic assets for the continent. Continued discussion of the Banking Union is puzzling. It is important to consider what that means for a normal EU citizen and whether permanently talking about the Banking Union can convince them. Without minimising the institutional achievement, when the idea of the Banking Union was developed in 2012, it was with political impetus on the future of the EMU and a Banking Union to tackle serious sector-limited issues. Forgetting the big picture could end up creating overwhelming differences.

However there is good news. It is positive for business to benefit from a large market with a cross-border vision. It is positive for the banks that are already cross-border; it can even be good for German savings banks that are in the markets for good. Savings exist in some countries due to the well-functioning Single Market and because companies benefit from a larger space. The financial sector must have the same non-fragmented analysis.

'Step-wise' is confusing. Last year, the European Parliament had two years of work on EDIS behind it. It is not fair to put the blame on them, as it is not their fault, but heads of state and government were proclaiming the Banking Union as a positive for outside investors who could know that things are functioning well because of the SSM and the EBA. If promises made at this level are not fulfilled and delivered, given that the Commission made an initial proposal on EDIS in 2015 and a second in 2017, common ground to safeguard the credibility of the political institutions of the EU is essential.

1.4. Trust is built through actions

An official advised that trust is built through actions, not words or beautiful horizons. The examples given illustrate that, for a truly European Banking Union, national governments should understand that the national banking system can no longer be seen as a sort of appendix for national public-policy goals and only that. If that becomes visible, it will create trust among depositors in certain countries that they should also be relaxed about guaranteeing deposits in other countries and banking systems, where there is no longer the national interference that has, unfortunately, characterised European banking for a long time.

1.5. It is in the German interest not to be seen as the ones imposing a vision or system, but as the ones listening to others

Another official noted that if the argument that Germany is two-thirds or one third of the eurozone population is always used as a justification for its system being the right one, something will be destroyed. A solution must be found which respects the fact that German savers need to be protected and that no one wants to destroy anything. It is also crucial to be aware of other Member States with other structures. It is in the German interest not to be seen as the ones imposing a vision or system, but also as those listening to others.

There are facts and figures that could help to find a common ground on efforts to clean up banks elsewhere, and it is hoped that this could be adopted quickly, as time is running out. Going into the next Parliament will be more complicated. Europe is a good combination of 'big' and 'small' Member States and it is important to build something that is sustainable.

2. Improving the EU resolution framework is a priority

2.1. Balancing liability and control in the Banking Union

A continuous discussion in the EU concerns the division of responsibilities between Member States and the European level. One guiding principle is that competences tend to be allocated to the European level if economies of scale and spill overs between Member States are large, and if differences in local circumstances and preferences are small.

Another principle is the balance between liability and control. The level that bears the consequences of

decisions (financially or otherwise), will also want a say in them, for example via policy coordination. These principles are central in the debate on the completion of the Banking Union. Before the financial crisis, banking supervision and crisis management were national. Liability and control were aligned, because EU countries themselves faced the consequences of the failure of a bank under their supervision. Yet the crisis showed that this situation was unsustainable. With the establishment of the Banking Union, the EU was given the responsibility for supervision (via the SSM) and resolution (via the SRM) of large banks. According to a public decision maker, still, the Banking Union currently remains a mixture of European and national elements. In terms of control or policy coordination, the SSM and SRM are responsible for bank supervision and resolution, but bank liquidation will still be executed by Member States under national law. In terms of liability, the European level now bears part of the cost of bank failures via the single resolution fund (SRF) and possibly the ESM-instruments for (in) direct bank recapitalization. It can also impose losses on the private sector via bail-in. Yet an important part of the costs still lies with Member States, because the SRF's public backstop is still in development, because deposit guarantee schemes are national and because national central banks provide emergency liquidity assistance (ELA).

So, the Banking Union is not finished yet. Tensions and discussions may arise as Member States are still partly liable for bank failures while the decisions on supervision and resolution are made under European control.

There are good reasons to complete the Banking Union, along the lines of the roadmap agreed by the European Council. Proposed measures include a public backstop for the SRF and EDIS. Streamlining liquidity provision under resolution is also being considered. The right balance between liability and control is key. These elements all imply more public risk-sharing in EMU as liability for bank failures in other countries is shared at the European level. These measures should therefore be accompanied by sufficient European control over these risks. This is why risk-sharing should be preceded by sufficient risk-reduction.

2.2. Aligning national insolvency regimes with the EU resolution framework in order to avoid a better treatment in liquidation than in resolution

An industry representative agreed that the Banking Union is part of a bigger project. It can be interpreted in two ways: not to focus so much on the Banking Union or taking the Banking Union as a precondition or an element of credibility for the whole approach and purpose. There is a common rulebook with several pitfalls, but it is essentially a common rulebook with common supervision. Other elements remain mostly national. In resolution, there is the mix of common decision-making, the SRM and the SRF, but insolvency remains national. This creates an inconsistency that potentially generates serious problems, which is the work that remains to be done and must be taken seriously.

On resolution, the idea was to make an exception when there is a legitimate public interest to be protected; otherwise, the general case would be insolvency. However, insolvency remains national and, in many cases, inconsistent with the spirit of the European resolution approach. How cases in some countries have been dealt with is remembered. The principle of no creditor worse off than in liquidation could be infringed.

A second issue is being serious about the capacity of capital instruments to effectively absorb losses and be truly subordinated when cases come. It could not be the case that senior debtholders are treated better than in resolution, as could happen depending on the national insolvency rules. Differences remain, including in Spain, Portugal and Cyprus. It is possible to pinpoint a number because the Single Resolution Board has done this analysis. It is public and shows the important differences that should be taken into account.

The aim should be at least for a common legal framework of resolution when it comes to insolvency law and to align it fully with the resolution framework, first ensuring that additional Tier 1 and 2 capital truly absorb losses and remain always the most subordinated classes of credit. It should also be clear that this principle of no creditor worse off should be respected in all cases. Finally, it would be a helpful element of discipline to avoid or limit the discretion that authorities have to decide which bank goes into resolution and which into liquidation. This could be avoided if there is an ex-ante communication of which institutions are systemic and connected to the public interest, and which are not.

This proposal is difficult because there is always an element of arbitrariness and it could also be time dependent; in any case, limiting discretion when qualifying an institution as deserving of resolution or liquidation is key. The harmonisation of these regimes is difficult. Those who look at the EU from the outside, like the International Monetary Fund (IMF), for instance, have proposed a common regime for bank liquidation, giving more powers to the SRM and this proposal is worth considering.

An official considered that the European Commission is specialised in working in the electrical power field between Germany and France, and between the German and French economic philosophies, which are at the heart of the European idea. The Commission will have to continue to do that. The Banking Union must be seen as a comprehensive entity, with resolution and diversity instruments intertwined in ensuring financial stability and the enhanced confidence of depositors in the banking system. Both are almost equally important for financial stability. A well functioning, effective resolution regime is an essential condition for credible bail-in rules. Bail-in rules that compensate for bail-out practices need an effective resolution regime to be credible in practice. The fiscal backstop for the SRM is at least as important as EDIS in ensuring that the taxpayer's purse is not used to handle a banking crisis.

3. A pragmatic way forward towards EDIS

3.1. All depositors should enjoy the same level of protection in the euro area

An industry representative advised that a fully mutualised EDIS is essential to genuine monetary union, because money is not only banknotes. One €50 banknote is worth the same in Athens, Berlin and Madrid, but that does not work for deposits. Consequently, genuine monetary union does not exist. The latest commitment was to have full fungibility of money, where the value of deposits should be the same regardless of location in the Union and the risk profile of the bank. The principle is to disentangle the sovereign and the banks. The only logical conclusion if this principle is accepted is that it is a must. Otherwise, the link is retained.

It is difficult to think in these terms due to emotions, which cannot replace logical arguments. There is a system that people know, so it is desirable to add belts and braces, but starting at the national level and not moving from there. Doing that misses a number of advantages of

having a fully mutualised EDIS on top of other elements of the Banking Union functioning well. The possibility of creating a true market for bank deposits across the Union is missed and with it opportunities for investment where investment is more profitable and attractive. It always creates a suspicion that, when difficulties come along, there will be a capital flight to sovereigns that are perceived to be stronger, because of savings, tradition or low debt, for example, or perhaps the TARGET2 balance is inflating, which a country does not like particularly, and so on.

To prevent moral hazards, contributions to this fund must be based on the risk profile of the institution, not the country. Many feel protected now because the sovereign is strong. This connection is understandable, but this is not in doubt, although the benefits of doing otherwise are different. Even the private sector is aware of an impact study done by the ECB in April on EDIS's impact in terms of response and cross-subsidisation, which is an important issue that is confused with solidarity. Solidarity has nothing to do with EDIS. It is an insurance mechanism, not one for producing transfers from one banking system to another in a systemic way. This is what the ECB says will not happen with a mutualised EDIS. The April study is good. If reinsurance gets stuck in the middle, paradoxically, there will be more transfers between banking systems.

However, it is important to remember that, if single money is desirable, that is both bank money and physical central bank money, each euro needs to be equally protected, given the risk profile of banks across the Union. This is achieved only by having the four pillars operating fully, on a mutualised basis and as mutualised as they currently are, with: regulation; supervision; an ambition for a common scheme on resolution and liquidation; and deposit protection.

3.2. A solution on EDIS must consider the diversity of banks, which requires a mix of remaining national DGS in combination with a European layer

An industry representative referred to the past and the statement of the four presidents at that time, when the third pillar of the Banking Union consisted in the Deposit Guarantee Scheme Directive (DGSD). Consequently, the statement that there is no common EU-level framework for depositor protection is nonsense and altogether wrong.

The optimisation of the third pillar should be in the focus, taking into account that there are questions which cannot be solved even by EDIS. These include ringfencing and problems around the free flow of capital and liquidity within banking groups. It should be borne in mind that liquidity floors and restrictions on group waivers are applied by the SSM and not only by the National Competent Authorities (NCAs). EDIS would not solve these questions, although they are solutions which would be more efficient than EDIS.

The diversity in the European banking industry was mentioned as being a major merit of the European financial landscape by the Committee on Economic and Monetary Affairs (ECON) of the European Parliament and the Economic and Financial Affairs Council (ECOFIN). The Commission's EDIS-proposal not only negatively affects the diversity of the European banking structure, it ultimately is destroying it. This is because Institutional Protection Schemes (IPS) which are relevant for almost half of all euro area banks and cover 20% of all assets, would no longer be workable. Provisions in the DGSD allowing for alternative measures are also important for countries like Italy as they acknowledge another form of diversity: the existence of highly concentrated banking markets, which is important for France. A solution to the discussion on EDIS must consider this diversity and requires a mix of retaining national systems, maybe in combination with a European layer. The aforesaid statement is meant to be a description of the current situation. Besides, the ECB paper mentioned previously is in many aspects flawed and completely neglects the danger of contagion in a single centralised deposit protection system.

3.3. More trust and stability in Europe requires building on existing trust and national DGS and adding at the EU level a mechanism that works and is acceptable to everybody

A public representative advised that initial discussions about making Europe stronger focused on the Banking Union. For deposit protection, looking back into the history of the story, only about 20% of each national fund is to be voluntarily exchanged between Member States, in case it is needed. This was the endpoint of the Commission's proposals for DGS. The Parliament and Council released this and it was not questioned for some time, until the Five Presidents' paper came out (June 2015), without speaking to anybody with an idea on the topic, without having a political discussion and with no political legitimacy. Five presidents found the definition of deposit insurance to be fully fledged mutualisation. This was never questioned again, and that was a mistake.

The aim is the same. The normal European person was mentioned, and people must be able to trust that deposits are safe. The promise made to the outside world of a Banking Union and what happens if it is not delivered was also mentioned. The promise is to give stability to the eurozone and to the EU concerning the question of topics, so it is crucial to be less dogmatic and more pragmatic, and consider what is needed to earn people's trust. Fully-fledged mutualisation does not give trust to people. The normal person wants to know that there is something above if a bank fails. Everyone, including the Germans, must realise that there are countries where people no longer trust national systems. This is a matter of fact. A Banking Union must accept this and find European answers. Something must be built at the European level.

It is intellectually poor to start at an endpoint because five presidents once thought that this could be a good idea without questioning whether it must be the endpoint or if there are other ways to reach the same level of trust. If something is delivered to European citizens at the European level which imparts the feeling that something in Europe can save their money if their bank or national system fails, they will be interested in nothing else. A system which helps to ensure liquidity helps avoid catastrophe, even in a problematic situation, as demonstrated by the Commission's impact assessment produced after the legislation.

To rethink this absurd mechanism: the endpoint was given first and the Commission had to write a proposal for legislation coming to this endpoint. Then Parliament turned to their obligation to write an impact assessment. What is usually the first step happened after the last point, and an impact assessment was written, with one mistake, which can be found on page 33 or 34: a graphic and explanation which was not deleted from the honest impact assessment, showing that a reinsurance system gives as much stability in 99.3% or 99.5% of cases as a fully-fledged, mutualised system. The Commission made an honest impact assessment before deleting anything that did not fit with the five presidents' expected result.

Returning to this point, being pragmatic means considering actions that work. Having national DGSs in the future and adding something at a European level

which gives protection without endangering trust in existing systems will find broad majorities all over Europe. It would be interesting to conduct research into the IPSs in Germany. In years of conversations with people from the system and different organisations, no system is more trusted than the IPSs. The reason is always the promise that everyone will be rescued, no matter what happens. Germany has more deposits than 15 of the other 19 Eurozone Member States. It has the same amount of deposits as France and Italy combined, and two-thirds of covered deposits are in the IPSs. Any European system which weakens the trust of these German deposits weakens the trust of European citizens in that system. Creating more trust and stability in Europe requires building on existing trust and putting something on top that works and is acceptable to everybody.

3.4. A reinsurance scheme seems the consensual way forward

The Chair noted that several proposals have been made on EDIS, with an official Commission proposal on the table. Since then, the Commission has made a series of suggestions to amend the proposal and distinguish between liquidity assistance in a first phase and loss-coverage in a second, with conditionality. Some banking sectors are promoting the idea of an ex-post funded system. A recent Eurofi/Centre for European Policy Studies (CEPS) paper promoted a European Reinsurance Fund. A reinsurance scheme can be beneficial and protect creditors across the Union, notably in cases of multiple bank failures. There is no guarantee that even strong schemes existing in certain Member States can withstand that, and it may be that, whatever the exact shape, a more unified system can do a better job even for those Member States.

An official noted that elements of compromise exist. A reinsurance scheme should be hoped for at this stage. The full mutualisation of risk seems politically not realistic, at least for the time being, so the solution could be based on reinsurance principles. The models presented in the background notes are good starting points and there should be some flexibility as to how to find a practical, pragmatic and functional solution. Finally, this indeed matters to the real economy, and to consumers and citizens. Numbers and macroeconomic figures are important but popular psychology and animal spirits also play a role. There must be momentum shown in EMU completion, to enhance citizens' confidence in the foundation of the euro.

Another official agreed that time can be spent on conceptual discussions around whether completion of risk-sharing is needed or not. From a pragmatic standpoint, the promise to be delivered on is that every European depositor will have their money back within seven days in a bank-default situation. Interim solutions may well focus on liquidity sharing, such as reinsurance or the Dutch situation of a credit-line-exposed arrangement with banks that can double the size of the fund overnight if needed, to satisfy the requirement of certainty of payout being equal everywhere in Europe and the first requirement. If moving from liquidity-sharing to loss-sharing is largely symbolic, then maybe 10 or 20 years from now it will be a non-event, rather than spending time and energy on what is somewhat a theoretical discussion.

An industry representative advised that the EDIS discussion highlights a remaining problem with the link between banks and sovereigns. A large fund would help in the case of a local or national shock that depletes national funds and the national DGS is unable to pay out. That could have happened in a Portuguese case with regard to the insolvency of Banco Popular's subsidiary, where the fund was lower than the payout amount. Fortunately, it did not, but it highlighted the situation.

In that situation additional funds could be helpful, but the systemic financial crisis at the European level could not be covered by any EDIS in the world. That is not something that EDIS is needed for, nor is it the purpose of EDIS or any DGS. Therefore, the DGS could be permitted to borrow from all other European DGSs in case of liquidity stress, to solve this issue of local depletion of funds. Mandatory lending could be a good starting point for a fruitful discussion.

Enhancing supervision and resolution in the Banking Union

1. A common supervision: a work in progress which requires a single rulebook

The Single Supervisory Mechanism (SSM) has merged the 19 national approaches into one single supervisory system. However without a common regulation, the EU supervision cannot treat banks equally and this opens the door to regulatory arbitrage and distorts competition. The single rulebook is currently not truly single and European supervision is still a work in progress.

1.1. The single rulebook is not truly single

The single rule book is not a truly single comprehensive regulatory framework for banking activities which makes supervision less effective and efficient. The legal framework underpinning banking activity in the euro area remains fragmented. A regulator stressed that enhancing supervision can and has to be driven forward at various levels. The first is regulation itself, where not one single-rulebook situation has been completed, not only due to options and national discretions (ONDs) but a few issues have at least been insufficiently harmonised in the level-one legislative texts. That said, on the regulatory level, if Europe chooses the path of applying a single rulebook across the whole banking industry, which the US has not done, the natural and necessary counterpart is a healthy degree of proportionality. That is a logical counterpart to having a single rulebook; otherwise, it runs into massive level playing field problems: small banks versus big banks; small risk versus big risk. Those two elements are inseparable.

1.2. Despite the elimination of a number of options and discretions by the SSM, there are still national options and discretions (ONDs)

A regulator noted that the majority of ONDs have been sorted out, in that they will expire within the next 12 to 18 months[1]. That is a step forward but, before each OND is disqualified, it is important to recognise that some are triggered by differences in national legislation which are not connected to financial regulation, such as tax law, insolvency law or, possibly most importantly, national accounting standards. The world cannot be saved through the lens of financial regulation alone. To the extent that any particular bank has to comply with accounting standards, a

certain level of ONDs is not only legitimate but necessary. It is not a black-and-white situation. Driving forward for the next three to five years, as has been done for the past five ones, should lead to optimism over an ever-more harmonised Banking Union.

An official agreed that progress has still to be made towards a unified legal basis. State-of-the-art common data collection and supervisory judgement can exist but when national specificities prevent a decision according to a European approach, then equal treatment cannot be delivered. National specificities may require different national rules, but many ONDs have nothing to do with accounting or national legal specificities; rather, they are rooted in different traditions. As a result, many different rules must be applied to the same topic, depending on the jurisdiction where the supervised bank is located.

1.3. European supervision: a work in progress

There is now a transparent and homogenous application of the Supervisory Review and Evaluation Process (SREP) but discrepancies between national supervisors and the SSM are still to be dealt with. A regulator advised that the Banking Union started with 28 or 19 different traditions of supervision and types of application, depending on whether the EU or only the Eurozone is counted. To a large degree, that is still the reality; this is fact, not criticism. Such practices must be continuously and vigorously aligned, as they can differ even when based on the same piece of regulation. This process is strongly driven and rightly so by the SSM, which is a game-changer and a quantum step ahead since November 2014. However, realistically it will still take years to align practices. Efforts to focus on a more consistent application of supervision should never be reduced.

1.4. Uniform criteria for assessing the same issues

This applies equally to significant and less significant institutions. The ECB has gradually been setting guidelines for various areas of regulation. An industry representative stressed that cooperation between the institutions is generally appreciated. It is getting better by the day and there is progress every year. However, there are four points to raise according to a representative of the industry:

• First, if there are shortcomings in individual areas that should not have consequences for all the institutions. New rules are not required for an individual problem. Individual failures should be dealt with individually for each bank concerned, as part of the Supervisory Review and Evaluation Process (SREP).

• Second, The ECB is currently working on internal capital adequacy (ICAAP) and liquidity (ILAAP) assessment processes, to set the same standards in these areas. These activities are important for internal risk management and highly appreciated. But more transparency is desirable. It is important to understand more about, for example, what comprises capital surcharges and similar issues.

• Third, is the importance of stress test. This exercise is expensive, and time consuming for banks and requires some improvement. In particular, it would be appropriate to strike an adequate balance between quantitative banking supervision, which is essentially based on the evaluation of huge amounts of data, and more qualitative supervisory practice, which focuses on the assessment of the individual risk situation. Even if digitalisation and rapid developments in the IT sector open up new possibilities for the monitoring process, largely automated processes seem less suitable for qualitative supervisory practices.

The final point is the need to more closely interlink regulatory and supervisory authorities in the future in order to improve financial stability. Communicating at an early stage - and therefore improving cooperation - avoids excessive administrative workload for banks and makes it easier to plan requirements.

An official noted that the ECB is more transparent than any national supervisor has been. Perhaps there are some exceptions here and there, but many papers on ECB supervisory policies are available on their website. A common supervision also requires further efforts from banks, supervisors and regulators to reduce the remaining stock of non-performing loans (NPLs), especially in countries where the NPL ratio remains high. A regulator noted that this point is somewhere between regulation and supervision. An important example is NPL portfolios. These are not an individual-country problem but a European one, as are the profitability and cost of capital. Europe must ensure its competitiveness on a global scale. Next to general comments on regulation and supervision, there are major specific issues which deserve a strong focus.

A regulator noted that making EU banks more profitable is necessary but unfortunately it cannot be just instructed. It must be done. Other than that, there has been a long list of important issues, and all of them are legitimate. Risk reduction is a key challenge, because it is there and is on the books. It is a reality. If that is not addressed, everything else becomes even more of a problem. Risk reduction would be the key thing, not because the others are unimportant but because that is the true entry point.

2. Further harmonising the supervisory toolbox and achieving a common culture of supervision

2.1. Creating European teams for onsite inspections

The SSM has harmonised the main tool of banking supervision: the SREP. In the SREP, the SSM analyses each bank's business model, its governance, risk management, and risks to capital and liquidity positions. But the supervisor's toolbox comprises other instruments, which need to be improved. Onsite inspections at banks are one example. In some countries, the preparation takes time, while the actual inspection is quite short, while in other countries, it is the other way round. This makes it difficult to coordinate and create international teams for on-site inspectors.

A Central Bank official agreed that more cross-border onsite inspections are required and the SSM strives to increase the number of cross-border on-site missions. Since the SSM and the ECB do not have a great deal of on-site inspectors, recruiting national onsite inspectors would allow more cross-border onsite inspections. The success of this initiative will largely depend on the number of on-site supervisors the national authorities are willing to make available.

2.2. The ECB cannot create a common culture of its own. National Competent Authorities (NCAs) should continue to contribute

A Central Bank official noted that a common culture of supervision within the SSM also needs to be pushed forward. A fully-fledged common culture requires a truly unified legal basis, harmonised administrative practices - (e.g. for the SREP, the treatment of NPLs, stress tests, the ICAAP, the ILAAP) – and time and cooperation. Indeed, staff from 19 countries and 26 authorities has to be persuaded to leave their cultural comfort zone and align how they think, assess and act. She added that when a supervisor has worked according to a specific national regime for 25 to 30 years, it takes time to get accustomed to the European view. It is important to convince people every day.

Therefore, the SSM has, for example, established a rotation scheme for members of the Joint Supervisory Teams. This too will help to spread a common culture. At the same time, it helps to avoid supervisory capture. It also fosters exchange between supervisors from across the euro area, bringing them together in many different working groups to devise training manuals and supervisory guidance. But the official confirmed that the ECB cannot create a common supervisory culture by itself. National authorities must embrace the European idea and seize the opportunity to contribute to a new, common supervisory culture. They must let more of their staff come to the ECB, for a while at least. Let them work in a European environment and carry this culture back to their home countries.

Furthermore, the idea of a European supervisory culture should be reflected in how banks are dealt with. For example, national reporting requirements should be dropped to avoid double reporting and disburden banks; instead, the aim should be for a single European reporting framework.

To sum up: a common supervisory culture is emerging, but it still needs to be nurtured and nudged. It will take time but this European culture in supervision emerges more and more from year to year.

The Chair stated that there is a point around the words, 'transparency', 'culture' and 'trust', namely the human relationship around supervision and resolution. It should be enhanced and should improve with time, because there is solid ground. It already has improved. Europe is on the right track, but whatever can be done to foster this common culture is important. In summary, this common culture is not only between national and central supervisors and resolution authorities, but also between the industry and the supervisors, such that everyone understands the aims of the other. As a supervisor, the industry understands that strong supervision is necessary for fostering the resilience of the European banking system. Transparency and dialogue will help to achieve this common understanding. This is near to day-to-day practice, so many different stakeholders can contribute to foster this common culture.

An industry representative stressed that a major lesson is the change in culture in the banks, the degree of which should not be underestimated. It is a primary responsibility of the banks to make sure that they are more resilient and better prepared. Of course, nobody wants to think about their own death, but the responsibility exists to be prepared for all situations. Cooperation with regulators and supervisors is important so that common objectives can be shared.

3. Achieving a unified framework for bank resolution for addressing the fragmentation of banking markets within the EU

3.1. The home/host supervisors for banks operating across borders have not been suppressed and the possibility of 'national bias' playing a part in regulation or supervision should be eliminated

3.1.1. The EU resolution framework is a work in progress, but the EU banking market remains fragmented

An official noted that the European banking market remains fragmented, and the lack of capital and liquidity mobility within banking groups impacts bank profitability. There is a solution to this problem: the IMF in its Euro Area Financial Sector Assessment recommends a unified and transparent framework for bank resolution in order to ensure that banks are not treated differently across jurisdictions. The SRM delivered a substantial upgrade in a short period in operationalising the new bank resolution framework. However, actual bank interventions over the past year or so show that the framework remains fragmented. So far, only one bank was resolved according to the new EU resolution framework and just a few others were handled by national bank-liquidation regimes following decisions by the SRB.

An industry representative stressed that for a European bank, the more European regulation and supervision, the better, while recognising that host regulators have important responsibilities in their countries. The more progress is made on the path of uniting Europe from a financial point of view, the better. The continuous attempts to insert discretionary national deviations into EU law should be considered critically. There are for instance elements of local requirements that increasingly take precedence over the requirements of the whole group (e.g. internal MREL). He noted that pools of funding and liquidity that are currently trapped due to regulatory constraints should also be tackled to allow for an efficient cross-border use of solvency and liquidity buffers throughout banking groups in the Eurozone. Europe creates its own inefficiencies because each subsidiary maintains idle buffers to prevent a local regulatory breach. And, even more concerning, is the fact that in the area of resolution we run the risk of inefficient and costly requirements at solo entity level in the Banking Union.

He considered that the flipside of that is the advantage provided by a transnational banking group. Pan EU Banks could manage balance sheets more efficiently. A larger pool of liquid assets would be available for all the constituent entities within the group, managed from a single source and able to be deployed as needed when a crisis occurs. Nobody knows when it will occur, so all those levels should always exist at all localities, rather than at a single point.

Another industry representative confirmed that a well-functioning, integrated financial system needs competitive and profitable pan EU banks. In this perspective, it is of paramount importance to achieve a consistent implementation of the Banking Union, to address notably the sovereign-bank doom loop and remove national discretions and the remnants of ring-fencing. Euro-area banks must diversify and not be overly linked to one single economy. Having strong and genuine euro-area banking groups addresses two points: efficient capital allocation and the cost of capital. An important lesson from the previous crisis is that, in times of crisis, foreign banks tend to pull back. Therefore, it is important to be mindful of not being too dependent on non-euro-area banks. More needs to be done to advance integration in Europe. Brexit and rising protectionism make it even more important. There is a cost to fragmentation: it took the eurozone twice as long as the US to recover from the crisis. Achieving the Banking Union and ensuring its single nature to the fullest extent means removing national discretion and the remnants of ring fencing critical for creating strong pan-European banks.

The Chair noted that profitability is in the hands of the market and is gained day to day with the business. What links it to regulation is the possibility of using the Banking Union to have sound diversification impacts between the EU and the Banking Union, which will normally lead to increase profitability. Again, it is a structural issue, so obstacles and the way around them in supervision and resolution must be identified. An industry representative stressed that whether banks in Europe are public or

private, big or small, national or pan-European, they must be able to earn money, be profitable and be competitive with American and other banks. Then resolution and other issues would not be a problem.

3.1.2. Balkanising everything will achieve nothing

The home/host issues have become most important. Moving from a going concern into the question of gone concern is a matter of trust to be fostered and enhanced by having 'skin in the game' or underlined by contractual or capital arrangements. That balance is still to be found because on the supervisory side, the rulebook must be finalised and some of the national elements somehow weeded out. However, at the same time as implementing a rulebook called Bank Recovery and Resolution Directive (BRRD) and the SRM Regulation (SRMR), legislators began work on version numbertwo. This is another issue to be considered.

A regulator noted that harmonising how liquidation is dealt with is of importance. Something that can be done without any regulation is to be ambitious at achieving that banks are truly resolvable, including the building up of needed MREL. For the moment, this is the only measure to avoid the further divergence of home and host authorities. It is important to prove it works and to ensure everything that can be done has been done in order to have a resolvable bank, while considering also profitability 'Balkanising' everything will achieve nothing.

An industry representative wished for a reduction in fragmentation and an avoidance of trapped liquidity and capital within the Banking Union. It is better to make sure that banks do not slowly die in good health but that they are profitable, resilient and competitive with an efficient allocation of capital.

3.2. Priorities for achieving a unified framework for bank resolution

3.2.1. The capacity for early intervention and advanced resolution planning must be strengthened

An official considered that the framework and capacity for early intervention and advanced resolution planning must be strengthened. To give a very concrete example, authorities need to be able to preschedule the resolution weekend when a problem bank is intervened and resolved, with minimal disruption to others.

An industry representative noted that supervisors and supervised entities have a common objective, which is to avoid the death of a bank. Supervision is about ensuring that it never has to happen, so that the market is reassured that it will not happen and that it works. In that common objective, there is more that connects and binds than divides, even if there may be differences of opinion from time to time on interpretation. Supervisors and supervised entities should find more common ground in this.

3.2.2. Completing the Banking Union (EDIS, backstop to the Single Resolution Fund (SRF)) is necessary

An official noted that a well-funded resolution fund with an appropriate backstop is needed, as well as funded national deposit-insurance schemes and a European deposit-insurance scheme (EDIS) to underpin national schemes. Another one stressed that EDIS is on the horizon but is part of the home/host equilibrium. Without an EU solution, we create the excuse for host authorities to take extra precautions because, otherwise, it falls on their system, he said.

3.2.3. Loss-sharing agreements in state aid should be aligned with the BRRD

An official advised that the priority is to reduce uncertainty about the treatment of creditors, with a focus on loss-sharing arrangements and discrepancies between state-aid rules and the BRRD. Loss-sharing arrangements in state-aid rules should be aligned with the BRRD, subject to the introduction of a financial-stability exemption which allows the relaxation of bail-in requirements to reduce contagion in a crisis. The exemption should be used only in times of severe euro area or country wide crisis and be subject to strict conditionality and governance arrangements.

A regulator advised that this is not the only issue. The current framework does not come out of space, but evolved from a system that existed. The de facto resolution authority was the European Commission's DG Competition, which set up rules for state-aid in cases of need. Now, the system has the BRRD and SRMR on the one hand, alongside a state-aid system to be applied, with a different history and a different target and aim. The time has come to align it. There is a good reason for that because even the Banking Communication[2] includes a sentence that it is in place until a resolution regime exists, so it must now be addressed. It does not need to be removed, but it should be aligned. There will always be a need to have optionality. Financial stability is at risk and is the biggest open door that it will not be possible to close. Financial stability is fundamental to finding a solution.

3.2.4. Addressing the home/host concerns in resolution

An official noted that the financial-stability interests of both home and host authorities must be carefully balanced. European institutions and national authorities have established collaborative processes for dealing with a stressful situation. The priority is to ensure the feasibility of resolution strategies for cross-border groups with domestic systemically important banks. This requires consistency between the resolution strategy and the amount and location of loss-absorbing capacity.

3.2.5. Clarifying the issue of liquidity in resolution would also strengthen the credibility of the bank crisis management

A regulator noted that a credible tool to address the risks of banks having insufficient liquidity following resolution actions is a missing piece in the puzzle. Liquidity might be the constraining factor after the weekend, even on Monday morning, because market trust must be built up again regarding the bank's solvency and viability. Therefore, a bridge into liquidity might be required.

At the same time, the work on liquidity issues has been enhanced. First and foremost, it is for resolution-planning and preparation of the institutions to make sure that there are adequate safeguards to keep the bank liquid, including collateral. Second, while easily said, timeliness of intervention is key. It is easy to be hesitant when it is time to jump in. At the same time it is challenging to take action early. Safeguards are meant for purpose. Refusing to use them, is as if you tell a patient not to spend their remaining money on the doctor, because it will be needed for the funeral.

This speaker added that even with all precautions, a liquidity facility for resolution is required. As everyone acknowledges, even when the SRF has a backstop and could provide liquidity, that is not what it was designed for, it would end with a small-to-mid-sized bank and not address a larger one. The fund having skin in the game is crucial so that the resolution scheme is trusted. This concerns pure liquidity, so one can forget about when liquidity was the substitute word for equity. However, more cannot be done and the issue of who should provide that liquidity returns. The discussion always goes in the direction of the central bank because fostering a bank in resolution and sovereign nexus by saying, 'That is for the government,' is to be avoided. A solution is needed because ending with

a resolved but illiquid bank on Monday morning is in no one's interest. The better a solution can be framed upfront, the less likely it is to be needed.

An industry representative noted that one important lesson from the crisis is that the issue is not often solvency, but liquidity. Probably the most important thing that remains to be built in case of resolution is a temporary public-sector backstop which allows the restoration of market trust, given that it is not only solvency that drives market access. It takes time to restore trust and have access to the market, so this missing piece is probably critical.

3.2.6. Achieving more predictability in the EU crisis management framework

The treatment of bank failures at the EU level is not sufficiently predictable. The decision to resolve, governed by EU rules, or to liquidate, regulated by national insolvency laws, relies on the SRB's assessment at the EU level of whether public interest is at stake, which depends on whether the functions performed by the failing bank are critical and whether the failure has a significant adverse impact on financial stability. Defining and agreeing on what constitutes a 'critical function' is an area of importance. While significant progress has been made in the collection and analysis of data, some important gaps exist between home and host authorities. Such divergence in understanding undermines cooperation and trust between national supervisory authorities. Moreover, the notion of public interest produces different outcomes depending on the level of the jurisdiction for similar banks, for example, whether European, national or regional.

An official stated that, on the application of the public-interest test, the SRM test focuses on the Banking Union and national levels. The European Commission, in its application, also considers the subnational level. More deference should be given to the SRB's judgement on this issue. The bottom line is that a unified banking market in the euro area requires the building of trust in the European bank resolution framework. There has been important progress, but more predictability and transparency is needed.

3.2.7. A more unified liquidation and insolvency regime is essential

An official stated that there are 19 insolvency laws in the Banking Union and 27 or 28 in Europe. This counterfactual is the core system to unwind a bank. Basic rules have not yet been harmonised. Earlier, an official said that this is a long stretch and an uphill battle. Another official also wished for more ambition and to move away from 'going-concern' issues towards 'gone-concern' issues. A more unified way of dealing with liquidation and insolvency is essential. It is impossible to get an insolvency law on a European level as such, but perhaps there can be a kind of module in the insolvency or liquidation law for banks that are active internationally or in Europe where all creditors are treated the same.

A public decision maker considered that the SRB should have an administrative liquidation tool which allows it to appoint a liquidator and commence proceedings. This would be especially useful for larger or cross-border banks that do not need full-scale resolution. The SRB should be able to apply this tool to all banks within its remit, mainly the so-called significant institutions, as well as other euro area banks deemed systemic at the time of failure. This tool would be especially useful for ensuring that cases involving cross-border banks are dealt with at a euro area level, facilitating necessary coordination and a level playing field. The tool could be applied by itself or in combination with other resolution tools, including an effective sale-of-business tool, and should be underpinned by a harmonized creditor hierarchy.

An industry representative advised that, while lessons are drawn from the previous crisis and implemented reforms that make the likelihood of failure lower, with instruments in place, the next time will be different. The previous crisis is always prepared for, but each crisis is different, often in quite an unexpected way. As a chief risk officer in a previous role, it is critical to think about other risks and now there are new risks to be addressed. That means having flexibility and creating the tools, and a mind-set of, 'Whatever it takes'.

Banks are less likely to fail, but a crisis could have other origins. There are three examples: first is the growing importance of shadow banking, which is of systemic importance. Second, markets can have very sudden movements in the current context of the significant increase in the size of shadow banking, but it should also be considered that banks will probably play less of an amortisation role in case of a sudden correction, precisely because of all the regulations in terms of capital equity as well as market-making. It is important to be cognisant of the fact that maybe the probability of a crisis is reduced but the magnitude of shocks could be quite big, and the channels of contagion to the broader economy less predictable. Finally, the new competitive landscape must be considered, as large tech companies will play a key role in providing financing. It is a challenge for financial regulation in terms of consumer protection and financial stability and a level playing field for the banks. Cyber is another type of risk which could have sudden repercussions that must be anticipated and addressed.

An industry representative summarised that Europe needs to keep the momentum in building the Banking Union. More European and market union is needed, with the objective of having not only more resilience but also more competitive banks that support growth and contribute to the resilience and recovery of the economies in the case of a crisis.

The Chair noted that, given that this is Eurofi, the convergence of the views towards the need for greater European integration and the suggested way of enhancing supervision and resolution by deepening integration is probably not a surprise. He also stated that there is a need for a simplification of the regulations. Some ask for an end to new ones; others for a cleansing of the old ones. Even in terms of data collection, 'Clean the past and concentrate on what is new.' He concluded that the backstop for resolution should be completed alongside, in some way or another, EDIS, which might not go all the way forward, but allows it to continue and deepen integration. The one issue that goes to level one is that the legislators have to come with propositions and ideas.

I. European supervisors identified 175 ONDs available under EU law, 130 of them have been suppressed and are now applied in a uniform way across the euro area.

II. The Communication sets out the updated EU crisis rules for state aid to banks during the crisis from 1st August 2013. It replaces the 2008 Banking Communication and supplements the remaining crisis rules. Together, they define the common EU conditions under which Member States can support banks with funding guarantees, recapitalisations or asset relief and the requirements for a restructuring plan.

Reviewing the operation of the ESAs

1. A more active role for the ESAs in developing supervisory convergence

1.1. Supervisory convergence is not starting from scratch and the positive role the ESAs play in the creation and implementation of common rules for financial services should be widely recognised

A regulator emphasized that without effective supervisory convergence, there is no level playing field and a growing risk of diverging rules affecting the degree of investor protection and market integrity between Member States. Consistent application of the rules is a prerequisite to mitigate the threat of market fragmentation. It should facilitate cross-border activities and economies of scales. He stated that supervisory convergence is not starting from scratch; it has been an increasing process. The issue is whether more needs to be done or whether more tools are needed to accelerate convergence. If passporting activities in the EU are expected to increase dramatically in the future around the CMU, impeccable supervisory and enforcement convergence is needed. There are only two ways to make progress when it comes to convergence: either by transferring direct supervisory powers to a European Authority (the SSM way) - which would make sense for cross-border and wholesale market activities - or by reinforcing the convergence tools of the European Authority. Since there is little appetite for the first solution (despite the fact that it has been done for CRAs and TRs with no major opposition), all efforts should concentrate on the convergence powers.

According to another official, the ESAs are good to have. However the assumption underlying the legislative proposal of the EU Commission seems to assume that the ESAs are insufficient and ineffective, which is fundamentally wrong. They do a terrific job, including sitting on boards of supervisors, working groups, teams and taskforces. It happens every day and is tremendous proof of European collaboration.

1.2. A single rule book is crucial to ensure convergent supervision

A regulator noted that the ESA review is underway. The European rulebook on convergence is essential to ensuring that harmonised EU regulation translates into convergent supervision. ESAs must play a prominent role in improving instruments for convergence, a key priority in the ESA review and reform process. ESAs need more resources and independence. They should assume a stronger role in peer reviews to enhance convergence, as they are key to that process.

1.3. A convergent supervisory approach is crucial to preserve financial stability

A regulator stressed that important topics for the ESAs, which have not formed part of the review process, include anti-money-laundering (AML) and terrorist financing. Against a backdrop of recent experience in the European financial system, especially the banking system, there is a prominent role for the ESAs, the European Banking Authority (EBA) and the Level 3 Committees on this important cross-sectoral issue. Resources and competences must be concentrated, especially in coordination. If national authorities are not effective, the competence to intervene will be key. This does not mean transferring all competences to a European level, but there is a case for a stronger role for Europe, to be played predominantly by the ESAs.

1.4. Mediation procedure should be used for the efficient and timely resolution of disputes among National Competent Authorities (NCAs)

A regulator noted that supervisory convergence is the bare minimum. The entire panel is involved with ESMA, so it is not a vote for eliminating national market regulators but about sitting them at a table that makes more sense. For many securities issues, that is European, not national. The work done nationally is nearly irrelevant, as the relevant work is appropriately done at ESMA. There may be some national implications or fiscal side. Diversities that come with economics or with tradition are fine, but supervisory convergence is the minimum, A regulator highlighted an interesting situation over the last 12 to 18 months, of four important people working at the European level moving to the national level. Committed Europeans are taking the decision to make Europe from the national level, which makes sense. It should be attempted, while not denying obvious and necessary economic and supervisory integration.

1.5. The ESAs should assume a stronger role in inspections to enhance supervisory convergence

A regulator advised that the focus must be on enhancing existing tools to foster convergence. Level 3 is currently guidelines, opinions and Q&As, which are important for implementing regulation in detail but have limited effectiveness. There is room to improve and enlarge the scope for 'comply or explain' for Q&As in order to ensure their consistent understanding and implementation. Conversely, there is the issue of enlarging the scope of peer reviews to check how Level 3 is implemented in each country, led by ESMA with a team of NCA experts. It is important and achievable, and it is hoped that an agreement could be found on it.

A regulator noted that NCAs do not always consciously violate European rules or fail to follow European practices. Reviews often uncover different practices, and the issue concerns defining common European practice. European market participants have a right to be treated equally, irrespective of where they are supervised, so there is room for ESA executives to have a stronger role. All countries and NCAs must have equal rights. ESA governance does not have to be changed for peer reviews, if parts of the industry are not transferred to their direct control. More support should gradually be given to the ESAs executive parts. Such reviews should be made more transparent, accompanied by follow-ups, and feed into reviews of legal acts.

The Chair highlighted a proposal that does not use the term 'peer review'; but proposes that senior ESA staff with associated NCAs on a voluntary and rotating basis should review and inspect NCAs. Where the quality threshold of a NCA is low, it is more efficient to have an ESA inspection than one from another Member State. The Chair asked whether this might not be easier than sending in the BaFin too late as in Greece. A regulator considered that even this new set-up can be too late. There is no guarantee of being in time. The proposal is appreciated but has been heavily revised since the original proposal. That demonstrates that the discussions over the past six months had not been in vain, which is good. It shows a paternalistic attitude, stating that 15 out of 27 countries may not be up to the job. That can be said but is difficult in the EU, and caution is advised. Regulatory framework discussions are driven by a belief that only little guys in little countries are misbehaving, which is a profoundly difficult proposal.

A regulator noted that anything which is not realistic and not meaningful can be dropped so that the accent is placed on supervisory convergence and the aspect of appropriate governance. Convergence is the critical issue and progress must be made on it. It is possible to be brutal and rude about a supervisory-convergence peer review. If someone is not working well, there is no problem having a name and-shame with the person's name and the name of the national supervisor. That is why sufficient tools are needed.

A regulator advised that reviews should assess not only the consistency but also the efficiency of supervisory outcomes performed by NCAs. The appropriate governance is perhaps not a new executive board, for which there is little support. Beefing up the current management board with highly qualified experts is not interesting.

1.6. Enhancing the role of the ESAs towards third countries is urgent

Entrusting the ESAs with the responsibility for monitoring the regulatory and supervisory practices of third countries is even more relevant because of Brexit. The monitoring of third country equivalence has a significant loophole to be closed. Entrusting the ESAs with monitoring it is wise and should be done.

A regulator noted that colleagues have a great mandate on everything to do with third countries. Being pragmatic means looking at outsourcing and the delegation of key functions, while ensuring that ESMA plays a crucial role in the details, whatever happens with third countries' relationships. This may make ESMA successful as a single-entry point and makes a great deal of sense.

2. Stumbling blocks for achieving a political compromise on the ESAs review

2.1. Realism is essential to achieve a compromise

A regulator noted that the ESA review must be finalised under the current European Parliament mandate, but realism is essential to achieve this. All parties could identify proposals where there is a possible compromise. No deal would be the worst-case scenario. It may be a surprise or shock to state, even without political legitimacy, that there is no consensus and no majority on several new direct supervisory powers for ESA.

A problem faced by the current proposals is a reoccurring objective of implementing a copy-and-paste of the Banking Union. Supervisors specialised in consumer protection do not work in the same way as prudential supervisors. Retail products are not the same in the different EU countries. Germany has a strong, self-regulated, excellent identity of structured products. In Italy, retail investors buy bonds. France, the Netherlands and Austria offer other kinds of products. This may be because national tax systems are not the same, but it is also about distribution. In the Netherlands, investors use pension funds and life insurance. In Belgium, Undertakings for Collective Investment in Transferable Securities (UCITS) are preferred. It is not only about language; different countries have different priorities. There is no competition between initiatives proposed by the EU and national legislation, just because there is nothing in the pipeline at the EU level.

In such a context, supervisory action must be fine-tuned to ensure an appropriate level of supervision. Without political legitimacy, it is possible to redraft a proportionate compromise to see where each authority (EU or national) is best-placed. It is not a competition between NCAs, which are strongly involved in the functioning of ESAs. It is important to consider which authority is best-placed to supervise the harmonised and the national. The discussion must be between wholesale and retail markets. There is no problem with wholesale or third-country as even benchmarking is for ESMA. But knowledge and experience of retail markets is national and their supervision should remain national.

2.2. Mistakes to be avoided

A regulator considered that, with few exceptions and contrary to their name, the ESAs are not supervisors. They are regulatory harmonisers and facilitators with a mandate to promote convergence and practical supervision, which is supported. However, as a practitioner and pragmatist, he stated that EU legislators should not create overlapping areas of competences and new complicated processes but should instead ensure that they are able to make more effective use of the powers they already have. Turning to the areas of competence of the ESAS, he agreed that the increased importance of third country relations and passporting should be elevated to a European level. But it is insulting to assume that a peer review to promote supervisory convergence is diminished by having representatives of NCAs participate, which is part of the proposal that should be changed. The proposal has fundamentally flawed assumptions and consequences.

A regulator explained that the Commission should review and redraft to achieve something more modern. Resources are not available to engage in processes which overlap and create a bureaucratic 'monstrum.' It is about not creating processes which a cynic would call typically European, with overlapping competencies that are not thought through. Given the example of the Single Supervisory Mechanism (SSM), either they do it or national regulators do. That is right. Many current Commission proposals are unclear and are sort of both, which does not work. Establishing EBA as an operational supervisor next to the SSM is also ridiculous and not thought through. It is not anti-European to call for a pragmatic process review. Products that are inherently European, with an obvious benefit to elevating them to European level, should be. But the legislative proposal is flawed and not worth concluding on.

2.3. No consensus for asking ESMA to approve all prospectus

A regulator advised that the impression of criticism without proposals should be avoided. If there is momentum towards compromise, issues for which there is no consensus can be dropped, such as direct supervisory powers to ESMA for prospectus, as these are not meaningful. Nobody understands asking ESMA to approve a prospectus and then have to go back at national level for local investors who are not interested in prospectuses.

A regulator considered that a prospectus on a national topic is national. But it is not clear why a prospectus on a non-national topic should have no European validation. Time may be needed to move it, as the system works and should not be destroyed for something that does not work. It may be gradual, but is worth thinking about.

2.4. A consensus on a fundamental modification of the governance structure is very difficult

A regulator stressed that the governance of the ESAs and ESMA must be reviewed and some sort of executive body introduced. Another one added that it is important to fine-tune current governance and enable delegation to an independent internal committee of each ESA. This internal committee can be set up rapidly and be composed of a majority of non board of supervisor members, such as three rotating board-of-supervisor members and four ESA executives. It would steer the various peer reviews at

staff level, take independent decisions on the outcomes, such as follow-up action, and prepare other supervisory-convergent decisions in the current framework. Those are interesting, realistic proposals where progress can be made in supervisory convergence, which is the main issue.

A regulator noted that more supervisors than academics and experts are needed because the job involves numerous standing committees and stakeholder meetings. Most are people from the industry, experts and academics. Supervisors are also important. Another regulator disagreed. The regulator offered to qualify the statement. On the question of increasing the level of academics or other advisors at board level, the answer is 'no' because few regulatory bodies have a strong inclusion of and impact from academics and that is a good thing. There is a thin line between asking for advice from experts and infringing on democratic decision-making. That should not be forgotten. Maybe it is somewhat old-fashioned to believe in democracy, but academics have no democratic legitimacy to make decisions. Delegating too much to academic or seemingly expert circles gives away too much decision-making to other people. Expert knowledge is positive and should be embraced, which is done and is good. There should be more sensitivity to the thin line between real decision-making processes and advices. That is blurring it.

3. Achieving the right balance between EU and national supervision

3.1. The main distinction to be made is between wholesale (B2B) and retail (B2C) markets

A regulator stressed that when reviewing the European System of Financial Supervision, it is essential to ensure the right level of supervision. The main distinction to be made is between wholesale (B2B) and retail (B2C) markets. Wholesale securities markets are more integrated and are regulated mainly at European level, so a case can be made for a strengthened supervisory role for ESMA in some areas (e.g. data service providers under MiFID II). ESMA has already been granted supervisory powers for credit rating agencies and trade repositories, and has a natural role to play as regards select B2B activities of a similar nature.

By contrast, retail securities markets are less integrated. NCAs are therefore best placed to supervise the compliance of retail products with the applicable legislation. NCAs have developed expertise in the applicable legislation, understand the language, and, thanks to their proximity to the local market, have a good view of the products sold there, are close to local investors and understand their preferences and vulnerabilities. Transferring supervisory powers over retail products to the ESAs ignores the existence of local ecosystems and risks leading to less efficient supervision. A division of supervisory responsibilities between the ESAs and the NCAs in some domains could result in losing the overall picture needed to grasp all risks at local level.

Another regulator agreed that market regulatory issues are increasingly becoming cross-border. Cross-border problems require cross-border solutions. Therefore it is necessary to think beyond personal interests to see what is appropriate for EU investors and best for capital markets.

3.2. Maintaining supervision at the domestic level seems necessary for consumer protection

A regulator highlighted a fear is that there would be a downgrading of consumer protection if nothing changes in the drafting of the current proposal. Customer protection is spoken about frequently, at ESMA, EIOPA or EBA level, but the scope of ESA's mission statement is smaller than what is done at a national level. Measures that ensure an appropriate level of customer protection make up around 60% of the domestic mission statement. There is no competition between initiatives proposed by the EU and national legislation, because nothing is in the pipeline at the EU level. Therefore, for consumer protection supervision should be maintained at the national level.

3.3. Increasing supervisory powers of the ESAs on cross-border activities where there are strong synergies at the EU level

Regulators as a network should consider how best to organise addressing important market problems to make their strength visible, transcending the centralisation/decentralisation debate to consider the best place for activities within the network. Mutual accountability is key; not centralisation versus decentralisation. The current network is restrained in terms of resources, capabilities and other aspects. The response is about how to deal with it, where to find the people to oversee it and why the 27 should be thinking about it. There is a query over what 26 other colleagues are thinking and why it is being done in 26 different places. He added that this does not make sense from a network perspective, so logic should be applied. If the national link is strong and local logic is needed, and if there is a strong link to national markets for NCAs, it should be kept at the national level. If that link is weaker, with principally European business, a fully-integrated market and cross-border problems, moving to the European level should be considered. If the Commission 's proposals are examined in that light, it is fine to think about prospectuses, the ESRB and benchmark regulations and to move that to an ESMA level with mutual accountability.

A regulator advised that further proposals would include market abuse. This is difficult to supervise in one country due to things taking place in one part of the Euronext market compared with others. Colleges and other aspects can overcome it, but a proliferation of markets where people can trade will make it increasingly more difficult, so organisation is important. The basic principle is to respect the size and shape of the risk or problem. If that is done through the analytical framework, it will produce something logical, although it might not be in fashion at that point. Fashion is not as important as providing value for the people of Europe.

A regulator stressed that an integration process needs an economic approach to make sense. The next decade will be one of securities, as the last has been one of banking-supervision integration. There is no difficulty in agreeing, even if it looks like disagreeing, with looking at the issues one by one. If they are taken like that: benchmarks are not national, neither is data-gathering, nor is CCP. Everything is European if reviewed in this way. The Commission's proposal anticipates what will happen in the next 10 years. If anything, it is too forward-looking, but it struck the right chord. A second point that could facilitate agreement is that, if the next decade is one of securities, it is worth focusing more on ESMA, which is where more integration is needed. Otherwise, strange things happen, such as licensing European products nationally, which creates discomfort among authorities, for good or bad reasons. This inevitably leads to a wrong set of incentives. It encourages a race and the acceptance of undesirable compromises in the battle to be quickest.

A regulator emphasized that there are places in the network where things can be done better. Benchmark regulation is one example. Prospectuses are coming under fire, and certain issues could be done better if taken at a

European level. Market abuse could be dealt with more efficiently and with less complexity at a European level. In terms of a proposal like financing reporting, these are markets that should be considered European. It should be possible to combine national and European pride and do what is best for the people.

There are many ways to address the issue of outsourcing the substance of delegation. The current proposal looks bureaucratic and has been addressed by an ESMA opinion but could be included as a guideline or as something to comply with or explain. Reviews of implementation could occur every two or three years. There are always solutions to make progress in that respect and it must be done.

An agreement on centralising data-gathering would be excellent for the industry as they would be bothered less. A point not in the Commission proposal is for an Erasmus for NCA personnel and board members.

Financing and investment challenges in the CESEE Region

1. Funding and investment needs in the CESEE (Central, Eastern and South Eastern Europe) region

1.1. The existence of a significant investment gap

A market observer emphasized that the CESEE region has recovered from the crisis and enjoys relative economic stability and prosperity. However, there is a persistent investment gap in the region. This is apparent in the low level of capital stock, which is approximately 50% of the average EU level and it is below 30% in certain CESEE countries, an official pointed out. Before the crisis, investment was an important factor in the region's growth, but after the crisis, investment ratios plunged across most of the countries except Macedonia, Poland and Estonia for country specific reasons. While the pre-crisis investment level may have been unsustainable, a comparison of current levels of investment with benchmarks indicates a significant lack of investment. Assessments conducted by international financial institutions (IFIs) such as the EBRD have estimated a shortfall of investment of about 3 6% in comparison to peer countries. They also show that the current investment dynamics in the CESEE region will not be sufficient to maintain the region's share of capital in relation to GDP and to close the investment gap in a gradual way, assuming a reasonable growth pattern. Maintaining capital to output levels would require the closure of an investment gap equivalent to 4% of the region's GDP.

In terms of composition, this gap is more pronounced in the private sector, because EU funds mainly target the public sector. There are nevertheless significant needs for infrastructure investment in the region and beyond, according to the IMF, the market observer pointed out. In the CESEE region, Turkey, Russia and Central Asia, there is an estimated total of €1.3 trillion in infrastructure needs. A proposal to build a European 'silk road' has also recently been made, offering a considerable potential for growth and employment with expected relocations of production sites to the region and further economic integration.

The official emphasized that the problem of investment is not only a question of quantum, but also of quality. There is a clear underrepresentation of research and development and innovation projects in the region compared to the wider Europe and this gap has increased since the crisis. Surveys also show that CESEE firms generally and service firms in particular need to upgrade their machinery, equipment and ICT in order to boost productivity and thereby also create sustainable growth rates for the future. An IFI representative added that skills and human capabilities for innovation need improving in the region. In a recent EIB study, 80% of CESEE firms suggested that the availability of skills is their biggest constraint. The outward emigration of skilled people is a significant issue but it is difficult to formulate a policy response to this. It is hard to establish the correct level of resource to put into education and training at the EU level. There could however be a balance in terms of how to manage resources and skills at the European and national levels and links between universities and the private sector also need developing.

1.2. Main funding needs of CESEE businesses

An official explained that firms in the CESEE region can be classified in three broad categories: large firms funded by foreign capital; so called semi private companies partially state-owned; and micro, small and medium sized enterprises. The third group is the vulnerable one, as these smaller companies are mostly dependent on bank financing, which is costly and collateral demanding. No significant funding needs have been identified concerning the other two categories of companies. Large firms are usually subsidiaries of large European or international groups and have direct credit lines with their parent companies and semi private companies operating for instance in the energy sector usually have sufficient capital resources on their balance sheets.

An official agreed that the largest share of finance constrained companies are SMEs, particularly those in the micro segment, which accounts for roughly 90% of SMEs across CESEE. The difference between large companies and SMEs is apparent in the success rate for loan applications. Even interest rates are estimated to be roughly 200 basis points lower for large companies than for smaller ones. The investment and financing gap is therefore not only the consequence of financing conditions but it also reflects other structural conditions which cannot easily be changed.

2. Supply of funding in the CESEE region and main drivers

2.1. Supply of bank financing

An industry representative believed that the supply of banking activities is appropriate in the region, with adequate liquidity and competitiveness across the different countries. There has been a certain recovery of the corporate market since the crisis with a growth of loans (+4.9%) and deposits (+5.4%). There are also strong improvements on NPL ratios across all countries. In addition, more capital could be secured in the future for companies through public private partnerships (PPPs). Some countries such as Turkey have made great progress on this already and others such as Poland, the Czech Republic and Slovakia could experience significant benefit from PPP schemes. However, banking activities are affected by the stringent requirements that regulators have imposed

and further impacts are expected from the ECB monetary policy and the progressive normalisation of interest rates. Issues such as volatility in Turkey and sanctions in Russia are making some international financial players more cautious also. The industry representative highlighted that the CESEE region is below penetration in GDP terms for loans and deposits, which indicates potential for growth. For example, CESEE countries have an average loan to GDP ratio of 47% (down from 53% in 2013) while markets such as Germany and Italy have reached 89% and 106%. The decrease in recent years is due to deleveraging and the elimination of NPLs.

An official noted that although the banking sector is profitable in many CESEE countries a large number of banks still conduct very conservative business targeting households and mortgages. They are not inclined to move into riskier segments such as SMEs or micro companies. An IFI representative emphasised the difficulty for banks to lend on the basis of intangible assets. This is a problem given the need for firms in the region to develop their innovation capacity, which requires more intangible investments.

A market observer underlined that financial markets generally have recovered in the region following the crisis, but interest rates have been too low given the modest capital stock compared to the euro area.

2.2. The small size and fragmentation of capital markets

An industry representative stressed that capital markets in CESEE are at an early stage of development. The aggregate size of all of the pension funds, insurance assets and retail funds in the entire CESEE region which counts 11 countries is approximately the same as that of Austria. Similarly, the aggregate value of the asset management industry in these countries is approximately one fifth of the investment assets of the top three pension funds in the Netherlands. The issue is that financial players need to handle 11 different supervisors and regulatory regimes. Another industry representative underlined that the ratio between corporate bonds and the total liabilities of companies in the region is only a few percentage points, compared to 11% in the US and 4% in the rest of Europe. Additionally, because of MiFID II, international brokers are closing their equity research departments, which is also causing a negative effect in CESEE.

2.3. Saving is improving but mainly focused on traditional saving products

In order to close the investment gap in CESEE, an important factor is developing the wealth and savings of its citizens, an official stressed, because a stronger focus is needed on domestic resources. The model of financing investments in the CESEE region has had to change since the crisis with a reduced dependence on external financing. The saving rate is growing but recent IMF estimates suggest that domestic savings across the region still lag significantly behind the benchmark saving rates of economies that have migrated from middle to high incomes.

An industry representative stressed that retail saving trends are positive in the region. A recent survey indicated that 80% of citizens in some CESEE markets consider it important to save. Saving rates across the region have increased by +10% to +35% over the last few years depending on the countries[1] and the average amount put aside is growing[2]. The problem however is the way in which people are saving. Savings accounts are the main option and only a few people consider life insurance and capital markets as a possibility. These savings are not generating enough return for wealth to develop, particularly in the current low rate environment, and sometimes the yield is even below the rate of inflation. This can be explained by the motivations for saving, which are mainly to put a financial back up aside for emergencies and to finance the acquisition or the renovation of a flat, but pension provisions also need tackling with an increasingly ageing population.

Another industry representative agreed that it is not the absolute savings rate which is important, but rather how savings are invested. From the industry's perspective, there is a lack of money going into securities and funds. A very significant proportion of savings (50 to 70%) sits in cash holdings even for private bank clients, compared to an average of 20-25% in Western Europe for these customers. In addition, while it is positive that the savings rate in the region is growing, it remains relatively low compared to countries such as Austria or Germany. Additionally, the capital base remains lower.

3. Main objectives for developing capital markets in the CESEE region

3.1. Improving financial education and incentives to foster retail investment

Several panellists emphasized the importance of developing financial literacy and a proper savings culture in order to foster retail investment in the CESEE region. The financial education level in the region is very low, an industry representative stressed. A worldwide financial literacy study by S&P showed that only one third or one fourth of people interrogated in CESEE can answer simple questions concerning interest rates and the diversification of investments[3]. Developing financial education is essential otherwise long-term savings will mainly remain in current and savings accounts and will not be properly invested, thus creating no extra wealth. This deserves a specific workstream in the Capital Markets Union (CMU) action plan, which is not the case at present. Another industry representative suggested that financial literacy could be enhanced through both education and technology. Technology now allows for far cheaper and more efficient ways to educate end investors, providing them with tools such as robo-advisors which can help them plan for their retirement based on the savings they already have, their future revenues and their objectives. The first industry representative added that the level of financial education of SME managers and entrepreneurs also needs improving. There is the ELITE programme for example developed by the LSE Group, through which selected SMEs are trained in the perspective of an IPO or a bond issuance. In Romania there is also "Made in Romania", a programme which selected the 50 top companies in the country and supports them. Similarly, developing the level of financial education of the media should be encouraged. An official concurred that the financial education of companies needs improving. National promotional banks can play a crucial role here.

The need to put in place appropriate incentives to foster investment in capital markets was also pointed out. An industry representative suggested that the most effective stimulus, though unfortunately the most difficult one to implement for political reasons, is the use of fiscal incentives. In the US, the capital gains of low income citizens were not taxed previously, although the tax rate has now increased to 20% similarly to the EU. Another issue to be tackled is the alignment of the fiscal treatment of equity and debt financing, as proposed in the CMU; this is possible to achieve as the experience in Belgium has shown. Additionally, best practices should be shared between EU governments regarding incentives for capital market investing.

3.2. Developing Pillar 2 retirement systems

An industry representative considered that retirement systems are the most powerful lever to develop capital markets. Generally speaking, there is a direct correlation between the level of development of capital markets and the existence of a proper capital funded Pillar 2 scheme. These schemes can contribute to address the needs related to ageing population, while also developing a significant pool of capital that can be invested in the local economy. Local stock exchanges and insurance companies can play an active role in this process. In most countries in CESEE, Pillars 2 and 3 systems are at early stages of development. Unfortunately, in some prominent countries which have developed growing capital funded systems, there has been a tendency to revert to a 'pay as you go' system.

There are different best practices worth considering. Whether this is a defined benefit or defined contribution scheme, it is essential to introduce workplace structures which reach a large part of the population. If this is combined with auto enrolment, it can make a sizeable difference. The Pan European Pension Product (PEPP) proposed by the Commission in the context of the CMU could support this evolution. Smaller markets and countries often benefit the most from such pan European products, which allow financial institutions to reach multiple markets of a relatively small size in a more profitable way.

3.3. The need for a more homogeneous legal and regulatory framework

An industry representative stressed the importance of a homogenous legal and regulatory framework for developing capital markets in the region. Ultimately, the closer the alignment between individual country standards and the EU rulebook is, the easier it will be for pan European initiatives to assist the development of investment capital in the region. This is a very important objective as Europe moves into the next phase of the Capital Markets Union. Consistent standards indeed facilitate the development of investment offerings for retail clients across multiple smaller markets, whether this is for retirement solutions or retail investments. There is still a relatively diverse set of rules regarding investments across different CESEE markets. Even in well established and common regimes such as UCITS, some countries maintain specific record keeping requirements for example. In respect of future EU pension initiatives such as PEPP, the region should aim to align closely with EU standards. Otherwise, it will be more difficult for regional, EU and international providers to give the local investment base access to adequate solutions.

An official suggested that structural obstacles to investment in the regulatory environment need identifying. All countries should screen their regulatory environment and consider whether it creates obstacles for the development of new financial instruments that could be attractive for issuers and investors. One of the working groups of the Vienna Initiative is helping countries in the region in their screening processes and providing guidelines on how to remove obstacles. Another official agreed that improving and stabilising the legislative framework in the region is essential. CESEE economies will continue to require external financing in the mid term, which means that predictability for investors is crucial. An industry representative emphasized the need for stronger collaboration between national authorities to improve the legal and regulatory environment in the region.

3.4. Developing and integrating local capital markets

Several panellists stressed that further developing and integrating local CESEE capital markets and their infrastructures is essential. An official noted that there have been several attempts to integrate stock exchanges in the region in order to increase volume and liquidity. This is however a challenging task that requires focused effort from both public and private stakeholders. Another official agreed with the importance of developing financial market infrastructures in the region and felt there is potential for fintech, especially with crowdfunding and ICOs to contribute to bridging the financing gaps in the CESEE region. Some issues however need addressing, such as money laundering and consumer protection.

The official also mentioned that the European Commission in the context of the Structural Reform Support Programme (SRSP) is providing CESEE countries with help to develop their capital markets. An industry representative remarked that this support is provided at the request of national governments. However, it should also be possible for the private sector to request support directly from the EU if the local government is not willing to ask for it. Some of these funds could for example be used to offset the costs of listing SMEs, which is happening in Poland for example. Indeed, according to a recent survey performed by the EBRD, the principal barrier to finance for SMEs is the cost of listing on regulated capital markets (e.g. the fees paid to lawyers and listing entities).

Another industry representative suggested that the region needs central bank programmes to support the repurchase and issuance of financial instruments. In addition, there should also be partnerships between issuers and institutional investors. Several interesting initiatives have been observed in the region. For example a covered bond purchase programme similar to what the ECB has done has been undertaken in Hungary by the local central bank in order to support the purchase of paper from local mortgage banks and support the mortgage market. An interesting strategy has also been implemented since 2016 in Bulgaria for the development of capital markets through a Council for the Development of the Capital Market.

Impacts are also expected from the CMU, an industry representative mentioned, but the CMU will not solve all the region's problems. The CESEE region needs to set its own key performance indicators and take bold measures of its own. The region must develop its own equity research capacity, because nobody is really active in the brokerage environment in CESEE. While there are large regional banks in CESEE, for whom the development of the region is critical, their main core activity is often not investment banking. The larger international banks do not do trading and investment in the CESEE region, because it is not a core business.

4. Changes in the role of IFIs in the region

IFIs such as the EIB and the EBRD play a major role in the financing of the CESEE region economy. An IFI representative explained that the EIB, previously focused on the provision of cheap long-term funding, is changing the way it operates in the region and is moving towards using new kinds of products covering different financing needs and instruments. The EIB is working in the area of venture capital and private equity. The EIB's Investment Facility is probably the biggest venture capital fund in Europe, investing in funds that operate in the region and also providing investment expertise, which is an aspect that needs developing. The EIB is also contributing to developing the link between banks and innovative firms, with a scheme providing banks with a first loss guarantee on portfolios of loans to growing SMEs and innovative firms. This allows banks to take more risks (e.g. regarding

intangible investment) than they otherwise would have taken. Another example is a pool of banks in Bulgaria that are investing in innovative start up companies. An official mentioned that the funds provided by the IFIs are in theory a possible source of funding for SMEs, but the requirements imposed are often too burdensome administratively and for the IFIs these financing projects are too small. An official remarked that the IFIs have also attempted to introduce instruments to produce a catalytic effect on domestic institutional investors, but this has not been particularly successful. Greater focus is needed on this segment, because the investor base is key for the development of capital markets.

Improving the usage of EU funds and the technical capabilities of Member States in terms of planning and prioritising projects are other objectives that the IFIs are contributing to. In the CESEE region, there has been considerable dependency on EU funds for infrastructure investment, but approaches need to change. CESEE countries need to take more of an initial stake in these projects and more projects should be developed with financial instruments that may optimize the use of financial resources. This requires advisory and technical knowledge regarding how to plan and prioritise projects, and how to use these new financial instruments. In addition, although there is a better allocation of EU funds, a large proportion of them still go into traditional areas such as transport infrastructure; there is a need to direct more funds towards other areas that may foster growth in the region such as innovation, technological transformation and the development of skills. The EU proposal to re bundle many of the previous programmes into the InvestEU programme seems appropriate and there are on-going discussions about how this mechanism should function. The EIB is also working on several other programmes, such as a programme to support 'smart cities' which is particularly relevant in the CESEE region, where cities are relatively small and need support in the planning of their digitalisation and interconnectedness projects. An official welcomed the general intention to undertake further pooling of projects across the region, noting the potential of initiatives such as the EIB's 'smart cities' programme. When it comes to the use of new financial instruments, Europe must ensure there is a level playing-field between European institutions and national promotional banks. A further issue that CESEE should consider, the IFI representative suggested, is how to position itself in the context of the negotiation for the Multiannual Financial Framework. Given the resources that will come into CESEE, the region should consider how to define and prioritise its policies for the future.

An industry representative encouraged the IFIs to undertake further work on capital market development. The region needs support to foster the listing of SMEs, identify anchor investors for SME IPOs and stimulate secondary trading on the capital markets. National capital market strategies that are being addressed in the context of the Vienna initiative are also important. Several other actions that could help to improve capital market financing in the region were proposed by the industry player. One would be for the EIB or EBRD to provide seed capital for the development of a regional ETF. Employee stock option plans are another possibility, in order to bring private individuals to the market. Further suggestions include developing equity research at the regional level; developing corporate governance; implementing a capital market development fund in conjunction with a sovereign investment fund; and increasing media cooperation and investor education.

1. +10% in Austria, 35% in Romania, roughly 20% in Slovakia, almost 10% in the Czech Republic, and there has been positive growth in Hungary.

2. It was €76 per month in 2012 and €83 in 2016; it is €91 in 2017.

3. One of the questions in this survey had asked participants to consider a situation in which they needed €100, asking them to decide whether it was preferable to pay back €105 or €100 plus 3%. This question was followed up by a question about whether to diversify their investment or keep 'all of their eggs in one basket'. Results in other EU countries: one out of two Austrians gave the correct answers to three out of four questions. In France, the results were the same. In Italy, one out of three people answered correctly. In CESEE, the figure was one out of three or one out of four. In the UK, it was two out of three.

Priorities for further developing financial markets in the CEE region

1. Changes needed in the funding model of the Central and Eastern Europe (CEE) region

1.1. Changing the growth model of the CEE region

An IFI representative stated that there has been sound post-crisis cyclical recovery in the region but, at the same time, there are reductions in the forecasts for potential growth and an extension of the timeline for the completion of the economic convergence process. This means that the region will have to evolve its growth model. The pre crisis model involved a great deal of foreign investment into labour intensive industries and a great deal of portfolio capital coming through foreign-owned banks, which will probably not continue. There will likely need to be greater emphasis on domestically driven productivity growth, local innovation and skills development.

Infrastructure will remain a significant priority but there will need to be a greater focus on how to finance not only tangible assets, like manufacturing plants and infrastructure, but also intangible assets and innovation, particularly in the services sector.

1.2. CEE economies mainly rely on bank financing at present

An official emphasized that the CEE region is bank-centric with most businesses relying mainly on bank funding and there is at present a financing gap in the region. Stricter bank regulation plays a role in this situation as banks find it harder to finance smaller, riskier enterprises because of relatively low returns. Levels of private equity and venture capital investment are well below what is seen in more developed countries and they are mainly focused on the larger economies of the region.

An industry representative stressed that many people do not realise the scale of the problem that this situation causes in the CEE region in particular. In Europe 75% of financing comes from banks and 25% from the capital market and in the CEE region the ratio is 90% / 10%. In the US it is the opposite, 75% of financing coming from the capital markets. Therefore any change in banking regulation has a substantially higher impact on the

financing of the economy in the EU than in the US, where companies can rely on capital markets as an alternative. EU banks are very strictly regulated and controlled because of their importance for the EU economy and in order to avoid any further taxpayer bail-out. This has made banks much safer but is limiting their ability to contribute to the funding of the economy.

Another official remarked that the ultra-low interest rates over recent years and the dependence on bank financing have not encouraged corporate bond issuance even for well-established enterprises and access to finance is scarce for small and medium enterprises and for start-ups.

There is, however, no 'magic formula' to resolve the current financing gap via bank financing, the first official believed. The companies that are currently non-bankable could benefit from some consolidation and economies of scale, thereby creating some synergies that could make them more prone to bank financing. But the long-term goal of governments should be to shift the focus away from traditional industries and support the development of more innovative, technology intensive and high growth industries.

1.3. Encouraging a rebalancing of financing in favour of capital markets

The panellists were in favour of a development of capital markets in the region, which is also an objective in the rest of the EU in line with the Capital Markets Union (CMU) initiative.

An official emphasized that certain countries in the CEE region, such as Romania, are trying to improve their position in the field of capital markets. As of 2017, stock market capitalisation out of GDP stood at 19% in CEE compared to 45% for the Eurozone and 146% in the US[1]. Romania aims to be close to 30% stock market capitalisation out of GDP by 2023, helped by new listings of private and state enterprises. The main goal of Romania's strategy is to overcome the frontier market status and obtain an emerging market status. This will increase the visibility of the Romanian capital market to, in particular, international investors, many of whom are subject to asset allocation constraints, and it will allow them to diversify their portfolios. The Romanian authorities also have a project for setting up sovereign funds to develop and finance profitable and sustainable investment projects in various economic sectors. One of the benefits of this financial instrument is to support Romania's efforts to achieve the emerging market position for the domestic capital market by increasing its liquidity following the listing on the Bucharest stock exchange of the companies in this sovereign fund portfolio.

An industry representative noted that regrettably the EU CMU project is taking longer than expected to materialize. The issue is that Europe has not set itself an appropriate goal in this regard. Europe's aim should not be to copy the US but to have a balance between bank and capital market financing, recognising that it is a more debt and social oriented society than the US. Before the CMU is a reality, which might take many years, further thought should also be given to the ways in which banks may replace some of the functions of a capital market in financing e.g. start-ups and innovation and the measures needed to facilitate this.

2. Facilitating the access of companies to the capital markets

An official stated that it needs to be easier for companies to access capital markets but that will not be a simple task and will take a few years to achieve. Companies tend to prefer debt and from a business perspective, debt financing is cheaper than equity financing, but there are limits to that. Also, generally, a company that does not have access to bank financing will not have access to capital markets either, via equity or debt, almost creating a 'catch-22' situation. A certain number of issuer and investor-related factors also create obstacles. Listing is still perceived as complex, expensive and intimidating by many companies, even with proportionality rules and regulatory exceptions. In addition, SMEs are riskier than larger corporates, which makes it hard to market them to retail investors, and institutional investors might not have an interest in small tickets. There is also still a negative perception from institutional investors when it comes to corporate governance in the region.

Developing trading and clearing infrastructures and connecting them across the region could create additional liquidity and attract more investors. Alongside traditional exchanges, it is also important to create innovative SME trading platforms with simplified listing rules. Crowdfunding is also an opportunity to further explore as it has worked well in the past.

In addition, from a policy perspective, governments should continue proposing attractive start-up and SME financing programmes, and tax exemptions within the state aid rules, the official emphasized. This will help SMEs to grow. Governments should also foster innovation as innovative companies are more attractive to investors and will have better access to capital markets. In the CEE region, many of the companies that are currently listable are owned by governments. A privatisation wave of those companies could provide an additional boost to capital markets and attract investors.

Another official stressed that companies need to develop a better understanding of the functioning of capital markets and of the responsibilities and advantages this type of financing involves. The Romanian Government is fully committed to support this process by working together with the industry participants.

3. Encouraging more active engagement of investors in the capital markets

3.1. Addressing financial literacy and investment culture issues

An official highlighted that the CEE region lacks a financial culture. Experience of the capital markets is much lower than in more developed countries and government policy should play a bigger role in addressing this.

An industry representative agreed that Eastern Europe does not have a capital markets culture and stressed that there will be no improvement without the support of politicians. Politicians in the region should stop criticizing and putting off investors, calling them speculators or capitalists. They also need to realise that the problems associated with pension, life insurance and social insurance systems and with wealth building are the result of a lack of capital markets. People living in the CEE region are all at a disadvantage now vis à vis those who live in countries where capital markets and pension funds are more developed because in the CEE region there are few attractive investments.

Ultimately, it is a question of culture, the industry speaker considered. However, only two countries in Europe have a real capital market culture: Switzerland, which has never been in the EU; and the UK, which is about to leave it. France and Germany are now supposed to be the basis for the future CMU but the CEE region should also create its own capital markets and sell itself as a region that is open for capital markets. The individual CEE countries are too

small for this endeavour; therefore a capital market culture needs to be developed at the regional level. Transparency and financial literacy are pre-requisites and the CEE has neither, so they need enhancing. Consideration needs to be given as to how this can be done. For example awareness about capital markets should be developed in schools. Products should only be sold to those who understand them, in order to avoid reproducing one of the causes of the previous financial crisis. The work of the EBRD and the EIB is to be commended in this regard, but politicians also need to push for developing a capital market culture.

3.2. A balanced approach to the different investor segments

An IFI representative highlighted the importance of addressing the diverse needs of the investor base with appropriate instruments and investment solutions. A key point is that there is no one-size-fits-all solution or generic policy on the demand side that could help each country to develop all the different investor segments at the same time. This is because there is a very diverse set of issues. A successful demand side policy also requires constant fine-tuning in order to avoid blind spots in the approaches to these issues.

Different investor segments have very different expectations. Market-makers need to hold inventory to trade and meet end-investor needs. Pension funds target assets with much longer maturities. Asset managers tend to invest in very liquid assets that can be valued on a daily basis. International investors have different needs from local investors because they put a strong focus on currency and interest rate hedging instruments. Retail investors seek access to a range of products that allows them to generate returns in a more protected environment.

Governments should develop a balanced approach to these different investor segments because overreliance on one of them in particular can raise stability issues. Over-reliance on international investors without a domestic investor base, for example, can lead to instability when international investors withdraw from these markets. It is not a coincidence that the countries that have been successful with the development of their capital markets are the ones that have tackled the different dimensions of the investor-base. Croatia and Romania provide very good examples of holistic approaches to the reforms needed for the development of capital markets. They both have a contributory pillar to pension funds, which form a significant part of the investment base, and they have been taking steps to enhance clearing, settlement and trading links. The reclassification that Romania is aiming for from frontier market to emerging market status in order to encourage inward investment is also an appropriate objective. The EBRD and the Commission are working with CEE countries on developing these approaches. The secondary market also needs to be developed. How dormant accounts, which is an issue linked to the process of privatisation, are dealt with is very important in this regard.

3.3. Developing appropriate incentives

An official stated that governments should develop attractive tax structures to bring investment funds in for incorporation into the CEE region. Improving the governance rules in the region is also very important as it would allow investment funds to allocate more funds into the region.

Another official highlighted that Romania has simplified account opening and the registration procedures for foreign investors, as well as the conformity requirements for corporate events and proxy-voting. Draft regulation has also been developed aimed at improving the registrar activity of the central securities depository and capital market entities interested in setting up a central counterparty have been identified. In addition, the possibility for Romanian issuers to be listed on external markets has been extended.

4. Changes in the approach of IFIs and promotional banks in the region

An IFI representative stated that there will need to be a greater focus on financing intangible assets in the CEE region, particularly in the services sector. This is not something that the IFI community, the promotional banks or the commercial banks are used to financing. Adapting to these new needs requires a change in the business models of promotional banks in particular. The EIB will have to focus more on advisory services and technical advice, and is co-operating very closely with the EBRD on this. More focus will also be needed on the corporate side in terms of corporate innovation and corporate investment, beyond the traditional infrastructure-related activities. The EBRD has done more on the corporate side in the past than the EIB, but there are countries that are not served by the EBRD and that the EIB will need to assist.

The nature of the EIB's financing instruments will also need to change in order to support the new needs of the CEE region. At present it carries out large-scale debt financing of significant infrastructure projects alongside structural funds and also off-balance sheet financing through PPPs (public-private partnerships). An expansion of PPPs is needed in certain CEE markets. More focus also needs to be given to equity financing. The EIB primarily provides equity financing indirectly through its subsidiary, the European Investment Fund (EIF), and there are some good examples of setting up funder funds in individual countries and regional funds to support the development of venture capital and private equity in the region. More of this is needed. The EIB will need to take direct equity stakes itself on the corporate side, which it does not do at present, unlike EBRD. The EIB does however undertake venture debt that carries equity risk, but which does not dilute the original shareholders. That product is working extremely well in Western Europe and it needs developing much more in Eastern Europe.

The EIB will also carry out more local currency financing in all the markets. Traditionally, it has funded the banks and they have passed low-cost funding on to the SME sector. Now, however, the banks are no longer short on funding but short on capital. The EIB will therefore need to issue more products to banks in order to allow them to lend to SMEs that do not have collateral. This will be a significant requirement in a more innovation driven economy. The SME initiative, which essentially is a risk-sharing mechanism that the EIB carries out with the local banks in order to allow them to lend uncollateralised, has been a great success in some CEE countries. The EIB will expand this quite significantly. In addition, the EIB is supporting new securitisations, particularly in Poland. It has worked very well in supporting the first securitisations of leasing receivables, consumer loans and so on as the anchor investor with a number of other stakeholders. The EIB has also fostered the first local currency hybrid bond in Poland, which is a new product for the Polish utility sector.

1. CEE capital markets (bond and stock markets) are equivalent to 78% of GDP compared to 340% in the UK and 350% in the US (A. Treichl – Views Eurofi Magazine September 2018).

Priorities for the next EU Commission

1. Strong political debate should be linked to policy alternatives

A public representative noted the importance of establishing a link with the work that is being done now in the financial integration area and that the European Parliament hopes to conclude as soon as possible in the next political and legislative cycle. Lively political discussions that are not disconnected from real policy choice are important in order to regain the trust of citizens. Real alternatives need to be brought to the public arena.

However, in such discussions, a unified pro European front against populist nationalism would be unhelpful as it would simply give populism a great deal of space. Instead, pro-European forces should foster lively and strong debate on possible alternative options before building legislative consensus. It needs to be made clear to citizens that the choice is not purely between Europe or no Europe but that there are different possible choices with different possible balances in terms of policy choices, social bases and so on.

These debates, while being highly political, should also be strongly linked to policies. The capacity to link politics and policies should be the key element of a European Commission that can successfully conclude, rethink, relaunch, broaden and streamline a number of policies. A good starting point is to build up a common agenda and a lively political debate, and to mobilise stronger democratic consensus and support in order to make politically impossible things possible as a result of acquiring legitimacy through having been part of an open and clear democratic debate at the European level.

An expert noted that belief in the EU amongst European citizens is highly correlated with the economy. The EU will fail unless it generates long-term sustainable growth, jobs and fairly distributes the benefits of that growth to all segments of society.

2. European authorities need to set out a holistic investment strategy

A public representative argued that the key headline going forward should be 'investment for growth'. European authorities need to be able to explain to citizens what a comprehensive investment strategy would look like. Jacques de Larosière previously commented on this point, stating that European authorities need to be able to, in a streamlined and comprehensive way, put together and combine areas that seem largely disparate. Instead of bureaucratically distinguishing between elements such as the Capital Markets Union (CMU), the Banking Union, investment routes and the Macroeconomic Imbalance Procedure, European authorities should be able to have a more comprehensive vision in which they clearly set out the goals and use all the tools that they have in a synergistic way.

There is currently a paradox in the private side of an excess of savings that are taken away from Europe as opposed to being channelled into investment for growth. This is an issue that cannot be addressed by a single piece of legislation but, rather, should be at the heart of a number of areas. The Banking Union and the CMU are not separate things; there cannot be a CMU without a strong and integrated Banking Union. This should be a holistic concept. There is also the investment and the capacity to bring public and private together. There is a problem of asymmetries and imbalances.

The role of the social dimension also needs to be considered. If one cannot imagine a fully-fledged transfer union with great redistribution or if one cannot realistically imagine fining Germany for having a current account surplus and instructing an individual to pay, things will not move forward. Internal demand and internal wages must be boosted in countries with persistent excessive surpluses. It is also the philosophy of Europe's social market economy to benefit from a stronger social Europe that is neither fully public nor fully private but that utilises a combination of tools. Europe cannot retrench itself in a global market. It needs a combination of financial, political and social elements, and this combination should be presented in a visible design that is simultaneously ambitious and realistic.

The chair expressed support for this holistic approach, stating that the segmented approach that has 'plagued' the current political cycle has seen a lack of coherent explanations, a lack of deadlines for action delivery and a lack of a tripartite political agreement between the European Council, the European Parliament and the European Commission. The holistic approach may not be an easy one but it could be a very powerful way of driving Europe forward.

3. Europe faces an institutional problem

A public representative highlighted three points. The first is that the three pillars of the Economic and Monetary Union (EMU), the Banking Union and the CMU have been considered from the point of view of within the EU. This is finished, not only because of Brexit but also because of the outcome of what has been delivered.

Second, as outlined by Jacques de Larosière, Europe needs to be careful because the rest of the world will not tolerate it failing to fix its internal problems. In such a case, they will 'destroy' the euro.

Third, the original intention of the CMU was to convince the UK to stay within the EU. This obviously has not worked but the CMU remains and needs to be considered in a completely different way because it now has to tackle the Brexit issue, which was not foreseen at the outset. The whole logic of the CMU is therefore inverted. This, however, does not weaken the need for a CMU but instead makes it even more important. It might have once been a measure to keep the UK on board, but it has now become a cornerstone of financing the European economy.

As stated earlier by Jacques de Larosière, new challenges are obliging European authorities to face issues that are threatening the euro. Europe may not be able to deliver to the level of ambition that Jacques de Larosière is calling for during this mandate, but this will need to be the first target for the next Commission. The financial market cannot be fixed without fixing the EMU.

As a result of the above, Europe faces an institutional problem. The new Commission will find itself in an international environment that is much more hostile to the EU. Europe believes in soft powers whereas the rest of world does not. Instead, they believe in an alignment of interest, which they know how to define and to express, and for which they have the leadership willing to fight. Europe will not be in a similar position unless it believes that the euro and its internal market, including in financial services, is of the essence.

The public representative suggested the appointment of an EU Finance Minister that would be able to speak for the EU in discussions with world leaders. Jean-Claude Juncker

has been in such discussions on trade issues but does not have a mandate over the EU's economic landscape. Such an appointment may not occur before the next Commission but should nevertheless be strongly considered.

The chair expressed agreement with much of the above comments, noting however that not all problems should be dealt with by way of institutions, which sometimes tends to be a European reflex.

A public representative stressed that now is not the time to rebuild the entire institutional setup of the EU. The current Commission does not have the best track record in terms of overcoming national positions, which has caused problems in relation to, for example, the euro area stabilisation function and the European Deposit Insurance Scheme (EDIS). The European authorities will need to convince everyone to overcome different national starting points. Understanding the perspectives of other Member States is one thing but European legislation cannot be predicated solely upon, for example, the regime of the Sparkasse. Instead, the Banking Union needs to be looked at with the three pillars that were previously promised.

4. The European authorities require the best talent but there is a concern of conflicting competencies

The Chair stressed the need for having the 'top people' in the Commission, which can allow the EU to achieve a great deal. Whoever takes over the finance portfolio has to be 'top class', with a project that is agreed trilaterally with a very fixed deadline and delivered, in order for Europe to attain a powerful position on the world stage. The Parliament also has an important role here. In addition, clarity of roles is required as too often there have been conflicting, overlapping competencies within and amongst the European authorities.

A public representative highlighted that a commonality between the single market and the single currency is a clear distribution of competencies. There can be both shared and exclusive competencies but shared competencies must be fully embedded in a governance system that clarifies who does what and who controls what. Problems occur when there is confusion as to what is European and what is national. In this sense, the focus should not be on institutions but on a clear vision.

Nevertheless, it is important to know the institutional and political framework. There will never be full harmonisation of economic policy, because this does not exist in any federal state; the budget cannot be controlled at the sub-federal level. This is an issue of size and differences. It is also important to learn the lessons of what Europe has been able to do well and to try to, mutatis mutandis, use this strength to open new policy areas and to build up this consistency in vision that is required to address very clear problems.

5. The single market and single currency are 'precious' assets

A public representative maintained that, while having quality people in post is important, the EU's main assets are the single market and the single currency, which have performed well against two powerful shocks. The Brexit negotiations have highlighted that preserving the integrity of the single market is more readily achieved not by infighting within and amongst institutions and Member States but by being united with an accumulated institutional culture and the political capacity to manage these 'precious' assets. Belief in those assets will allow Europe to better manage its negotiation with the UK, as demonstrated by Mario Draghi in relation to the single currency.

Another public representative concurred that the single market and the single currency are 'worth fighting for' and highlighted three dimensions that will need to be at the top of the next Commission's agenda in order to do so: the fight against inequality amongst Member States and within Member States; climate risk and environmental, social and corporate governance (ESG) criteria; and cyber risk, which should not be seen as merely a technical side issue.

6. Europe must implement the tools that it develops

A public representative stressed that the tools that have been created to deal with various issues must be used rather than simply spoken about, as has been the case with the Macroeconomic Imbalance Procedure and the single resolution fund. This resolution fund took years to be built but it is never mentioned as a solution when there is a crisis in a European bank. European citizens are told that issues have been identified and that tools have been created, but this is not then delivered upon. If Europe has the tools, it should dare to use them.

An expert agreed that instruments should be used and that rules should be applied rigorously. If European authorities set themselves deadlines, they must deliver to those deadlines. Otherwise, public confidence in the European authorities will be undermined.

FINANCIAL STABILITY CHALLENGES

Ten years after Lehman: are the EU and global financial systems safer?

Introduction

It is 10 years since the financial industry confronted the failure of Lehman, which led to the biggest drop in economy activity in EU economies since the Second World War.

Thanks to central banks' concerted efforts and their accommodative stance, a repeat of the Great Depression was avoided. Since then, historically low, even negative, interest rates and unprecedentedly large central bank balance sheets have provided important support for the global economy. But lasting very low interest rates combined with bulging central bank balance sheets, have supported a further rise in the global stock of debt, private and public, in relation to GDP. Global debt reached the record peak of 318% of global GDP in 2016. The last financial crisis was produced by rapid leveraging, particularly in the US but, based on the previous metric, global leveraging is continuing. The world is now 12 per cent of GDP deeper in debt than the previous peak in 2009. Experience shows that in a cyclical upswing, it is wise to raise interest rates in order to create margins to reduce them when the next recession comes.

The continuous accumulation of debt is worrying for at least two reasons. First, the higher the debt, the more sensitive the economy and financial valuations are to higher interest rates. This, in turn, makes it more difficult to raise them, favouring further debt accumulation – a kind of "debt trap". Second, higher debt – private and public – narrows the room for policy manoeuvre to address any downturn. High sovereign, corporate and household debt levels in many parts of the world could expose the financial system to losses, rising credit defaults and increased rollover risk as monetary conditions tighten.

The BIS Annual Economic Report (June 2018) explains that a number of developments could lead to the materialisation of risks. A tightening of financial conditions could trigger or amplify a downturn, possibly generating financial strains. Such tightening conditions could stem from surprises in inflation, a general reversal of the risk appetite of financial markets in response to self-reinforcing cyclical developments (e.g. disappointing growth or certain geopolitical events). Any further escalation of protectionist pressures is especially worrisome. Its global impact would be very significant. These risks are not independent and they can interact. For instance, risks may materialise in emerging-market economies, exposing vulnerabilities in the weakest advanced economies, not least owing to financial linkages.

There are three parts to the discussion. First, an overview identifying the challenges ahead and how the industry is handling them. The second theme builds on this by raising the question of how far macroprudential frameworks can help. The last part explores how future shocks could be transmitted and whether there is a risk that problems may arise in non banking areas.

1. Ten years later, the international financial system is safer but vulnerabilities and challenges remain

The G20 programme of reforms launched in 2009 has significantly strengthened the resilience of the financial system. Moreover, emerging market economies have built up their defences since the serious strains in the 1990s -- better macroeconomic-policy frameworks, greater exchange-rate flexibility, and larger foreign currency-reserve buffers. However, financial risks continue to build up in their usual gradual and cumulative way.

1.1. The banking system is safer and more stable

The post-crisis financial reforms have greatly strengthened the resilience of the financial system. Banks are now better capitalised and draw on more stable funding and the financial system as such is less leveraged.

1.1.1. A great deal of progress has been achieved on the regulatory side

An industry participant thought it was indisputable that, following a huge commitment and will, most of the reforms of the banking system are now complete and the system itself is more resilient. A second industry speaker reflected that banks are much more resolvable and authorities have enhanced their cooperation via institutionalized settings such as the Core Colleges and Crisis Management Groups. Policy is in a better position to tackle financial stress than at the start of the crisis when so much was unclear, and there was disagreement and doubt about which instruments to use. A representative observed a shifting focus by the authorities on macroprudential topics, following a period of microprudential focus to create resilience, transparency and information aggregation.

A third industry representative agreed that the financial system is definitely safer, pointing to three key reasons. First, important steps have been taken in the formidable regulatory reform process that started during the crisis. Second, banks have adjusted their strategies, overhauled their legal structures and strengthened their culture and conduct framework. Third, the global economic recovery has been gathering strength in the last few years, which has been excellent for healing the system and allowing it to build bigger buffers.

1.1.2. The financial ecosystem is less leveraged than before

In addressing the resilience of the financial ecosystem, an official commented that it is probably less leveraged than before. Certainly, most governments are not less leveraged, households and banking intermediaries are, but it is necessary to understand different forms of leverage, whether financial or economic and the purpose for which leverage is used. An industry speaker noted that many bank balance sheets have now been significantly reduced and comprise more high quality liquid assets. Analysts must carefully assess them for evidence of proper diversification, concentration and exposure to particular areas.

Another public decision maker reported that the implementation of a decade of reforms is now largely complete, but questioned how they should feel about the

large banks running about 20-times levered. It makes more sense than 40 to 50 times, which is closer to the position before the crisis, but this is still a highly levered system and some care is required.

1.1.3. Bank' capital and liquidity buffers have significantly increased

In assessing global financial stability, a public representative reported that the post crisis financial reforms have left banks with much bigger capital and liquidity buffers. Substantial progress has been made with most banks meeting the more stringent capital requirements and new liquidity standards[1].

A major lesson for anyone who lived through the crisis 10 years ago is that liquidity is key. Most companies are better prepared now and Asian countries have much higher currency reserves than before. In general, the sector has grown more cautious, which is one of the positives learnt from the crisis. An industry representative added that there is also more transparency and higher capital buffers now. Liquidity is often underestimated, but is likely to drive the next crisis as it drove many in the past.

Another speaker described how, in a world where monetary and market liquidity are still abundant, the level of structural market liquidity is lower than it used to be. Cyclical liquidity vanishes as monetary policies normalise, so the structural core of market liquidity has to be sufficiently potent. For this reason, speed in implementing any non bank regulations is critical to avoid future problems. An industry representative agreed with much of what was said, but warned against forgetting how much of a surprise it was when the crisis hit in 2008, when the conventional wisdom was that the new architecture was distributing risk across the system safely. Regulators are now beginning to worry about where the risks have been transferred to.

1.1.4. The system is safer as long as growth is there

It is clear that banks are stronger now and do not expect to have to operate in a weak economy. As UBS Chairman and former Bundesbank President Axel Weber highlighted, banks need sustainable profitability, but it is difficult to generate profits in a low or negative interest rate environment, so these fundamental issues cannot be disconnected. A policymaker concluded that the solutions that monetary policy provides will inevitably become problems when they need unwinding. The regulators knew these measures would be criticised, and a central bank official commented that some of the old risks are still there in banks, during this time of transition. The policymaker agreed that sustainable profitability is key.

In assessing whether growth is sustainable, there may be an issue if monetary policy support is not accompanied by more inflation and growth. The more that an economy normalises, the more central banks estimate this shift too carefully. However, it is clear that the environment has improved overall and other microprudential instruments may be activated. The regulators need to be gradual, prudent and persistent in their policies, while looking carefully at any building risks. The question in practice, therefore, is when to change and how. A public decision maker agreed with an IFI representative speaking earlier that a three pronged approach is needed by the G20. One cannot do nothing or react only when another party moves, as everything would collapse. There will be stability as long as there is growth, but one must also consider the political consequences of any future recession.

An industry representative stated that banks have collectively underperformed against global stock markets and this cannot be ignored, particularly in Europe. The progress made in healing has been phenomenal, but the idea that victory can be declared is complacent, in particular in light of significant differences between US and European banks. There is concern that European banks in particular have been struggling against the non banking sector with issues such as non performing loans. Using an illustration, a participant likened banking in Europe to playing the final of the Champions League with 300 players on each side, many of them being unfit. A difficult process of attrition will have to follow.

1.2. Vulnerabilities and New Challenges Remain High

1.2.1. Financial vulnerabilities have become more important, and have been building up

A public sector representative stressed that financial market valuations are overstretched. Despite the equity market wobble in February and the recent tightening in emerging-market economies, financial conditions remain quite easy from a long-term perspective: equity markets are elevated, especially in the US, volatilities are rather low and, above all, credit spreads are hovering around pre-crisis levels.

In addition, leading indicators of banking stress are pointing to risks in several countries less affected by the great financial crisis. These are countries that have seen a further build up of financial imbalances -- essentially, prolonged, strong private-sector credit growth, often alongside strong increases in property prices. This has been the case in a number of advanced economies such as Australia, Canada, some Nordic countries and Switzerland but also in several emerging-market economies, not least China, some others in Asia and also in Latin America.

Moreover, a number of emerging-market economies have seen rapid foreign currency credit growth post-crisis. The aggregate stock of such credit to non-bank borrowers in emerging-market economies has more than doubled since the turmoil to something like $3.7 trillion.

1.2.2. Private plus public – has continued to rise globally in relation to GDP

A public decision maker explained that too much debt was at the heart of the crisis, but debt has increased as interest rates have declined and remained unusually low in both nominal and real (inflation-adjusted) terms. Moreover, interest rates are expected to remain low for quite some time, which could encourage a further build up in debt. If this continued, he asked "how far would central banks manage to raise rates without triggering the very problems they are trying to avoid?".

The very easy financial conditions in advanced economies are one reason for being cautious about the optimistic outlook beyond the near term. According to research at the International Monetary Fund (IMF) and the BIS, easy financial conditions boost economic activity in the short run but increase downside risks further down the road. As a result, financial excesses at some point have to be corrected.

1.2.3. Short-term funding of long-term illiquid assets remains an issue

An official conceded that much progress has been made on regulation but, in many cases, the same old problem is emerging, which is the short-term funding of long-term illiquid assets, and often in foreign currencies. This is at the core of a potential crisis and where lessons have not been fully learned. The official emphasised that it is extremely dangerous for private consumers to borrow in foreign currency. The only substantial response is to strictly prohibit it, but such an unpopular measure could also result in lower growth in debt and investments. Therefore, it is always important to develop capital markets in your

own country first. An industry speaker agreed that this has been one of the key lessons of the crisis, although a single bank cannot change the system without efforts from the authorities. A policymaker sees how one function of the financial system is short-term funding for long-term investment, but another is to transform maturities. This leads to the issue of how much to inject in the short-term and whether doing so will create problems.

Another public decision maker observed that safe assets have so far been absent from the discussion. Before the crisis, there was a huge supply/demand imbalance, so the industry created AAA synthetic assets that collapsed afterwards. Safe assets such as bonds have been overpriced since prompting the question of what is safe. Even bank deposits in private money are not always safe. BRRD is at its limit, in this official's view. This increases tension on the supply and demand for a safe asset. People want central bank money, but it is not transferrable, because reserves are needed by the bank.

1.2.4. Trust between authorities has not been lifted to the level needed to smoothly implement the cross-border resolution of systemically important financial institutions

A central banker noted that bail in able debt is being produced at a good rate and the level of total loss absorbency is approaching 30% of risk weighted assets in many jurisdictions. This is better than was expected five years ago. Looking forward, there are some hard final yards to make on bank resolvability. The regulators have set themselves the objective of completing this work by 2022, but parts around operational continuity and funding remain difficult, and more effort is needed. Part of the problem is that global banks are affected by different regulatory regimes. A representative of one has seen a strong commitment to implementing international improvement measures, but national translations then diverge. Meeting these requirements brings huge complexity and regulatory cost.

On the matter of operationalising these plans, an industry representative advised some wind downs or restructuring measures. Working together, the industry and regulators need to become accustomed to handling extraordinary situations. It must be possible to issue bail in debt, not to retail but to institutional investors that understand the purpose of the instrument, but those involved must first ask how well all the authorities across jurisdictions are working together. This is something that can be trained and tested for, and they should be more of a focus on developing these plans. A policymaker who participates in the Single Resolution Board has seen some bail ins, but no large or cross-border examples. Bail-in approaches are difficult to implement in practice, and every bail in is different. At the beginning, bail ins were seen as an easier option than bail outs, but they have proved to be another difficult way to manage a crisis.

Trust has been mentioned, although a central bank official thought it safer to expect everybody to ring fence in a crisis. If cooperation is expected but does not happen, there will be a catastrophe. Referring to the last IMF FSAP, the official is unclear as to what is happening on BRRD and how it is going to work. There was some testing before the crisis, but it did not help very much, because it created expectations of a cooperation that sometimes has not been manifested. The recovery plans in place today have not been fully tested.

In addition, some banks face challenges in profitability, which is more important than long-term capital. The trinity of a currency and fiscal union with deposit insurance has also not been attained in Europe, and authorities' bail out tools are now significantly constrained. The resolution of cross-border banking groups requires strong political trust between countries, because it is ultimately a zero sum game for the depositors.

1.2.5. The limited scope for monetary and fiscal policy response in the event of a systemic crisis

A public representative described how, since the crisis, the monetary policy and fiscal room for manoeuvre has narrowed considerably. Post-crisis, not only have interest rates declined substantially to new depths and central-bank balance sheets ballooned to unprecedented heights but public-sector debt has also reached peacetime peaks.

The greatest worry for one public representative is the more limited scope for policy response. It was not monetary policy that saved the financial system in 2008; it was government intervention. In the US, Dodd Frank now puts clear limits on the abilities of the Fed and the Treasury, while in Europe the BRRD, for understandable political reasons, prevents sovereigns from rescuing their banks as they did last time. An industry speaker asked whether those in charge today have the wherewithal and political legitimacy to act. The answer is not known. The system is still interconnected, and domestic issues play out across borders, but some lack confidence in its full participation.

1.2.6. Cyber security and cyber risks – regulation needs to step in

Then there is the nature of the shock. The next crisis may be cyber, but few know how to react to this or how much attention it should be given. A central banker's perspective is that the collective framework for operational resilience is nothing like as good as it needs to be, and an industry speaker believed that regulation needs to step into the domain of cyber security and risk, not just for financial institutions but for many non financial ones as well. It is certainly essential for G SIBs. This issue is receiving the focus of the regulatory community at national and international levels, but institutions have much to do themselves to improve their standards.

A related issue is the challenge from big technology firms. Big tech is growing quickly in Asia and will soon reach other parts of the world. This could be an opportunity or a significant challenge to the banks, if these new entrants take the highest margin parts and leave them with the less attractive bits. The question is how banks will use big tech to increase their profitability.

An industry representative stressed that the risk of a potential crisis emanating from cyberattacks must not be underestimated, and could be the subject of reflections in another 10 years from now. With this and all the other risks that discussants have raised, the industry should consider itself not in a state of alarm but in a state of alert. It must keep its guard high. Public authorities cannot be allowed to make mistakes that would kill economic recovery and cause trouble all over again.

1.2.7. New forms of shadow banking are likely to emerge in the future, therefore demanding a forward looking approach from the regulatory community

Listening to all these risks can be a bit depressing, but it is important to use them to look at how to develop markets. Whatever is handed to the next generation should include a foundation for new financial markets, in which banks will have significantly transformed their business and operating models in a digitalised future. An industry speaker reflected on the resources needed to deal with this change. If the banks can share tasks and agree on priorities, perhaps they can move away from costly regulation efforts and gain enough space to concentrate on the innovation needed to have a valid role in that future.

The growing importance of asset managers and other institutional investors in both domestic and cross-border

financial intermediation requires national authorities to monitor potential risks from these activities and both the national and global levels and to consider how best to employ macroprudential and microprudential approaches to deal with such risks.

For non-banks, one of the worries is CCPs, not just their resilience, but recovery and resolution. CCPs are systemic nodes in the global financial system linking G SIBs and other intermediaries. Much work has been done in this area by different Basel committees, but implementation is still needed.

1.2.8. The importance of appropriate governance and culture for financial institutions

Although they have refreshed their purpose and culture, the banks realise they still have work to do. Certain countries have moved significantly ahead of others. The UK implemented the Senior Managers Regime, and an industry representative emphasised how different governance can be around the world. Strong regulation and supervision are not enough to keep banks out of trouble if they make the wrong decisions in the boardroom.

In such an environment a speaker stressed that the policy mix needs to be rebalanced and regain precious room for manoeuvre. Too much responsibility has been put on the shoulders of central bankers over the years. This means reinvigorating flagging structural policies, finalising the implementation of the financial reforms, activating macroprudential tools where vulnerabilities are building up, consolidating fiscal positions, and normalising monetary policy with a steady hand.

All this should be seen as part of the establishment of a more holistic macro financial-stability framework designed to ensure lasting financial, macroeconomic and, hence, price stability. Such frameworks should be firmly anchored to a long-term focus, with all policy levers working in the same direction; after all, financial vulnerabilities build up only slowly, and the cost of high debt may emerge only after a long time.

2. Remaining challenges with macroprudential frameworks

Macroprudential frameworks have become a key new element of the post crisis financial reforms designed to ensure financial stability. This is important because the Great Financial Crisis and previous crises have shown that vulnerabilities can build up across the system even though individual institutions may look stable on a standalone basis. Progress has been made in the implementation of the frameworks but more needs to be done.

2.1. Macroprudential frameworks have become a key new element of the post crisis financial reforms designed to ensure financial stability

A policymaker was involved in the legislation that created the macroprudential framework in the EU. Its first objective was to act as an early warning system. It was intended to aggregate each sector, but also to look across them. Mucg work has been done to identify any problems, though the macroprudential framework was thought to have succeeded in meeting its objective. Then the issue became what to do after risks have been identified, as macroprudential action is technically and politically tricky. Such actions were being assigned to central banks in the hope that they would be freer to move in this area.

A question was put to the panel on what role a macroprudential framework can play in addressing future problems. A public representative was one of the first advocates of including a countercyclical buffer in the Basel framework, so did not object to macroprudential policy. The last 10 years have shown a policy mix of easy money and tight regulation, with the hope that such a combination would bring both growth and stability. One must now think carefully about whether it can remain unchanged in the future.

2.2. Interaction between monetary policy and financial stability in the context of the normalisation of monetary policies

The macro prudential framework with its own objectives, authorities and tools provides a complement to monetary policy. This improves the room for manoeuvre that monetary policy has. While more restrictive monetary policy may be able to lean against the build-up of financial imbalances, targeted macro prudential measures can be a more efficient way of addressing their causes. Moreover in the euro area macro prudential measures can be aimed at specific member countries in order to coorect the build-up of local imbalances, which cannot be addressed by the single monetary policy.

An official disagreed that their organisation's primary aim is to contribute to financial stability. Plenty of authorities and instruments, including government ministries, assume this duty. Microprudential instruments have created the expectation that central banks are in charge of financial stability, but they are not and such ambiguities can be annoying. The central banks have tools to assess macroprudential issues, but others could also participate too. This official does not deny there is a problem, but supervisory responsibilities create issues and can get central bankers into trouble. The monetary policy central banks were required to conduct in the past facilitated ordinary deleveraging. There have been discussions about whether they went too far, which are fair and timely, but at the time central banks needed to tighten rates with the tools they had to hand. Political pressures then sent the ball back to them. If the authorities in charge cannot agree, complicated countercyclical buffers will arise, but this topic has not been much discussed in public.

Another official agreed that institutions such as their own cannot be 'the only game in town' for financial stability. Macroprudential policy can be politically difficult and sensitive, but the raison d'être of an independent central bank is its willingness to do unpopular things with countercyclical buffers. Switzerland and the UK operate a countercyclical buffer, which has a psychological impact as people are more aware of what the risk should be and what is involved. There will always be disagreements about what the unintended consequences and opportunity costs are. The question is then when to employ the macroprudential measure so that it does not become procyclical. An industry representative believed the toolbox is right, but wished to send a clear message about making sure measures work in concert with others. An asset might be bubbling too much, which would need to be countered in a low interest rate environment. The natural evolution of assets will be one of the key sources of the next crisis and is why there is such hesitation. People may criticise a central bank for employing certain measures but, on the other hand, it is important to make a real difference at the right time.

An industry participant disagreed with the view that the macroprudential framework is just piling things up. It adds a degree of stringency to capital requirements, the purpose of which is to preserve the stability of the financial system for the public good. Macroprudential policies have gained enough respectability now to be part of the policymakers' toolkit, both in advanced economies and emerging markets, but one should be hopeful and also humble about their use. Hope comes because the evidence

shows they can be effective at building structural resilience, but humility is required in managing expectations to use macroprudential policies as only a part of the overall policy mix. The right architecture is needed where macro and microprudential supervisors can work together.

There are different kinds of macroprudential governance arrangements around the world, but it is key that all should avoid putting microprudential behind the curve. Central banks use macroprudential measures to avoid raising interest rates or limiting capital inflows, but an industry representative stressed how they should only be used as prescribed and not for other purposes. Some people say that microprudential policies were activated and tightened when monetary policy was easing, now it is normalising, it should be eased, but this is wrong, according to this speaker. Risks will still build up in the process of monetary policy normalisation, so one should not relax microprudential policies until there is a clear indication that risks are falling.

Emerging markets sometimes seek to use microprudential policies too intensively, often to escape having to make hard choices. They could have done more macroprudential policy tightening in the good times, but there is still room to activate these policies around foreign exchange, hedging and borrowing. Should risks materialise, they can relax the buffers, as is the natural role of macroprudential policy. This can be tricky, as buffers have to be lowered consistently to preserve confidence in the institutions.

There is still some controversy on the topic of long-term interest rates and how much room there is for monetary policy to manoeuvre. This lower bound does not mean monetary policy is ineffective, as it can fall further or there could be further QE, but it substantially complicates the task of monetary policy. The steady state needs stronger macroprudential policies if natural interest rates rise.

2.3. Macro and microprudential policies should operate together

A public decision maker argued for consolidating macroprudential and microprudential elements in one entity, as can be seen in parts of Europe. That body then demands a huge amount of information, which is essential in the event of a crisis. A public representative worried about the tendency to think of macroprudential policy as totally distinct from microprudential regulations, each with their own institutional arrangements and policy tools. If employed in this way, the risk of macroprudential policy being too late or too strong is significant. A public decision maker recalled that initially the regulators felt macroprudential policy will go against the instincts of a microprudential supervisor, which is to tighten when risks emerge and loosen when they decline. This is the opposite of what the macroprudential wants, which tightens when things are going well.

Another official sat on the macroprudential body in the UK, but headed the microprudential regulator. The central banker sees the macroprudential as an essential complement to what is done on the micro side, primarily because the regulator cares about highly indebted households and firms regardless of whether it has sufficiently capitalised the banking system, because of the propensity of individuals and firms to cut back sharply in a recession. Stress testing for lending has been introduced in some areas, which seems a common sense way to deal with the problem of debt traps. Another reason for combination is that the behavioural aspects from microprudential action do not always serve the industry well. Rather than focusing on individual institutions, a top down team is needed, although 'sparks can fly' in such a context. This individual's impression was that it is safer and more complete to put the macro and micro in one place, which can only be within the central bank.

3. The propagation channels in the event of a large negative economic or financial shock in a context where risks are shouldered more by investors and savers

3.1. The maturity mismatch in investment funds and the propagation of the bail in tool through the financial system represent two possible channels of systemic crises

One way to look at the last crisis is as a generalised crisis of confidence. It happened because nobody knew where the risk was nor trusted any counterparty. If we are to avoid another crisis, participants will need to be reassured there is a backup in case of another sudden loss of confidence in the financial system. An industry participant hoped to start talking more intensely about preventing future surprises from being fatal next time round.

An official sees one possible propagation channel as the maturity mismatch in different sorts of investment funds. There was a minor but recent experience of this in the UK with some potentially destabilising behaviour in commercial real estate funds. Another speaker returned to the subject of a bail in of which, despite its complexities, this speaker remained a strong supporter, because bail ins better align incentives and therefore make a major crisis less likely. There is no obvious reason why a bail in could not be used on much larger firms. When it comes to a systemic crisis, however, the choice is between a bail out or blowing losses out through the financial system. Insurance companies in particular might be on the receiving end of such measures. Some people take these arguments further to say that resolution tools cannot apply in systemic situations, but this central banker disagreed. Bail ins, ring fencing and sovereign wind downs will work by giving the authorities several options. It would be foolish to have absolute faith in just one of them.

3.2. The systemic consequences of a sharp decline in asset valuations and the expected reactions of the authorities

In assessing to what extent a banking crisis could trigger a larger crisis somewhere else, an industry participant cautioned against over engineering, trying to regulate what has not yet been regulated and missing emerging or evolving risks. There is also the question of an increased dialogue between the industry and policymakers, which must be encouraged.

An official referred to the intention to remove risks from the classical intermediaries, banks and insurers, and wondered about the nature of the shock if most of these risks have already been shifted away from fragile institutions. Normally, there is a severe asset price correction, and the wealth effects impact an economy then affect aggregate demand, but this panellist feared this is too benign a view of the next shock. It may start as described, but the asset price correction will allow many banks still to continue operating. If growth starts to fall, the mechanism will move in a different way and another shock could come from inflation. The central banks could become market makers, not liquidity providers, as the private sector does not fulfil this role to the extent it has previously. The liquidity shocks that have occurred so far have been well absorbed by the system. The concern is now of a fundamental and unknown shock.

In all of these cases, financial markets would play a prominent role either as triggers or as amplifiers, and new players in the asset-management industry would, in all likelihood, take centre stage. Market liquidity may now appear plentiful but it is bound to evaporate under stress. Corporates and emerging markets appear especially vulnerable but even sovereign-bond and equity markets would not remain unscathed.

The same official turned to the amplifying mechanisms, the G20 or the G7. Multilateral organisations are key to this, but their operations are based on trust. G20 meetings aim for a common view about what to do, but there are serious doubts about following multilateral organisations in the United States. Chacun pour soi. Efforts could be made to ring fence as much as possible, and the speaker believed tools like dollar swaps between authorities could be useful. After Dodd Frank, it is not clear what the power of the Fed will be when a crisis happens. It can reduce moral hazard, but this is a second order problem when facing a huge shock.

The enormous ambiguity at the heart of the financial sector is that nobody wants to be seen as fully in charge and accountable for financial stability, but central banks often discuss whether financial conditions are accommodative or not and in which direction they are moving. Even during this discussion they raised pertinent questions about who will be jumping in to rescue the market if it breaks down. They are asking the smart questions, so financial stability is clearly on their minds. This inevitably creates the expectation that they are the authority in the event of a crisis. They might not have the most direct tools, but there is nobody else in the official sphere talking about these issues. An industry participant stressed how the central banking community needs to keep thinking about this issue and ultimately deliver answers.

A policymaker characterised financial stability as the child around the swimming pool, who everyone thinks somebody else is responsible for when the child falls in. Some think the child, who is financial stability, is an orphan, but others see it having too many parents. Nobody is uniquely responsible for financial stability in the euro area. It is a shared responsibility, but it is uncoordinated. The issue is bringing the right people around the table at the right time.

3.3. The likely interaction of high levels of indebtedness and the normalisation of monetary policy is a potential source of macrofinancial risks across the global economy and policymakers

A large systemic shock will propagate very quickly, because the global economy and financial system are now so interconnected. As an IFI representative said earlier, corporate debt is at the same level as before the crisis and sovereign debt is significantly higher. This looks fine when growth is high and interest rates are low but, if either of those two variables were suddenly to change, much rerating will occur. This will lead to price gapping and the public sector will need to decide how long it should wait before acting.

An industry speaker said that there was only a limited risk of a shock propagation similar to that of 2007 08, when a relatively small market segment imploded and contaminated the entire economy. In fact, since the start of the year, market risk has realised itself. There was the VIX ETPs implosion in early February and turmoil in a few emerging markets, but little contagion. These were self contained events, and all technical indicators of robustness are looking good. Various indicators of risk appetite appear to be in line with long-term averages, so this participant is not alarmed by the fragility of the system today.

Conclusions

The near-term prospects (the next 12 months or so) for the global economy are still favourable, though no longer uniformly across the world. However, the risks ahead should not be underestimated. The path is a narrow one. Structural economic problems can only be addressed by structural reforms. Policymakers and market participants should brace themselves for a bumpy ride.

Progress has been made to put a robust regulatory framework in place, but the proof of the pudding is in the eating. Reforms have not been fully implemented yet and certainly not tested through a real crisis. Some of the old challenges in the banking system remain and some new challenges have emerged in the last 10 years. The question is how to allocate limited resources among them and the focus now has to be directed towards upcoming challenges, not the last crisis. The macro toolbox tells a similar story: the industry is beginning to use it, but learning that doing so is not easy, technically nor politically, because there are inevitably winners and losers from any macroprudential decision.

Ten years ago, the crisis happened because banks thought they would transfer risks off their balance sheet through securitisation, but as the crisis unfolded, the industry discovered instead that some risks returned on the balance sheet. In the trade off between stability and growth, the latter has to be managed so that it does not come back to bite. This is a multiple responsibility that requires cooperation and coordination, domestically but more importantly internationally, as cross-border is where the real tensions will come if a crisis ever needs to be addressed. The panellists' conclusion was that they are relatively depressed, but preferred being depressed now to their optimistic but complacent mood of 2007. There is much to be happy about, but plenty to worry about too.

1. For instance, between end-2014 and end-2017, the CET1 capital ratio for significant banks directly supervised by the ECB rose on average by over 3 percentage points, to 14.6%, and the total capital ratio increased by over 4 percentage points to 18.1%. During this period, the liquidity coverage ratio of the banks supervised by the ECB rose on average by 16.4 percentage points to 143.6%, and the net stable funding ratio rose by 11 percentage points to 113.4%.

Supervision of EU and third-country CCPs

1. Rationale behind the EMIR 2.2 proposal and progress made

1.1. Rationale behind the proposal

A regulator emphasized that the EMIR 2.2 proposal to improve the supervision of EU and third-country CCPs was not only driven by Brexit considerations. CCP supervision and regulation have wide stability implications and the need for more effective tools to supervise financial market infrastructures outside the EU has been underlined by ESMA since 2015. But the UK's decision to leave the EU has been an important impetus for the EU authorities to reconsider third country arrangements, which is reflected in the EMIR 2.2 proposal and also in the review of the

ESAs. In addition, there is a need to ensure convergence and consistency across the EU in the supervision of CCPs, given their cross-border activities and risks. The limit of what can be achieved through existing CCP colleges has been reached.

An industry representative stressed that this legislative proposal must be considered in view of how well CCPs have functioned in general and during crisis situations. Following the Brexit vote for example, there were significant market swings in the magnitude of 10%, similar to what had been experienced during the Lehman Brothers crisis. All CCPs managed in a way that proved their resilience. The speaker also suggested that not everything should be left to regulation. Market-led solutions can be developed to enhance competition and choice for clients, as has recently been done in the interest rate swaps market. Another industry representative added that it is important in the context of discussions on EMIR 2.2 not to "trivialise" the role of CCPs and the complex risks they manage. CCPs manage the defaults of complex derivative and cash products in multiple currencies. Their purpose is to provide certainty in times of uncertainty in order to strengthen markets and improve financial stability. These are highly resilient and efficient infrastructures that apply already the highest possible risk standards and have a high level of scrutiny.

1.2. Progress made with the EMIR 2.2 legislative proposal

A regulator remarked that progress has been made on the EMIR 2.2 proposal in the last few months with the publication of the Parliament ECON Committee report and on-going discussions on the text in the Council. A public representative stressed the importance of the Presidency finalising the work and entering into trialogue. The vote in the ECON Committee has given the Parliament power to strike a deal with the Council in one reading, which should help to speed up the process. There is still hope that there will be a deal on Brexit and a transition period, which would provide more time to fine-tune and implement EMIR 2.2. However, it is important to prepare for a lack of agreement or a very last minute deal, which would bring challenges for all parties. Negotiations over October and November will hopefully provide the market with 90% certainty that there will be a deal. The speaker also emphasised the importance of working on intra EU and third country CCPs simultaneously in order to keep the two regimes as closely aligned as possible. An industry representative stressed that as we are reaching the 'vortex' with March 2019 only a few months away, financial market infrastructures (FMIs) including CCPs and their customers will soon be making irreversible decisions and financial stability risks are increasing. The industry speaker called on the community of supervisors, regulators and central banks supervising CCPs to provide the market with certainty as soon as possible and no later than end-November in order to reduce these risks. Whether it is temporary relief or a similar mechanism, some form of transition regarding third country CCP recognition must be offered.

1.3. Contract continuity issues in the perspective of Brexit

An official emphasized potential contract continuity risks in the perspective of Brexit. A significant amount of OTC derivatives is cleared between UK CCPs and EU members, and EU CCPs and UK members. EU firms have around £ 67 trillion notional of outstanding contracts at UK CCPs, of which nearly £ 40 trillion mature after March 2019. In December last year, the UK announced a regime that would allow for the recognition of non UK CCPs once the UK leaves the EU. The government has also established the legislation which will provide a temporary recognition regime. This gives UK participants confidence that they will be able to continue using EU CCPs once the UK has left the EU, but clarification is needed from the EU authorities on how this may work in the opposite direction.

An industry representative underlined the practical implications of contract continuity. Clearing members will need to contact their clients on an individual basis to discuss how this situation will be managed and there will need to be some transitional arrangements or grandfathering clauses to manage this situation. A public representative mentioned that the magnitude of the problem in respect of contract continuity is being evaluated by the EU authorities. At this stage some areas appear to be more problematic than others, for example very long-term contracts.

2. Proposals to improve the supervision of EU CCPs

2.1. Outstanding issues regarding EU CCPs

An official summarized the main points still under discussion at Council level, notably concerning EU CCPs. The Council's objective is to have a general approach agreed by the end of the Austrian Presidency in order to 'pave the way' for negotiations with the Parliament. The first pending issue relates to the extent of the involvement of ESMA in the supervision of EU CCPs. It is essential to promote the convergent application of EMIR throughout the EU, especially if decisions are taken with cross-border impacts. At the same time, it is also important to ensure there is a clear allocation of responsibilities, accountability and legal liability for the decisions being taken and this becomes especially relevant when the fiscal responsibilities of Member States are involved. The options currently being discussed in the Council include: the right for ESMA to confirm, amend or reject individual supervisory decisions made by National Competent Authorities (NCAs); the introduction of procedures to consult ESMA, which could be combined with a 'comply or explain' mechanism for NCAs; and the enhancement of the regulatory activities of ESMA by means of technical standards, guidelines or similar measures. The second question concerns the way these tasks should be conducted within ESMA. The Commission suggested introducing a CCP executive session, which would be a single designated body within ESMA to handle CCP supervision. Alternatives include introducing specific internal committees within the existing ESMA structure to prepare decisions which would be taken by the ESMA Board of Supervisors. Ultimately, an internal committee within ESMA is more likely to be accepted by the Member States than an entirely new structure. A third issue concerns the role of supervisory colleges. Assessments show that these colleges work very well at present, but the Council is evaluating possible improvements to their functioning (e.g. by amending their composition or improving their procedures). Finally, the Council is discussing the role of Central Banks of Issue (CBIs). Several areas where CBIs would wish to be further involved in CCP supervision have been identified, such as liquidity risk control, margins and collateral requirements. A challenge however is identifying the powers which are necessary in these areas for conducting monetary policy, which is a difficult balance to find, notably in relation to measures to be taken in exceptional circumstances.

2.2. The role of Central Banks of Issue (CBIs) regarding EU CCP supervision

A regulator stated that it is generally agreed that central banks of issue and supervisors should both have an important role regarding CCPs, CBIs focusing on the

monetary policy perspective and supervisors on the micro one. Discussions however continue over the interaction between the two and the precise role of CBIs i.e. whether it should take the form of an endorsement of decisions or be a consultative role. An official considered the proposals made by the ECON Committee quite acceptable and did not believe it necessary for CBIs to have a veto power. The main concerns of CBIs regarding CCPs are about liquidity risk management.

An industry representative suggested that CBIs should be involved in CCP supervision for three reasons. First, CCPs are connected to payment and settlement infrastructures, where central banks play a major role. Secondly, CCP clients are predominantly banks and credit institutions, which are also supervised by central banks. Finally, CCPs clear products which are relevant for monetary policy, such as repos and interest rate swaps. An official confirmed that CBIs have an obvious interest in the resilience of CCPs and in ensuring they are being operated and run robustly and added that central banks have other roles that are relevant for CCPs such as being the authority responsible for financial stability and for resolution. With respect to clearing, the Bank of England's focus from a monetary perspective is on two areas: first, on the resilience of markets used to implement monetary policy and that are cleared; and secondly, markets and clearing activity that could generate significant liquidity needs, potentially requiring central bank intervention in a crisis. These criteria are most relevant for products like repos that are physically settled on a gross basis, but much less so for derivative transactions such as interest-rate swaps, which are cash settled on a net basis, the official stated.

2.3. Possible improvements to the functioning of CCP supervisory colleges

Several panellists stressed that CCP colleges work well in the EU. An industry representative explained that domestic NCAs take the lead in these colleges, but they also include ESMA and representatives from the ECB in particular. This may look like a large number of people, but in practice this has worked well since their introduction in 2013. Reacting to a remark made by a regulator that CCPs often complain about differences in the supervision of CCPs across the EU, an official considered that the variations in treatment across CCPs are restricted to very reasonable boundaries and are driven by differences between CCPs in their business models, the products they handle or their membership. The industry representative added that the main point is to ensure that the appropriate expertise is gathered to supervise CCPs, which requires a combination of market supervisors, central banks and representatives of the CCP. A regulator observed that funding is essential to build a supervisory capacity with the appropriate expertise, adding that the level of funding proposed for EMIR 2.2 is substantive and sufficient.

A public representative felt that the functioning of colleges could be further improved, as has been proposed by the ECON Committee. Their effectiveness depends on the level of coordination of their work and how well connected and consistent they are between them. The objective is for colleges to the greatest possible extent, to view the same circumstances in the same way and act accordingly. The system would become more consistent and effective if ESMA could coordinate the activity of colleges, the speaker suggested. This is particularly important in the Brexit context that may lead to relocations of activities to different EU jurisdictions and possible risks of supervisory arbitrage.

2.4. The importance of clarity in the allocation of responsibilities and decision-making

Several panellists underlined the importance of clear decision-making processes (i.e. who makes decisions and how decisions are made) in normal times and particularly in times of crisis and saw constructive progress in discussions on EMIR 2.2 in this area.

An industry representative emphasized that a clear allocation of powers and responsibilities between NCAs, ESMA and CBIs should be established, in order to avoid duplications and overlaps that would make the framework more complex and burdensome. Constructive dialogue between the industry and the regulators, notably ESMA, must also be maintained so that issues can be addressed on an on-going basis. Moreover clear rules need to be defined regarding the decision making timeline, because with more people around the table decisions may be longer to take, which may create additional risks.

An official stated that although the decision-making process can involve consultation and collaboration with different parties, it should be clear who has the power to decide, particularly in a crisis management situation, when speed and clarity are essential. Ultimately the final say should lie with the home supervisors, who are closest to CCPs and have the ultimate accountability for their supervision, the official believed, as is the case at present. A regulator considered that the importance of clear decision making is properly addressed in the Parliament's report on CCPs. The movement away from a consent model to a consultation model should also help decisions to be quick enough. Experience in the EU however demonstrates that timely decision-making does not necessarily mean that one organisation should make the decision; what is important is having clear rules governing the decision making process. The official agreed that multiple authorities (and not one) can indeed be involved during the decision-making process, but there must be clarity on how decision-making will ultimately work.

Another industry representative pointed out that the supervisory approaches needed in normal conditions and during a crisis are quite different. While seeking input from different experts in on-going supervision (e.g. in the context of colleges) is important, it is essential to have effective decision making during a crisis because any confusion would be very dangerous for financial stability. A third industry representative mentioned different default scenarios linked to clearing members or to a CCP defaulting[1] but emphasized that the default of a CCP could go way beyond market situations that have previously been experienced e.g. if the default fund of the CCP is insufficient. To anticipate this type of scenario and preserve financial stability, it is necessary to put in place detailed and effective arrangements ex ante before any crisis, including recovery and resolution tools and defining how the potential default of a clearing member would be handled. Moreover, although it is important for there to be 'only one pair of hands on the wheel', as previously suggested, cooperation will continue to be essential in case of a default, because CCPs cannot be considered in isolation and the entire marketplace will be in turmoil. Broadly speaking, the initial EMIR 2.2 proposal is somewhat insufficient in these areas, but the work done by the Parliament and the Council is moving in the right direction.

3. Proposals to improve the supervision of third country CCPs

3.1. Cross-border supervisory cooperation regarding third-country CCPs

A public representative stressed that deference to third country jurisdictions has always been the basis of the

EU third country regime. The EMIR 2.2 proposal also strengthens the possibility for comparable compliance. Under the tiering system of the proposal, full deference will remain the norm for all Tier 1 CCPs (those that are not systemically important for the EU). In addition, enhanced cooperation arrangements (or memoranda of understanding) are essential because they can facilitate the avoidance of problems and ensure stability in the supervision of third country CCPs.

An official emphasized that more clarity is needed on how ESMA and the home authorities respectively will work with third country authorities. Secondly, it should be clear what regulatory requirements apply to a CCP if several authorities seek to place requirements directly on a CCP. In order to avoid overlaps, requirements should be based on international standards, set out in the CPMI-IOSCO PFMIs, as is the case for the existing version of EMIR, so that rules are mutually compatible. Thirdly, there must be clarity on how comparable compliance (which allows one set of rules to apply to a CCP if a comparable outcome is provided) will work. There is no detail in the present text on how it will work or how it may be withdrawn, which needs defining for market confidence. Finally, the text is silent on crisis management. It gives the CBI powers in exceptional circumstance, but there must be clarity on how this will work and who has the final say; that should be the home authority, the official believed. A regulator emphasized that EMIR 2.2 is the EU's response to these different issues and risks and the priority now is to speed up the process so that the legislation can be implemented in a timely way.

3.2. The role of CBIs in third country CCP supervision

A public representative remarked there have been many discussions between the European Parliament and several CBIs on their role in CCP supervision and also some difficult discussions with US financial institutions on the role of CBIs, because the situation in the US is somewhat different. A delicate balancing act is needed between legal certainty and flexibility as often in EU legislation. The legislative proposals have come a long way in achieving this balance: the system is as minimally discretionary as possible, but at the same time it gives CBIs some freedom to act. In exceptional circumstances, it will be possible for them to extend decisions. In future negotiations, it is important to continue to use the approach and criteria used by ESMA for the assessment of systemic significance, although there should be proportionality. Sufficient assurance should also be built in the regulation. If, on reflection, activities are not deemed to be systemically significant for the Union, they should not be unnecessarily captured in these assessments; this is an important safeguard. An industry representative agreed on the importance of the role of CBIs in supervision, provided that it is proportionate and that it relates to the products and services that are relevant to the EU in relation to monetary policy and liquidity aspects (rather than to the whole of the CCP) such as e.g. EU government bond repos, as pointed out earlier.

3.3. Questions raised by denial of recognition measures

A public representative emphasised that denial of recognition is included in EMIR 2.2 as a 'last resort' possibility, because it is preferable for relocation to occur, if needed, through market mechanisms. The related decision-making process should be fact-based and proportionate and changes have been made in this regard to the initial Commission proposal. There is some uncertainty however, because this has never been put in place before, which is why an adaptation period was proposed by the European Parliament.

An industry representative considered that including a denial of recognition in the EMIR 2.2 legislation will affect competition in the market because it is in effect a denial of access notably for EU counterparties. That will also impact global markets, restricting access to liquidity and causing fragmentation. This also appears as a somewhat "isolationist" measure, going against the G20 and FSB commitments. Additionally, it is important to distinguish between different products in such an approach, considering the liquidity of these markets, their use in transmission of monetary policies and whether there is physical settlement. Repos were the main problem during the Lehman crisis, not hedging tools such as OTC interest rate or FX derivatives. As mentioned previously by an official, the liquidity needs for these latter derivative instruments are far lower than for physically settled products such as repo. Another industry representative disagreed with the view that interest rate swaps are not relevant to monetary policy or are not systemically important, noting that these swaps are the major source of initial margin held at some CCPs. The CFTC seems to be making a carve out related to areas which do not affect the systemic stability of the US, but these terms must be further defined in both the US and Europe, because market participants should all be able to compete on an equal basis.

A third industry representative noted that these measures would also affect clearing members and their clients and it is important to ensure that the industry will be able to adapt to the new framework. The worst case scenario would be a situation in which only EU clearing members would have additional constraints in terms of the relocation of euro denominated clearing in case of denial of recognition. The higher costs this would lead to would not be sustainable for some of them, who might exit the business as some other banks have previously done, thus risking to significantly reduce choice for end-users. The first industry representative supported these concerns. Denial of recognition may provide a bleak outlook for EU entities, customers, buy side, clearing, brokers and dealers which is in nobody's interest.

The industry speaker added that the potential for denial of recognition creates uncertainty throughout the market which needs to be eliminated as soon as possible. There are questions in particular around what happens to existing or future positions. In addition, the EU could end up being isolated, which would be to its own detriment and to the detriment of global markets. This was supported by the first industry representative who insisted on the need for certainty by end-November.

3.4. Comparison with the US approach and current supervisory cooperation with the US

Referring to the recent remarks made by the Chairman of the CFTC, an industry speaker felt that the European Commission was seeking with the EMIR 2.2 proposal the same type of access, power and authority that the US has regarding foreign CCPs. Chairman Giancarlo however is now suggesting that the US has overreached extraterritorially in some respects. The industry representative queried whether the EU should consequently rescind some of its proposals, which are similarly overreaching. An official considered that although the EMIR 2.2 proposals are often described as a replication of the CFTC's regime, Chairman Giancarlo's recent speeches made clear that they actually go further than what the CFTC does in terms of intrusiveness. Another official felt that these proposals are akin to an invitation for nuclear disarmament, which ultimately was successful. The US is in a very powerful

position at present, and Europe is catching up. The US is now offering to be less intrusive if the EU does the same.

Another industry representative mentioned that when the US created a legislative framework around clearing in 2010 in the context of Dodd-Frank they were the first to do so. It is arguable whether this went too far or not, but overall, the Dodd Frank system has been positive. However, other parts of the world have since caught up. Nobody in the industry wants this 'arms race' around extraterritorial supervision of clearing, because it will disrupt and fragment markets and liquidity. The industry representative felt Chairman Giancarlo's intervention was timely and relevant. It is time to consider whether there is a different way. A third industry representative had a slightly different interpretation, suggesting that Chairman Giancarlo's remarks should be interpreted as demonstrating that both the US and the EU are talking about the inclusion of a strong element of deference.

An official highlighted their extensive experience of engagement with the CFTC on the supervision of UK CCPs which also operate in the US. There is a high degree of supervisory cooperation with teams discussing with each other on a very regular basis. This is also based on a significant degree of deference to home state rules. Chairman Giancarlo's remarks suggest building on this already strong level of supervisory cooperation. The EU authorities now need to clarify how they will engage in cooperation and coordinate with overseas authorities. A regulator stressed that the current EU system should be properly characterised in this discussion. At present, for third country CCPs that have been recognised by ESMA there is reliance on third country supervision and regulations and the EU approach is in no way a line by line extraterritorial system. For the US, in addition to nearly full reliance, there are only a small number of additional specific rules concerning CCPs active in the EU. The US may well be moving in the direction of the EU, but the current proposal made by the Commission or the positions of the Parliament on EMIR 2.2 are not comparable to the current US system in terms of extraterritoriality.

1. In a first scenario, major clearing member institutions across the world will have defaulted. Bank prudential requirements will have turned out to be insufficient and the recovery and resolution of the institutions concerned will have failed also. In this scenario however, the CCP would not be in a default scenario and this would still be business as usual, although rather hectic. In a second scenario a CCP could have declared a default. In that case the initial margin of the defaulter will be eroded, as well as the 'Cover 2' default fund. This could go beyond the default fund into a market situation that has never been seen before.

Profitability challenges of EU Banks: impacts and possible solutions

EU bank profitability recovered in 2017, supported by an improvement in economic growth, but it remains weak. According to the Financial Stability Review issued by the ECB in May 2018, the aggregate return on equity in significant institutions in the eurozone increased to around 6% in 2017, compared with 3.5% one year earlier. However, the updated Risk Dashboard issued by the EBA in April 2018 stressed that the return on equity for a number of EU banks remains below the cost of equity. An industry representative highlighted the fact that the median return on equity within S&P's top 50 rated banks in Europe was 6.6%. Only 14 of these 50 banks have a return on equity above their cost of capital, which is around 8%.

In years since the crisis, the profitability of European banks has recovered more slowly than that of US banks. Aside from the different economic factors (level of economic growth, interest rates...) this gap is largely due to structural issues (the way financial fragmentation has been implemented in US and Europe, the absence of a single banking market and overcapacity in Europe, the absence of a structural organisation of securitization which handicaps EU banks, management capabilities, legacy issues in some Member States). Lifting the barriers, which impede cross-border consolidation in Europe, optimizing the Banking Union and developing a securitisation market would significantly contribute to addressing profitability challenges in Europe.

1. The nature and causes of profitability challenges

1.1. Since the financial crisis, EU banks are less profitable than US ones, notably due to differences in legal and regulatory environments between the EU and US

Domestic US banks reported an average return on equity of 11% in the first quarter of 2018, well above the 6% that a rating agency projects for Europe's largest 50 banking groups in 2018. This gap is due to several structural revenue and cost disadvantages for European banks compared to their US peers.

1.1.1. Unlike their US peers, EU banks do not enjoy the benefits of a single market and the economies of scale that this brings

An industry representative stressed that the US is home to the largest capital market in the world. Comparing investment banks around the world, it is not surprising that on average the European banks have had to face deeper and more costly restructuring than the US banks, which have been able to leverage a large homogenous domestic market to sustain their higher capital requirements.

A regulator agreed that European banks broadly lag behind their US competitors, highlighting the importance of market fragmentation in Europe. The top European banks have a market share of around 25% of assets; in the US, it is 50%. This produces different economies of scale and scope for US banks.

1.1.2. The way regulations are applied by national supervisors has also led to a retreat of the Single Market and to higher fragmentation in the European banking sector

An industry representative explained that national regulators and supervisors have pushed for maximum local financial stability, applying a solo approach for the main prudential ratios (capital, liquidity, MREL...) and refusing to allow waivers to pan-European groups. The latest example of this is the requirement of an internal MREL at 100 % for subsidiaries of EU transnational banking groups, when the FSB recommended a range between 75 and 90 %. The consequence for European banks and their clients is that, unlike their US peers, they do not enjoy the benefits of a single market and the economies of scale that it brings.

This speaker also cited the regulatory treatment of the repo market in the Net Stable Funding Ratio (NSFR) as another barrier to profitability. While the Basel Committee wants to obtain a cooling effect on the US repo market, given its size and the interconnectedness between banks

and non banks, this rule will significantly jeopardise the smaller EU repo market and hence the EU sovereign bond market, which is very fragmented.

Additionally, US banks are not subject to the multiple levies and contributions which target their EU competitors. An industry representative outlined the situation of BNP Paribas. BNP Paribas achieved a return on equity of 8.9% in 2017. If BNP Paribas were a US bank, its return on equity would be more than 10%. In 2017, BNP Paribas paid €1 billion of banking levies in Europe: BNP Paribas' contribution to the Single Resolution Fund was €500 million. At Member State level, €500 million was again split between different European countries.

1.1.3. Contrary to US banks, EU banks cannot reduce their balance sheet assets through true-sale securitisation

This industry representative also described how US banks sell their conforming housing loans to Government Sponsored Entities (GSEs) while keeping the servicing rights and cross selling benefits of client relationships. If BNP Paribas could do the same, its balance sheet would be cut by around €150 billion. Such a smaller balance sheet would improve the liquidity coverage ratio and allow BNP Paribas to cut its HQLA buffer by around €10-15 billion. Removing this expensive buffer[1] would both reduce the balance sheet and increase revenues. In total, the bottom line would see an increase of more than €1 billion, compared with BNP Paribas' 2017 net income of €7.8 billion. In terms of specific regulation, the two issues handicapping European banks are this harsher treatment, particularly regarding taxation, and a lack of structural organisation for securitisation and offloading balance sheets.

An official agreed that there are good reasons for the increased profitability of US banks. Although the same storm is hitting these banks, they are able to consolidate and securitise. They are able to transform their business models, unlike the European banks. Cross-border consolidation is not taking place as it should in the EU, and this is partly because there are hindrances to entry. An official felt it would be difficult for EU banks to reach US standards for securitisation. Europe has no equivalent of Fannie Mae and Freddie Mac, for instance. However, there are two proposals on securitisation that have been passed by the Parliament which will become operational in January 2019.

Noting the points made by the industry representative about European banks being at a disadvantage, a regulator described how they participated in the Basel negotiations and suggested that the industry representative's view is not shared by US colleagues. They talk about things like 'Basel compliance', while Europe does not; they talk about 'internal models', where European banks have a huge advantage compared to US banks; and they compare the different leverage ratios. The regulator questioned whether the lack of a securitisation market in Europe is the result of European regulations, suggesting that this is a consequence of the long economic history in Europe of banking being the predominant way of financing the real economy.

1.1.4. Software treatment: EU banks are at a competitive disadvantage vs. US banks

An industry representative considered that EU banks are at a competitive disadvantage versus US banks in terms of software treatment. There is a problem about strictly aligning to international rules designed with the US framework in mind. European authorities are imposing the full deduction of software investments from capital. This is an issue that has become particularly acute because of the need for banks to invest in digital technologies. Clearly, when the Basel Committee introduced the deduction of intangibles from capital, they did not have software in mind. This is an error that could easily be corrected. A Central Bank official noted that there is a trialogue proposal aiming to align the treatment of software to the US model, which will address this issue.

1.2. The effect of the economic cycle on bank profitability

1.2.1. Bank profitability and economic growth

A Central Bank official emphasised that there is no single explanation of the challenges in bank profitability, noting the strong link between profitability and economic growth. There is a strict correlation between GDP growth and bank profits, which functions mainly via loan loss provisions and credit dynamics. Additionally, this explains the heterogeneity within the European banking system. Countries which were hardest hit by the 'double dip' recession were also those in which the banking system experienced a bigger profitability problem. Interestingly, the literature also suggests that this effect of GDP is asymmetric over the business cycle. To some extent, this explains the difference between the US and Europe, given the higher weight of investment banking in the United States. Of course, as growth in Europe has resumed, there is reason to believe that this differential will recede if not disappear. In Italy, for instance, the results for the banking system in the first semester in 2017 point to an average return on equity of 7%. This might be below the cost of capital, but it is still a very good number. The cost of capital is an important issue. At present, this stands at between 8% and 10%. The higher capitalisation of the banking system has been brought forward by the efforts of regulators; capital is the denominator of this ratio. The industry should not worry too much about lower profits to the extent that this factor is a main driver.

1.2.2. The economic cycle and the profitability of banks: the example of the Romanian banking sector

Another Central Bank official agreed that the economic cycle is the principal determiner of the profitability gap between EU and US banks. In Central and Eastern Europe, where economies are probably at the peak of their finance cycle, profitability has recovered to healthy levels. The Romanian banking sector reached a peak level of return on equity during the last three years of between 10.5% and 12.5%. In this case, the main driver of increased profitability has been the lowering of provisions for impaired assets under the circumstances of strong economic growth. Major balance sheet clean ups have been implemented since 2014, with the NPL ratio decreasing from 20% to less than 6%. Operational efficiency rests at the moderate level as cost to income ratio fluctuates around 55%, five percentage points more than the EBA's 50% threshold.

However, these features are not homogenous across all credit institutions. The positive results are concentrated in large banks. Against this positive picture, there are a number of specific concerns in the medium term, including: limited space for further sound credit expansion due to weak solvent demand; undercapitalisation in the real economy; a relatively high debt service to income ratio in the household sector; operational risk in relation to legislative initiatives that could undermine credit discipline; and short-term market risk and medium term credit risk caused by interest rates rises.

1.3. Structural factors in the market impacting the profitability of banks

1.3.1. A structural storm hitting banks everywhere in the world

An official described how Scandinavia experienced a severe banking crisis in the 1990s and had since undergone a

consolidation process. What is happening now is a perfect structural storm hitting banks everywhere in the world: a low long-term yield environment combined with low productivity, a tougher regulatory regime, de regulation enabling competition in payment information, and advances in technologies.

1.3.2. Business model, jurisdiction and management capability affect bank profitability

A regulator stressed that business model and jurisdiction both affect bank profitability, noting however the clear link between GDP and bank performance. Different business models are also affected in different ways by the low interest rate environment or new regulatory changes like the leverage ratio. However, the SSM can now analyse banks in a way that was not possible before using new databases. The SSM's analysis clearly shows that in every business model and in every country there are both 'stars' and banks which do not perform very well; no one country or business model consistently outperforms the others. Rather, these 'star' banks usually have superior steering capabilities. Additionally, they are more cost efficient and offer products that are more value-generative. They have superb risk management and they align their risk appetite to their targets. In the end, long-term management capability produces long-term return on investment.

A Central Bank official considered that regulatory reforms pose another big challenge. The big wave of regulatory reform is over, but some of the effects on profits and capital absorption are yet to come. Clearly, some structural adjustment is needed. There have been reductions in the numbers of branches and employees. In a number of banks, there is an ongoing process of consolidation in Europe. Again, this is heterogeneous. On average, it is taking place more strongly in the countries hardest hit by the recession.

Another Central Bank official noted a recent IMF working paper on European bank profitability, highlighting the fact that institutions which managed to contain the rise in NPLs were more successful than their peers which did not. In this respect, the SSM is making a powerful contribution not only to banks' profitability in the long run but also broadly to economic development.

Through benchmarking exercises and other validation tools, supervisors are able to identify the weak points in banks' internal models and thereby stimulate better risk assessment by the banks themselves. The Central Bank official highlighted a 2016 ECB paper on bank efficiency and regional growth, which pointed to a number of critical structural issues regarding lending in the EU. One of the paper's most concerning conclusions was that the recent financial friction in the euro area was driven by financial intermediaries' inefficient allocation of resources to sectors where the marginal effect of capital was low and not to those associated with technological changes, which would broadly have a higher impact on potential growth. Putting in place safeguards to prevent possible abuses is essential to avoid a future build up of NPLs.

An official suggested that drawing the correct conclusions and taking the correct actions is the job of the owner of a bank. When a bank's return on equity is not meeting its requirements, the owner should react. There is a question about why they do not, and this must be because they are being 'babied to death'. They have a special position: they have access to central bank money and access to clients' data. Europe is trying to ensure this taxpayer subsidy is taken away. This is why the Banking Union would be an extremely strong tool if implemented in the right way.

1.4. Profitability challenges linked to digitalisation and technology

A public decision maker stated that the digital revolution can be friend or foe depending on banks' ability to exploit new technologies. Banks that do not quickly respond to the new environment may face an existential threat in the not-so-distant future. Substantial investment in new technology, then, is a necessity. At the same time, however, it is also a risky business, as betting on the losing horse is a concrete possibility. Banks need to find ways to diversify these risks.

An industry representative felt the issue of how digitalisation affects profitability should be approached not by considering the short-term costs of digitalisation but rather the extent to which digitalisation will transform the conventional banking business model.

The enabling technologies now present in the marketplace are transformative; they change both the supply and demand sides of the market: On the supply side, marginal costs are decreasing dramatically. Even fixed costs are diminishing, and there are asset light entrants in the industry. With artificial intelligence and machine learning, operating costs can be reduced. On the demand side, there are network effects due to platforms, improved customer experiences, customisation, always on banking and virtual banking. The critical issue is the extent to which the banking industry will suffer the fate of many other industries which have been invaded by big tech companies and digital platforms. The banking industry, and particularly the retail sector, has a critical advantage relative to new entrants and big tech companies: the banking industry benefits from the trust of their customers. Indeed people seek reliable partners for significant transactions or milestones in their personal and financial lives. To that end, investing in technology is crucial.

Establishing the right priorities is also key. Security and data protection, for instance, is surely one of them. Transforming legacy IT systems into a more flexible, cloud-enhanced architecture, another.

Investment in new technologies, while important, is not enough to succeed. It must be combined with the best human talent and new ways of working to reach its true potential. Firms must change the way they operate, abandoning rigid and overly hierarchical structures that delay decisions and the time-to-market for new products and services. In a constantly changing environment, the best way to succeed is to embrace uncertainty and be quick and productive in trying new ways and new things. Agility and flexibility, together with a people-centered culture and a clear common purpose, are also necessary to attract and retain the best talent. Banks that embrace this transformation will be well positioned to face the technological challenge, provide the best possible customer experience and create value for customers, employees and shareholders.

An official stressed that banks are and have always been information platforms. They had access to data and they were allowed to make money from it. Now they are being challenged by new technologies and different operational models. However, nobody knows what business models will exist in a few years' time. Europe will be left behind unless profitability improves and the banks and new data platforms are able to come to this arena and shape it. Europe must focus on the better pricing of risk. Hopefully, the development of capital markets, improvements in new technologies and cognification will enable the better pricing of risk and make the system more efficient. The question here is about whether the industry is moving from entities to activities in terms of both industry action and regulation and supervision.

2. Challenges in cross-border consolidation in Europe

An increase in cross-border mergers within the euro area could bring three main benefits. First, it would deepen financial integration within the euro area, paving the road towards the common goal of a truly European banking sector. Second, savers would have more options when investing their money. Both companies and households would be able to tap more sources of funding. Third, there would be an improvement in risk sharing, helping the EU economy to become more stable and more efficient. Moreover, bank mergers can play a role in reducing excess capacity and making banks themselves more efficient.

However, these benefits do not materialise notably due to regulatory disincentives. In the 10 years since the financial crisis, consolidation in the European banking sector has been very limited. This contrasts with the United States, where the five biggest banks hold over 40% of domestic assets, compared to 20% in the EU.

2.1. The EU regulatory framework impedes the reduction of overcapacity, cross-border consolidation and the related economies of scales

An industry representative stressed that cross-border consolidation would be considered by supervisors as rating neutral at best or even negative in terms of execution risk. Despite the existence of many cyclical conditions for cross-border consolidation, the structural conditions are not yet favourable. In terms of the drivers for consolidation, there is a mix of prolonged revenue pressure, fragmented sectors, overcapacity, and the need for scale to make huge investment in digital and the stabilisation of the regulatory environment.

Fundamentally, he believed that the Banking Union would address the bank sovereign feedback loop, build resilient and diversified pan European banks and make the transmission of monetary policy more effective. However, the banking markets remain very fragmented in terms of legal environment, bankruptcy law, tax treatment and variety of products. One area where EU public decision makers could work is to reduce prudential regulatory barriers. This is related to the trauma from the crisis: the bigger and more systemic a bank is, the higher its systemic risk buffers will be. This is an incentive not to grow past a given size. There is also a specific surcharge based on cross-border exposures, which is a further incentive not to consolidate cross-border, even within the Eurozone. The industry representative observed that there is a kind of 'schizophrenia' within the regulators. On the one hand, there is a long-term goal to build a Banking Union. At the same time, there is ongoing ring fencing, leveraging and issues around national discretion. There is no fungibility of capital, liquidity, and bail-in instruments. He also noted that the disruptive innovations (e.g. digitalisation) mentioned by previous speakers in fact produce a lower appetite to buy legacy systems and huge branch networks, which over time might lose their value.

An official emphasised the importance of regulatory action. The consolidation process is not easy in the Nordic countries. The Nordics are close to each other culturally, but it is always emotional to start thinking about which bank will eat which. There needs to be a slight push from the regulatory side. It is important to respect the limits that have been set on what a profitable bank is and what the requirements are in a bail in regime. If those constraints are broken, action needs to be taken. If the owners are not seeing the light, regulators and supervisors need to take action.

2.2. Other impediments to cross-border consolidation in Europe

Several speakers emphasised that advancing decisively with the Banking Union in order to achieve a larger banking market comparable to the US one, would be an important step forward in addressing bank profitability. But the risk issue stands in the way of the Banking Union. An official stressed that much progress has been made in terms of risk reduction, but the debate on risk reduction has been a bit lopsided. Discussions about risk, focus on credit risk, but market risk is also important. The Bank of Italy has made this point explicitly in several publications. The issue around capital and liquidity waivers has resurfaced. Bankers indicate that they would be happy to make cross-border mergers under the right conditions, but this is a 'chicken and egg' question. More profitability would help reduce risk, but the risk problem stands in the way of the Banking Union.

An industrial representative stated that a completion of the Banking Union is needed to reduce the artificial barriers that prevent further integration. He considered that in the absence of a full Banking Union (a risk-sharing mechanism) countries and local authorities want to keep some policy tools (ring fenced liquidity, domestic control of resolution process) to avoid and prevent risks and their impact on the sovereign. At the same time, countries with stronger systems are unwilling to grant public risk-sharing because of the contingencies associated with the legacy assets. If no protection is provided (EDIS, backstop SRF) banking integration will continue to be blocked politically.

A regulator noted that the ECB did a small and non representative study on the barriers to cross-border consolidation and what the ECB could do as a supervisor. Interestingly, the study suggested that this is not a problem of regulation. Primarily, banks indicated that the potential benefits and required workload of cross-border consolidation do not appear greater than the potential benefits and required workload of investing in new technology.

3. Policy measures to address profitability challenges in Europe

Optimizing the Banking Union, developing a securitization market and ensuring regulatory certainty would contribute to addressing profitability challenges in Europe.

3.1. Optimizing the Banking Union

To achieve a true single market, measures must be taken to enhance cooperation and trust among national supervisors in order to ensure proportionate requirements at a national level. A full Banking Union is needed, which would also allow the greater consolidation in this sector necessary for a single market. An industry representative stressed the importance of advancing decisively with the Banking Union in order to achieve a larger market size comparable to the US and a proper market for corporate control. This would allow the European market to facilitate the exit of poor performers through acquisitions, for example. Some Member States do not want to relinquish the tools they have to control their domestic banks, because they fear an impact to their sovereign. Therefore, they block the advancement of the Banking Union. With a monetary union, they have lost access to the issuance of safe assets. They do not control monetary policy and, therefore, they are in a higher risk position. They would like to have an explicit risk sharing mechanism, which the Union should provide.

Another industry representative considered that burden sharing is the reason for these national protective measures. While EDIS is unlikely, national discretion must be addressed. It will be very difficult to achieve branchification without EDIS and without addressing national discretion.

3.2. Developing a securitisation market

A representative of the industry recalled that no significant improvement has been introduced in the regulation to allow European banks, which finance the economy mainly through banking intermediation, to reduce their balance sheets assets through true sale securitisation. In fact, this activity has collapsed in Europe, as the figures on the issuance of European securitisation demonstrate: from €819 billion in 2008 to €235 billion in 2017. Meanwhile, American issuance has climbed sharply from €967 billion in 2008 to €1713 billion in 2017. Europe does not even try to adapt to the US inspired regulation it imposes on its banks: the upcoming finalisation of Basel III, with its multiple input and output floors, is going to penalise low risks assets on banks' balance sheets without allowing any practical possibility of securitisation.

The speaker emphasised that there are two possible doors for low risk assets: the US door, where these assets are put in the market and sold to institutions; and the European door, where the assets are kept on the bank's balance sheet. Conspicuously, Europe is closing both of these doors. One has always been closed in Europe, and the market is not being opened. The securitisation measures are too small and too slow. The other one is to keep these assets on banks' balance sheets. Of course, those low risk assets yield low returns because it is economically justified. Up until now, Europe recognised that these assets were low risk and they were charged as low risk weighted assets. If Europe introduces floors and forfeits because the weighting seems too low to supervisors, it becomes completely uneconomical to keep them on banks' balance sheets, and hence profitability is hurt. It is one or the other, but it is impossible to close both doors.

3.3. Europe needs regulatory certainty

A regulator suggested that Europe needs regulatory certainty. In the last 10 years, regulation has been changing constantly. Basel III is closed, but it must now be implemented in European law. There must be an end, because certainty is necessary. Second, Europe requires further cross-border harmonisation. There must be more directly applicable European law rather than national law. Additionally, there is also uncertainty in some countries which is blocking this in terms of higher NPL levels and risks. Lastly, there are a few issues which are beyond the scope of regulators: insolvency laws, tax laws and language issues. Those things exist on a much higher scale, but they also prevent cross-border activity and real economies of scale.

1. It consists mostly in deposits held by the ECB, which yields minus 40 basis points.

Risk reduction measures in the EU banking sector

A Central Bank official outlined the main topics for discussion: the relationship between risk reduction and risk sharing, the progress made in reducing NPLs in the eurozone banking system, and issues around sovereign risk concentration and sovereign risk exposure on banks' balance sheets.

So far, there has been more risk reduction than risk sharing. Risk reduction and risk sharing should not be seen in opposition, however. These two goals are complementary; one cannot be substituted for the other. Second, NPL success stories are actually tailor made success stories. Issues here continue to be bank specific. Finally, sovereign risk is a particular issue in cases of extreme concentration.

1. Significant progress has been achieved on NPLs in Europe, but there is still much to be done

The reduction of Non-Performing Loans (NPL) is challenging since progress on this matter also depends on the existing macro-economic conditions. However, we have observed important advances following the Action Plan adopted by the ECOFIN Council to tackle non-performing loans (July 2017).

1.1. The policy actions taken towards the reduction of NPLs

In March 2018, the Commission presented its package of measures to tackle high NPL ratios. The proposed measures aim to speed up progress already made in reducing NPLs and preventing their renewed build-up. The package included a proposal for a regulation amending the Capital Requirement Directive and introducing common minimum coverage levels for newly originated loans that have become non performing. This measure aims to make banks set aside funds to cover the risks associated with future NPLs. There is also a proposal for a directive on credit servicers, credit purchasers and the recovery of collateral. This measure should provide banks with an efficient mechanism of out of court value recovery from secured loans and will encourage the development of secondary markets where banks can sell their NPLs to investors and make use of specialised credit servicers.

The SSM has also taken several steps to address the problem. In March 2017 it issued qualitative guidance on how to address non-performing loans and the way in which they should be managed. The journey to deal with NPLs began with a Comprehensive Assessment in 2014. Subsequently, it became evident that the approach to dealing with NPL workout and resolution varied across Member States and that a more proactive supervisory role was needed. To address this, the ECB established a High Level Group to develop a consistent approach to the supervision of NPLs. This led in 2016 to the ECB's Stocktake of national supervisory practices and legal frameworks related to NPLs. With the addendum to the qualitative guidance in March 2018, the ECB then expressed its quantitative supervisory expectations regarding the provisions needed for new non performing exposures, like flows. Additionally, the SSM is currently working on the implementation of this addendum for the stock of NPLs. Another addition to the guidance has been the announcement of further steps in the supervisory approach to address the stock of NPLs.

A Central Bank official outlined the quantitative and qualitative focuses to supervisory work. The qualitative approach is about setting out the ECB's supervisory expectations by looking at individual bank' circumstances while trying to be consistent. This is the focus of intense engagement by the Joint Supervisory Teams. The quantitative approach is more difficult. Clearly, the public consultation on the Addendum was subject to intense debate in relation to the ECB's supervisory expectations for provisioning. Nonetheless, this was then introduced earlier this year for new NPLs. More recently, it was announced that as part of the SREP process there will also be bank

specific supervisory expectations for existing NPL stock. The Joint Supervisory Teams are undertaking an intense engagement with the banks on those issues. In terms of next steps, there is the day to day approach of the Joint Supervisory Teams: engaging with the banks, looking at their strategies and seeing what progress individual banks are making. Achieving a right number is not the important factor here, however. In a way, this is connected with some of the political issues in respect of EDIS and so on. The key thing is a balance between ambition and reality. This is about whether banks are really driving to make the progress that needs to be made in a realistic way which is supported by credible, detailed plans and for which the board and senior management have an absolutely clear responsibility. Additionally, the ECB expects deliberate and determined reduction. The Central Bank official noted that the 'wait and see' approach, or 'extend and pretend', was a feature of the market a number of years ago; but this is no longer acceptable. The ECB does not want to see restructuring solutions that break down after a period of time; it seeks continued progress along a path that is measurable, deliberate and determined. Supervisors have taken important steps in relation to taking stock of NPLs. The numbers demonstrate that progress is being made. This is now up to the banks, but it is also up to others in terms of some of the other factors such as insolvency, judicial proceedings, out of court settlement and so on.

1.2. These actions are paying off; the NPL success stories are tailor-made success stories

A regulator underlined that the European Union is sometimes not very good at congratulating itself on its achievements, but it does get results with the roadmap for NPLs, which was developed in the Council in July 2017. To some extent, things have moved quite fast. In terms of NPLs, the levels are going down. What is more interesting, however, is the time dynamic. There has been an acceleration in the reduction in NPLs in the last period. The regulator felt that this is due to the policies and supervisory pressure developed by the ECB and the development of a much more efficient and liquid secondary market.

There has been a reduction of almost €400 billion in NPLs in the last three and a half years. Considering the second half of 2017 and the first quarter of this year, the acceleration is increasing. In the first quarter of 2018, sales reached a peak of €130 billion. Interestingly, the bid/ask spread is also decreasing. According to Bank of America Merrill Lynch, the price for SMEs and consumer secured loans is now around 27.5 cents on the euro. Considering the provisioning levels of the European banks, this market is very attractive.

1.2.1. The Spanish experience

A Central Bank official acknowledged that the improvement in terms of de risking in the banking sector has already been very significant. In the Spanish case, there has been a 60% reduction of the volume of NPLs from its peak in December 2013, to €79 billion in April 2018. Additionally, 43% of the NPLs which are on the balance sheets of the banks are already provisioned. Taking into account the value of the collateral, the coverage ratio is above 90%. The process of de risking in Spain has been conducted in parallel to the deleveraging process in non financial corporations and households. This has been equally significant. There has been a decline of 40% in the debt to GDP ratios of non financial corporations since the peak and 20% in the case of households. This process is going to continue because the central macro scenario is relatively benign. Additionally, the measures being taken at a European level are very important for this de risking. These include the July measure on stocks, the beginning of the implementation of MREL and the European Commission package that will hopefully be approved soon.

1.2.2. The Italian experience

An industry representative described how Italy experienced a market failure in its ability to dispose of NPLs. First of all, there was a regulatory and fiscal treatment of provisioning which was punitive and almost prevented banks from provisioning on NPLs. There was also a lack of specialised intermediaries which handled NPLs as a business area. There have now been significant improvements to the system. The Italian banks have played a role in accelerating the trend towards the reduction of NPLs; UniCredit has played the role of an icebreaker. UniCredit eventually decided to go forward with a rather significant reduction of NPLs when there was a complete standstill.

Foreign intermediaries were offering 10 cents to the euro for disposing of the assets. The banks considered that this was absolutely unacceptable and that it might have triggered destabilising trends. Now the situation has changed. UniCredit has halved its level of NPLs from 16% to 8%. It has also identified so called non core NPLs, which will be reduced to zero over the next few years. This will put UniCredit in line with the European average ratio of 4%.

1.2.3. The Croatian experience

A Central Bank official noted that Croatia is not in the euro area but it has had the same problems with NPLs. After this crisis, it was essential to do something about the large amount of NPLs, which peaked above 17% at the end of 2014. It was important to push the banks to do something in order to repair their balance sheets; otherwise, they tended to extend and pretend. In Croatia, the supervisors understood that corrective actions were needed but knew the process could not be too abrupt. In the short-term, it was not possible to push banks without being able to estimate the value of their collateral, but the supervisors did not have a correct idea of the value of their collateral.

As a result, the supervisors decided to create a gradual incentive for the banks to solve the problem by asking them to provision 30% initially for anything overdue for two years and then every six months to increase this provisioning by 5 p.p. That increased the NPL coverage ratio from 46% up to 65% in three-years' time. At this level of provisioning the banks sold almost half of the NPLs. The NPL ratio declined below 12% at the end of 2017. However, the Central Bank official stressed that it was not only important for banks to offload NPLs from the balance sheet; what happened to the NPLs once they were offloaded was also important. Croatia has had a very positive experience here, because the companies which bought these NPLs resolved the vast majority of them within 12 months of purchase. Additionally, it is essential to look at the carrying value of NPLs rather than NPL numbers. The metric should be net NPLs compared to the capital adequacy of the bank. That is a much better measure than the pure level of NPLs, which provides much less information than the carrying value of NPLs.

1.3. There is still much to be done

1.3.1. There is a large stock of almost €800 billion, but there is no one size fits all solution

A regulator noted that progress in the EU is good, but there is still a large stock of NPLs (€800 billion). The regulator was sceptical about the idea of having single thresholds. There are business models with relatively high levels of well provisioned and well priced NPLs. If there was a cap on NPLs, there would be a risk of damaging business models that feature a great number of high risk

SMEs. There can be differences in ideal NPL levels for different portfolios, so it is very difficult to have a one size fits all solution. If Europe wants a wholesale solution from the political point of view and to clean balance sheets much faster, the solution is to lift bad assets off the banks' balance sheets, move them somewhere else and manage them in a separate fashion. One issue that is slightly disappointing is the fact that in the EBA's sample there are 54 banks which have an NPL ratio above 5%. 20 of these banks have distributed dividends consistently in the last years, and seven of these banks have a payout ratio above 50%. This indicates that there is perhaps the capacity to do more, and supervisory pressure should help achieve this. The regulator noted that this issue is always considered in terms of aggregate data.

For the secondary market, large banks are more active because they are diversified, they have better earnings from other jurisdictions and they have larger stocks and better access to the secondary market. Smaller banks have a much lower capacity to tap into the secondary market and sell NPLs. With the ECB, the EBA has been developing the idea of a platform or portal in which investors can browse through different portfolios and buy NPLs. The regulator noted that the EBA had produced a quantitative impact assessment of the Commission's prudential backstop proposals. These proposals will begin to affect banks around 2026. This timeline affords governments and parliaments sufficient time to rethink judiciary procedures which are inefficient and which penalise the banking sector. On the other hand, it is correct to seek more harmonised ways of writing down NPLs after a crisis and avoiding a big build up in the next crisis.

1.3.2. The capital requirements on NPLs should be increased and developing deeper and more liquid capital markets is essential

An industry representative explained how the role of treasurers within banks is to safeguard financial stability and to work with the regulator and on behalf of the customer; best in class treasury functions are not profit centres themselves and therefore they should avoid potential inherent conflicts. The NPL package from the Commission is a step in the right direction but there is still too much risk in the system: €800 billion on a €17 trillion loan base means that one out of every 20 loans on bank balance sheets in Europe is still non performing. In the UK and the US one of the big drivers of non-performing loan reduction was the large increase in capital requirements that banks and regulators assessed for NPLs. With significantly higher capital requirements it results in a sale being capital accretive at lower prices. Capital requirements go up and reduce capital ratios which means that selling the NPLs at lower prices likely results in capital ratios improving. This accelerates NPL reduction and gives the market more liquidity (brings buyers and sellers closer together on price).

On this point, more progress must also be made on the capital markets. Speed has already been mentioned, but, even at the pace at which the capital markets in Europe are absorbing NPLs, it will be 5 10 years before all of the NPLs are off banks' balance sheets, which is likely to overlap or slow the onset of the next downturn. Going into the next downturn with this level of NPLs will have more negative consequences. Measures to improve the depth and liquidity of the capital markets are important. The development of pan-European financial institutions will result in deeper European capital and financial markets. Further, finalization and support for significant risk transfer and securitization will enable NPLs to be cycled out of the banking system faster.

In terms of pan European banks, it is essential to promote or encourage more pan-European financial institutions. Bigger banks have economies of scale, are more profitable and therefore are more resilient having the ability to regenerate capital faster.

In the US, the level of NPLs is below 2%. The US has cleaned up banking system balance sheets faster and the economy is growing. A faster growing economy inevitably leads to rising rates which is good for bank profitability and rising share prices. An argument can be made that – taking a longer term view – dealing with the NPL problem faster in a potentially more capital intensive way will lead to a more robust economy, rising rates, more profitable banks and higher share prices sooner. Banks can deliver for shareholders by taking pains now, because these efforts will lead to economic growth, which is going to cause rates to rise and in turn cause shareholders to value banks more highly.

1.3.3. US banks have conversations with their regulators about the overall business models, which is difficult in Europe

An industry representative stressed how risk sharing, along with consolidated supervision, enables banks to put their customers first by building financial stability and balancing this against price in a better way. In the US banks are having single conversations with regulators spanning the entire prudential landscape from supervision to resolution to liquidation. While there are virtues in the US' federal conversations, these conversations are repeated as many as five times given the different federal regulators for the different entity types. Europe has the opportunity to do it better and really enable banks and regulators to have an integrated conversation across all aspects of the enterprise, delivering financial stability to the customer at a lower cost. In terms of NPLs, risk sharing and a single pan-European regulator would increase transparency and consistency.

2. Less risk sharing than risk reduction: it is time to improve risk sharing policies

2.1. The same level of progress has not been seen on the risk sharing front. Since the Commission´s proposal in 2015, we have not seen progress in the design of a fully-fledged European Depositors Insurance Scheme (EDIS)

A Central Bank official stressed that risk reduction and risk sharing measures should go hand in hand because if risks materialise we may still face fragmentation and a lack of policy coordination. However despite the decisive steps in the EU to reduce risks stemming from banks and in particular the reduction of NPLs, no progress was achieved on the risk sharing front. The Banking Union will remain incomplete until a fully-fledged EDIS is in place. It would be very helpful to fix a date for this. This will also assist the de risking process. This development would be considered positively by markets; of course, EDIS will equalise the level of depositors' confidence across the single market, help to delink depositor protection from depositor location, thus contributing to reduce the link between banks and sovereigns, strengthen depositors' protection against local shocks and reinforce the level playing field. Another outstanding initiative to complete the Banking Union is the common financial backstop for the Single Resolution Fund. The Commission has recently produced a proposal for a regulation of this area. It is necessary to prioritise its operationalisation while guaranteeing that the magnitude of this backstop is sufficient to ensure banks can be resolved effectively.

A representative of the industry also emphasised that the same level of progress has not been seen on the risk

sharing front. EDIS and a common financial backstop for the Single Resolution Fund are important steps forwards for a true Banking Union, he said.

Another industry representative advised that UniCredit put great value on the completion of the Banking Union, because it is a precondition of moving to Capital Markets Union, adding, that there is no real need for 'Capital Markets Union' to be plural, because Europe needs a single European capital market. The debate between risk reduction and risk sharing is now becoming a conundrum which is preventing further progress towards the completion of a Banking Union and a Capital Markets Union. Since the Banking Union was launched in 2012, the emphasis has constantly been on risk reduction, which was perfectly justified at the beginning. There have been significant improvements in capital and liquidity requirements; NPLs have declined; there has been an acceleration in this risk reduction process, which is undervalued. Now the time has come to complete the missing elements of the Banking Union: EDIS and the backstop to the Single Resolution Fund. There is no reason for further discussions on more risk reduction. The current package before ECOFIN involves a long list of measures which will probably put the European banking system at a competitive disadvantage with other banking systems due to, for example, the introduction of MREL requirements, which are more severe than TLAC ones.

2.2. One matter that is hindering the completion of the Banking Union is the current regulatory treatment of sovereign exposures, where changes have been demanded as a pre-condition

2.2.1. A holistic and flexible approach for any policy assessment on this matter is required

Sovereign risk has very special characteristics. It plays multiple roles in financial markets and the economy, and interacts with monetary and fiscal policy. For these reasons, standard prudential tools do not work effectively in the case of such risk. The best way to tackle this problem is to address its root causes. For the EU this means continuing to strengthen banks' resilience in order to prevent stress in the banking sector spreading to sovereigns. It also means achieving fiscal discipline in all parts of the Union and continuing to strengthen the economic governance of the EU. All of this justifies a holistic and flexible approach in making policy assessments on this matter.

A Central Bank official suggested that it is important to remain cautious on the issue of sovereign exposures. Structurally, the sovereign plays a role in safe assets. Since there are no European safe assets, it is essential to be careful. Cyclically, the financing needs of governments are very high, because debt to GDP ratios are still very high. It is important to be careful before making any change. Any change on this must be very gradual.

2.2.2. It is difficult to define what the level of sustainable debt is

Another Central Bank official felt it is difficult to say what a sustainable level of debt for sovereign exposures is. In history, some countries have defaulted with public debt to GDP ratios of 55%, like Argentina in 2001; some countries do not default with ratios of 255%, like Japan today. To assess the correct level, so many assumptions must be made. Even economists do not agree on this. It is impossible to know what kind of government will be in place in two or three years 'time or what kind of policies they will have. Politicians have the power to change things, so they will. It is a naïve assumption by economists to suggest that they can estimate sustainable levels of debt. The BCBS indicates that this issue should be considered in terms of foreign currency denominated debt versus domestic currency denominated debt. However, this is also not helpful. For example, Russia defaulted on domestic debt in 1998, not foreign debt. It could be a huge mistake to think that sustainable debt levels can be differentiated on this basis. The Central Bank official suggested that it should be left to the 'well paid' rating agencies to indicate what the likelihood of a default would be and let them also make the mistakes, rather than regulators. If somebody must make these mistakes, the Central Bank official's preference is for it to be ratings agencies rather than regulators. Given the difficulty of the task of establishing what a sustainable level of public debt is in a particular circumstance, clearly the industry cannot have simple rules there. In general, the zero weight on sovereign debt should be removed, but doing any more than this is very difficult.

2.2.3. Nevertheless there is an issue of concentration

A regulator stressed that there is an issue of concentration, however. The EBA has studied the data and does a great deal of disclosure. On average, 65% of a medium sized bank's Tier 1 capital is on the domestic sovereign, but in the whole distribution there are banks which have up to eight or nine times their Tier 1 capital on the domestic sovereign. From the prudential point of view, this is something which raises some red flags. There is not much of appetite to move into hardwired regulation in this area, but there should perhaps be some pressure on these banks. For instance, regulators are asking the banks to have liquidity buffers, which are essentially composed of sovereign exposures. This liquidity buffer should be mark to market, because banks must be ready to sell this in the market if there is liquidity stress. There should also be some incentives to act on the tail of distribution where there is excessive concentration on the domestic sovereign.

2.3. Risk sharing contributes to risk reduction

When markets are confident that banks can be resolved efficiently, it stabilises the system and reduces the costs of crises. In other words, risk sharing actually reduces risks. An industry representative expressed his strong belief in the positive interaction between risk sharing and risk reduction. The US has resolved 500 banks without creating any destabilisation. This was possible because of their confidence in the resolution framework being effective and because the FDIC was backed by the resources it needed to do the job. The completion of the Banking Union would represent a major improvement, certainly for the banking industry. Its depositors in the eurozone would be equally protected wherever they were located. The industry representative felt that this is a question of, 'If not now, when?'.

Resolution of banking groups at the EU Level

1. A new resolution framework is starting to work but is the hardest "nut to crack"

The chair outlined how resolution and rebuilding trust is at the core of many regulatory issues facing the EU in the financial area. Rewinding to the toughest moment of the crisis, trust between authorities was shattered. There were crises in groups that were solved by splitting them along national lines to make them manageable with national crisis management tools, financial support by

governments accompanied by the repatriation of business and a refocusing on domestic markets. Looking at data on the de globalisation process he highlighted the reduction in cross-border banking. Considering the breakdown by area, almost all of the reduction is explained by intra EU business, which has collapsed since the crisis. An industry representative noted that bank resolution and capital mobility are deeply intertwined. Mobility in good times and bank resolution in bad times are 'part and parcel' of the same issue.

However, trust died 10 years ago. The reflex among regulators was not to trust each other. The chair noted that there has been a huge effort at the global and European levels to re establish this trust by changing the institutional set up and the legal setting. The key ingredients in this area are the recovery and resolution framework, bail ins, which requires banks shareholders and creditors to bear the cost when a bank fails, crisis management preparedness (e.g. living wills) and cooperation within colleges. Another regulator stressed that there is a substantial amount of work ahead to foster confidence among Member States and stakeholders in the resolution regime. In the future, resolution authorities must become a reliable and predictable part of the regulatory environment for all stakeholders, markets and Member States. While a substantial amount of progress has been made, this progress was mainly achieved internally in silos and not by cooperation between stakeholders. The Single Resolution Mechanism (SRM) worked internally on its own establishment as an organisation and on several policies and resolution plans. At the same time, certain non Banking Union resolution authorities did the same for themselves. The banking union should not lead to a rift between ins and outs, but facilitate cooperation throughout the EU.

An industry representative felt the function of a ratings agency was not to survey the industry's progress and offer congratulations. Rather, ratings agencies must take account of what is happening and listen to what the official sector is saying about progress and what remains outstanding. Of course, the BRRD has been a 'game changer' for banks and the investor community, and is therefore a game changer for rating agencies. When BRRD was enacted, they had to take a view on many different aspects of the legislation. The first one of those was government support. The replacement of bail outs with bail ins has implications for ratings, because many banks had government uplift in their rating. One consequence of BRRD, in his view, is that government support is unlikely for small and average sized banks.

A regulator noted that they regularly hear in meetings that the process is going too slowly for some people and too fast for others. The process is probably somewhere in the middle, because everyone is somewhat unhappy. Another regulator feels the tool of EU law could be very powerful here, because it overrides national law. On the institutional side, the industry must trust the Single Resolution Board (SRB) and other authorities to develop a step by step approach to develop trusted relationships with people inside and outside the Banking Union. A regulator outlined how a very large number of people at resolution authorities and supervisory authorities have been devoting their time to crisis preparedness. The system is starting to work, but the area is probably the hardest 'nut to crack' in this package of measures.

Many reasons explain the lack of confidence of Member States vis à vis the EU resolution framework and their current ring fencing policies. But realistic solutions exist to solve these issues.

2. Many factors explain the lack of confidence of Member States vis à vis the EU resolution framework and their current ring fencing policies (capital, liquidity, leverage, bail in able instruments)

The preference for decentralized buffers reflects an awareness that most of the costs of prudent bank risk taking and banking failure remains national. Three main concerns of host countries were expressed: the treatment of bank failures at the EU level is not sufficiently predictable; the availability of group financial support to a failing subsidiary is not guaranteed in case of bank failure; and the issue of liquidity in resolution is not yet clarified.

2.1. The treatment of bank failures at the EU level is not sufficiently predictable

An industry representative suggested that uncertainty was the principal driver of risk and fear during the financial crisis. The situation was defined not only by where losses were situated, but also by the fact that the rules of the game were changing constantly. Considering the approach to resolution since the crisis, this ad hoc approach has unfortunately continued. Taking the examples of SNS REAAL, Co operative Bank, Banco Espírito Santo, Cyprus, the Slovenian banks, Hypo Alpe, Banco Popular or any of the various Italian situations, it is very hard to find consistency among them. "There has been a substantial move towards private sector loss absorption, but consistency is hard to find", he said.

A regulator stated that one of the key psychological obstacles to trust is that at some point the host resolution authorities will let a subsidiary go to insolvency and not embark on resolution. At least psychologically, this is one of the key drivers of mistrust between the authorities. The regulator reiterated what had been said about predictability, noting that predictability between authorities is very important. It is needed in resolution and, before that, it is needed as a part of supervision when the first intervention measures are taken. Europe must be sure about what the sequence of resolution will be. An industry representative suggested that it is very difficult for ratings agencies to make assessments on banks which are 'too big to fail'. It is not possible to say that for these banks there will never be any government support again. It could be in particular difficult to manage bail-ins during periods of systemic crisis, despite the existence of the MREL buffer.

Another industry representative felt the real question in the debate concerns which system will replace the current one. The simpler strategy is to subsidiarise, ring fence and build a national sandbox. It is simple and it puts things into states' control, but it is dangerous. If all of the capital is pushed to national subsidiaries, the bank will be more likely to fail; it will be much less resilient, given a set of assets and capital, between five and 15 times less resilient. In other words, ring fencing policies are dangerous for financial stability.

2.2. The availability of group financial support to a failing subsidiary is not guaranteed in case of bank failure

In general, the root cause of domestic ring fencing practices emerges from the concern that, should a banking group face difficulties, the parent company will repatriate liquidity and capital to the detriment of subsidiaries in other jurisdictions. This lack of trust between national authorities is one of the most damaging legacies of the recent financial and sovereign debt crises. The perception of this problem is particularly acute in countries which are strongly dependent on foreign banks for the financing of their economies.

An industry representative raised the question of guarantees and support agreements between the parent

company and the subsidiaries of EU transnational banking groups. The problem that is always raised is that host countries want collateral for that guarantee, and preferably in cash. A regulator advised that one piece of legislation that would be helpful to authorities' work on developing trust is the strengthening of group support. If the scope of group support is predefined, Europe can begin building predictability. Another industry representative stressed that Europe must build economic incentives to induce and compel group support. This question is a game theory problem. If a neighbouring country is ring fenced, it is also advisable to ring fence, because it is dangerous to be the one 'no fencer' in a ring fenced world. The industry representative noted that Credit Suisse published a paper on this subject, which concludes that there should be modest replacement, a large pool of group capital that can be moved to where trouble is, and groups should have skin in the game and legal incentives that force them to support hosts.

2.3. The issue of liquidity in resolution is not yet clarified

An industry representative stressed that behind this call for cash and collateral, there is an elephant in the room, which is the missing factor for the creation of trust in Europe. This is the subject of liquidity in resolution. This is not about whether the Single Resolution Fund is liquid or whether it has a backup in case it is called upon faster or quicker than expected; this is about the day to day liquidity of the bank in resolution, or the role of the lender of last resort. The United States and the United Kingdom have both explained to the world how they will institute a lender of last resort. This is a missing piece in Europe. Additionally, European authorities have the power to put this in place rapidly. The fact of its existence would remove the pressure on collateral and cash guarantees that comes from host countries. Fundamentally, this emerges from the fear of a lack of liquidity. If host countries know a newly re solvent bank has access to liquidity from a lender of last resort, the stresses, tensions and fears would be far less acute.

A regulator agrees that the liquidity or funding in resolution is an elephant in the room. Funding in resolution is something that happens in resolution, which means we deal with a resolved entity. To be in resolution means the capital position has been restored and a viable banking business has been created. But according to this official, the trust issue comes before that, because when a group goes into resolution people will believe they can ignore the subsidiaries.

An industry representative agreed, suggesting that the role of the lender of last resort is to be the lender of last resort to a solvent institution, which means it has been bailed in and reconstructed. Adjustments to the resolution and crisis management framework are therefore needed to achieve a unified, transparent and predictable resolution regime.

3. Solutions to address home/host issues and restore trust vis à vis the EU crisis management framework exist and need to be implemented

3.1. Optional group support from EU parent banks to their subsidiaries based on EU law is needed for going concerns and not only during resolution

A regulator felt it is essential to ensure the validity of group support once Europe has agreed on the quantum of scope necessary to build trust in the system. At present, validity is provided by company law; there must be a European law to ensure group support. It is also important not only to ensure validity but also validation. An industry representative also stressed the importance of creating a system which incentivises group support both legally and financially. Another industry representative noted that Moody's often examine internal support within groups. Notwithstanding concerns around harmonisation or fragmentation, Moody's takes the view that for some banks the commitment to supporting a subsidiary is very strong and for others it is less strong, and this is reflected in their rating. Secondly, given the existence of the fragmentation of banking markets in Europe and the national and solo approach, which maintains a domestic focus in the way prudential requirements are imposed on banking subsidiaries across the EU Moody's considers that a resolution scenario for a very large group would be highly problematic.

The first industry representative agreed that improving the legal structure to improve trust with hosts is very important. The industry representative reiterated their view that a mix of financial support with some pre placement could put enough 'skin in the game' to demonstrate to a host supervisor that the host subsidiary is in a better position than any comparative local bank. Groups can show host authorities they have made the subsidiary of an international bank a safer place to conduct financial transactions in that country than an equivalent local bank. Europe can build a much safer system for the host with that mix of moderate pre placed finance, although not full ring fencing, and legal support.

An official clarified that their comments about group support had not been meant in respect of an obligation. This is a tool for institutions to use if they think it better for them; it should be optional and be achieved through a contractual agreement which is fitted at different levels. At present, there is no complete support, or agreement, because these are branches and hence part of a group. With this type of agreement, support can be modulated to a group's risk appetite, which can be useful.

3.1.1. Would such guarantees lead to adverse effects?

A regulator disagreed with the remarks made by the previous panellists, expressing their view that Europe does not need stronger intra group guarantees. The obligation to create trust exists more on the side of the authorities and not on the side of the industry. The regulator explained how the subsidiaries of Austrian banks in the CESEE region have not been abandoned by their parent banks. Rather, the banks demonstrate full commitment to these local markets without any strong intra group guarantees. Such guarantees will in fact lead to adverse effects by removing intra group risk diversification and increasing moral hazard at the subsidiary level. In conclusion, the regulator expressed his conviction that such intra group guarantees will ultimately lead to a branchification process to allow groups to steer subsidiaries and reflect the risk bearing structure of their groups. However, failing a common deposit insurance scheme, such branchification would shift the groups' entire risk to the home deposit insurance system, which would increase risks in these countries unduly. Lastly, these guarantees would substantially damage the development of local financial systems, including regional capital markets.

3.1.2. The two resolution strategies – Single Point of Entry (SPE) and Multiple Point of Entry (MPE) can perfectly coexist very well

An industry representative felt that the regulator had cogently explained the differences between the two types of resolution strategy. The industry representative noted that the regulator had described the multiple point of entry strategy (MEP), which works perfectly. However,

there is also a single point of entry strategy (SPE), which could serve the way a group is organised. The two models can coexist perfectly well, and Europe should not oppose the existence of both of them.

An audience participant wondered whether a single system of entry or multiple points of entry should prevail over the other, given that Europe is seeking an integrated financial market. An industry representative felt that the most important issue is to know which kind of strategy is being implemented. A regulator suggested that this issue is a question of how groups at the European level are organised. They can be organised in compartments which function relatively independently or they can be aligned to the centre. The regulator expressed his conviction that nearly all groups are both of these things in various markets. These two structures are not two separate systems, and one system is not better than the other. The SRB has always expressed the view that this is not about groups choosing how they would like to optimise their MREL. The solution should be derived from how a group is organised and run.

3.2. Fostering cooperation between supervisors and resolution authorities and enhancing the transparency of the resolution strategy for external stakeholders

A regulator felt that Europe must break up its silo mentality and acknowledge that the European Union is far more than the Banking Union. After three years in which the focus of the work has been internal, it is important to refocus attention towards non Banking Union EU countries. There should be common policies which are applicable to all Member States. A common understanding should be developed, along with a unique basis for resolution plans, especially for cross-border banking groups. This common understanding should lead to joint decisions within the resolution colleges. These colleges should be the forum where the resolution authorities discuss their strategies with full transparency, common understanding and agreements on resolution plans. Second, there should be close cooperation between supervisors and resolution authorities, between the SSM and the SRM. There is definitely room for improvement even within the existing framework. The regulator considered it inexplicable why it is so difficult to share information and cooperate very closely in ordinary business as well as crisis situations. Lastly, transparency is not only key within the regulatory world; transparency is also key for external stakeholders. Therefore, resolution authorities should create clarity through structured communication.

A regulator stressed the importance of cooperation. When tackling a problem like this one, it is important to start with the headquarters of banks and not the subsidiaries. This method may have given some non euro area members of the EU the feeling they were being excluded. In respect of predictability, it is also important to be sufficiently clear that resolution is a dedicated special insolvency system; it is the insolvency procedure for highly complex cases.

The most important part is to make banks resolvable, which is what resolution planning is about. It also means defining critical functions, particularly in respect of critical financial market infrastructures and how to unwind portfolios in a structured way. There is a great deal of work to be done, but European authorities should get some credit for the work they have already completed. Resolution is being worked on, and the Single Resolution Board (SRB) is trying to expand to other authorities step by step. Within Europe it is probably still necessary to convince the last few countries who are concerned with safeguarding their institutions. It is important for all players to understand that this cannot be the solution. However, saying this can be done from a single jurisdiction alone is also not the correct approach.

3.3. Moving towards a common liquidation regime for transnational EU banks

Europe must develop an approach to the liquidation of transnational banking groups in case of this happening to a large group. Indeed, despite the fact that these transnational banking groups are supervised at the EU level and that this liquidation would impact the whole euro area, liquidation is still managed at the national level on an entity by entity basis. This can require public money from the Member State where the entity is located. In addition, recent cases have shown that idiosyncrasies in national liquidation rules give rise to unforeseen impacts on resolution execution. The scope and variety of these differences create unwelcome uncertainty. A common liquidation regime for these banking groups should ensure an equal treatment of creditors of the same rank within the group and should address the possible costs at the EU level.

3.3.1. Completing the insolvency hierarchy related to loss-absorbing liabilities

An industry representative explained that it is unnecessary to create a perfect insolvency hierarchy; it is only necessary to perfect the parts containing loss absorbing liabilities. It is essential to consider capital instruments through to senior non preferred debt. Europe did something extraordinary with the change to article 108 of BRRD. In less than one year a legislative proposal went through the European Parliament and the European Commission, and was introduced. This part of the hierarchy is now harmonised across Europe. Completing this work can be done. Europe should address this in BRRD 2, before the end of the current Parliament. Europe needs a harmonised banking insolvency hierarchy for the layers down to senior non preferred debt, i.e. the layers that matter in relation to bail ins. If Europe develops the essentials of individual bank insolvency regimes in the right way, it will be able to build more quickly an insolvency regime for banking groups that will be common across the desired perimeter, whether that is the Banking Union or the European Union. This ambitious, but it will take Europe to where it could go by using branch structures and bring an entire banking group under a single insolvency regime.

4. Conclusion

The chair emphasised the considerable amount of work being done by the Single Resolution Board (SRB) and resolution authorities to make this topic progress. At the same time, there is a perception, certainly on the industry side, that if Europe waits until everything is finalised to let cross-border business flourish again, it might be too late. There is a clear sense of urgency here. Importantly, Europe must ascertain whether further legal fixes are needed, because these will take a considerable time. The regulator summarised the discussion, noting the following key messages. First, the issue of group support is not an obligation for all groups but an additional tool with a stronger legal basis. The issue of pre positioning is mainly an issue for discussion in resolution colleges. This is not a question of whether Europe will have it or not; it is an issue of quantum. If pre positioning is high it could reinforce balkanisation; if it is low, there could be a problem of trust. Europe must find the right balance; this is a task for resolution colleges and joint decisions. The balance between ins and outs, especially in the single market, will be a very important element.

Second, liquidation was clearly highlighted. There are situations in which the bar of the public interest test is set relatively high and then there is liquidation at the national level. There are cases like in Denmark where liquidation would go into normal corporate insolvency without the possibility of deploying an administrative tool. This means the Danish authorities have concluded that all banks must pass the public interest test and will need to be put into resolution. In the single market, this is one implication on the funding costs of different banks. Europe must address this issue somehow.

Third, harmonising insolvency laws will always be challenging, but there are areas where this is possible. Finally, the completion of the safety net via the European deposit guarantee scheme will reinforce trust from host authorities.

Insurance comprehensive risk framework

1. Sources of systemic risk and transmission channels in the insurance sector

1.1. Exposures and transmission channels favouring systemic risk

The discussion opened by first taking stock of the current position for systemic risk and macroprudential elements of insurance. The roundtable was a valuable opportunity to assess what fundamental issues remain in the macroprudential framework. Work has been evolving in this area and IAIS is now bent on an activity based approach (ABA). An official outlined how there has been neither intellectual nor jurisdictional consensus on this topic for quite some time. What exists at the moment has been built internally through IAIS supervisors, but also by taking industry feedback into account. There are three potential exposures that could lead to activities that would generate systemic risk, and two transmission channels. The risk exposures are: activities that generate liquidity risk; significant macroeconomic exposure or synthetic leverage; and counterparty interconnections. The two transmission mechanisms are asset liquidation and the exposure channel.

An industry representative believed the transmission channel analysis is key to understanding how an ABA can address both domino and tsunami types of systemic event occurrence or propagation. Whatever the activity, analysing it through such a lens grants insights on how best to resolve it. An official explained that consensus exists on using a gap analysis to address the holistic framework. Such an approach starts by identifying what tools already exist within the standards, the Insurance Core Principles (ICPs) for all firms supervised by IAIS and ComFrame for the IAIGs. Tools outside the IAIS universe could also have an impact on systemic risk generated by the insurance sector. Once the gaps are identified, policy measures have to be taken to fill them. A regulator commented on the importance of consistently dealing with any gaps in the micro-prudential regime and not creating notably different ways of measuring (risk, exposures, ...).

1.2. Risk detection tools and stress testing already in place

There is an emerging consensus that some ICPs and parts of ComFrame will need to be revised with stronger guidance on liquidity risk and macro exposures. NAIC supported supervisors are developing additional macroprudential analysis, including stress tests, for individual company activities and as part of a cross sectoral analysis. The association believes there should be a common stress test and reporting in order to form such an analysis, although the chances of stress testing discovering the cause of the next financial crisis are slim. If the regulators have an idea of interconnectedness from the way firms react to the same stresses, at least they will be well placed to know how to respond when the time comes.

Version 2.0 of the ICS was described as 'nothing else but a stress test' by an official. It assesses shocks and balance sheets consistently, according to different risks. One could thus argue that compliance with the ICS is one way of implementing stress testing policy, but not the only way. Regulators have to consider ComFrame, filling possible gaps in micro prudential frameworks including liquidity planning in order to build a working ABA.

A regulator found it difficult to assess whether ICS is needed for an ABA to create a proper level playing field. Since ICS is mainly related to a micro view it is difficult to understand stress and ICS outcomes from a macroeconomic perspective. An industry representative likewise had a reservation about capturing the complexity of insurance in one figure, emphasising that since a large number of worldwide players rely on capital markets the insurance sector needs to attract investors, not frighten them away and varying requirements from different standards is likely to diminish their interest.

2. The activities-based approach

2.1. Macroprudential methodologies

At a European level, EIOPA has been working on macro-prudential tools and measures that could also be considered in light of the Solvency II review.

In the US, NAIC has constructed its macro-prudential initiatives. They are focused on the interconnectivity of activities and support a global system to assess systemic risk, but it is important to ensure that any insights gained are appropriate to the cost of implementing initiatives. That cost is ultimately borne by the policyholders and will be rejected if it limits markets or products. These initiatives focus on a number of issues, liquidity foremost, but also exposure concentrations, resolution and capital stress testing.

The goal of liquidity stress testing for large life insurers is to provide reasonable estimates of asset sales by asset type that could hit the market in response to various scenarios. Activities will be compared to sales volumes during normal and stressed times for those markets but, as this type of testing is costly, it may not be necessary for smaller insurers. The real value of systemic risk is that it allows jurisdictions to collect data at a level that reflects the significance of that risk in their local markets. Discussions then continue with global regulators to identify what possible stresses those insurers might be exposed to down the road. An official did not believe the US jurisdiction is moving towards less regulation, but towards more specific regulation that is more appropriate to the type of entity involved.

An industry representative agreed that proportionality is a key aspect of the evolution of the ABA. An entity based approach (EBA) and the G-SII process were useful as a post crisis stopgap but, 10 years on, the industry has learned the

lessons of past regulatory measures. Analogous activities should be addressed similarly, whether carried out by banks, insurers, asset managers or anybody else.

A regulator felt that not only large but medium sized and smaller companies have to be considered in aggregation. This is captured in EIOPA's work, which does not only consider the impact in case of failure of a G-SII or D-SII, but also in case of collective failures of non-systemically important institutions as result of exposures to common shocks. Other work is being developed in parallel in different institutions and although there are sometimes differences in language, all are converging towards the same logic. However, any consideration of the indirect effects on systemic risks remains useful.

2.2. The effect of ABA on the entity based approach and a holistic approach for addressing systemic risk

IAIS recently issued a discussion paper on the ABA, which is being widely discussed. An official hoped their work would contribute to mitigate all systemic risks, but conceded they may find in the future that its implementation or design has not been perfect, as this is the first time this has been done. In particular should systemic risks arise at the individual entity level, consensus will then have to be reached on how to deal with them.

An industry representative supportive of the ABA, questioned whether its implementation meant an EBA would still be needed and if the two approaches could coexist. In the US, an ABA is considered to have more potential value than an EBA in identifying systemic risk. Taking AIG's difficulties during the crisis as an example, an ABA could have identified what was happening earlier and reacted before the mortgage market meltdown. A system to examine activities outside the scope of insurance would have been helpful 10 years ago.

A regulator appreciated the goal of a holistic approach. Everybody accepts that the EBA is not perfect, and the ABA is often presented as a way to get rid of it, but there are no compelling arguments to abandon the EBA. This regulator detected a level of agreement about systemic risks for certain entities, policy and supervisory measures that should be maintained, and thought the holistic approach offers a solution. An industry representative likewise saw the ABA as a promising construct that is clearly still evolving. Their company is heartened by the development of a holistic approach, as a system that addresses both domino and tsunami risks transmitted through asset liquidation and counterparty exposure channels would obviate the need for an EBA. IAIS is due to publish a consultation paper on the holistic approach at the end of the year and aims to finalise its policy by next year. This needs to be peer reviewed afterwards to assess implementation and whether a level playing field is being created. IAIS has no enforcement powers, but at least it can act as a conduit to let supervisors know what others are doing.

3. Scope of the policy

3.1. A proportional approach to the firms involved and level playing field issues

A regulator cautioned that one must apply proportionality when applying any holistic approach to the insurance market. One of the major criticisms of the old EBA is that the size of a company is an overly important element. The regulator questioned whether it can be used as the basis for proportionality assessments in an ABA. Another regulator commented that, in a holistic model, there could be a defined point in the cycle when measures could be applied to some cohorts, based on the size and complexity of their activities. The problem then lay in interconnectedness. In theory, all insurance firms should be subject to risk policies, because systemic risk could be generated by small firms acting together in cohort. An industry representative believed that it is not the size of the entity that matters as much as its activities.

Another industry participant favoured a more principles based than rule based approach. In the first years after the crisis, the focus of policy measures was on a limited number of large players, the so called G-SIIs. This was understandable given the propagation of crisis through the domino effect, namely the bankruptcy of Lehman Brothers and the troubles of AIG. The point has now been reached when a more comprehensive view of the risks in insurance markets can be taken, lifting the focus away from a limited number of players to identify macro risks. One reason this is a good idea is that the focus has been on larger firms so much that some of the risks in smaller companies have been neglected.

Everybody supports properly identifying and measuring risk, and an industry representative gave an example from US derivatives reforms of how proportionality can be used to analyse a problem from an activities perspective. Applying an ABA instead of an EBA focuses on the real issue and eventually entities will be affected anyway. One of the challenges mentioned earlier was that of scope. Conventional wisdom says that that only IAIGs should be affected, but they are usually more diversified and, therefore, less risky than large companies in one country that may be more exposed to a specific market behaviour.

3.2. Data selection and gathering

Another emerging consensus within IAIS is that this holistic framework should continue with the collection of data it has been so far undertaking. There are mixed views on whether IAIS should collect other types of data too.

An industry representative described an ABA as being about how individual activities flow through the system. The end result, properly analysed, leads to the appropriate policy measure. Central to its operation, therefore, is providing the supervisors with sufficient information to understand the key material asset liquidation risks that each firm has, whether there are internal controls in place to monitor them and plans to address any that materialise. NAIC already maintains a good industry database in the US with its 'blue books', which have recently been enhanced.

The same industry representative estimated there are roughly "50 AIGs'" worth of data to be collected under current G-SII assessments, and this will still not properly measure and capture risk. Had the current G-SII assessment been applied to AIG before 2006, for instance, it would not have detected any blip. Perhaps only a thorough dialogue with the regulators will provide the real data insights needed.

An official reported there is broad agreement that the first measures in implementing a holistic framework should be preventative and, therefore, better monitoring is needed. The same official had earlier outlined the three macroprudential exposures and the systemic risk transmission channels. However, collecting data is not relevant to those issues, nor does it properly analyse them, in an industry representative's view. A large bulk of current G-SII data collection can be misleading.

National supervisors are able to advise on doing this within their own jurisdictions, but then a core international data set is needed to take a macroprudential view. As part of this holistic strand, IAIS is looking at a more consistent cross sectoral analysis. One much criticised element of the

EBA is its relative nature, so supervisors are seeking more absolute measures to collect data that will inform their views about systemic risk.

Information is also collected from supervisory colleges that form part of ICS monitoring. Discussions are also ongoing to find other ways to gather more information from these bodies. Another official stated that IAIS needs data to evaluate the actions of group wide supervisors. NAIC's position is that such supervisors ascertain the systemic risk of a company and what policy measures to take, whereas IAIS is a conduit for information sharing and not a regulator itself.

3.3. The possible contribution of ORSA

The European Commission believes ORSA is proving to be an excellent tool, it is satisfied with how it has been implemented through Solvency II and would prefer to keep it unchanged. A policymaker commented that, as it is a company's own assessment of the risks to which it is exposed, it might not be linked to the macro-prudential space. Before considering any potential enhancements to ORSA, the EC needs to ensure that it is used equally across the globe, which is necessary to create a level playing field.

An EIOPA paper was recently published on macro-prudential tools and measures to enhance the current framework, it also focussed on how ORSAs could be enhanced from a supervisory perspective, if individual company documents are read in conjunction to see in which direction a certain market is headed and where macro risks might materialise. A regulator understood such an aggregation to be qualitative, and another regulator hoped that EIOPA's proposals would go beyond this, as Liquidity Risk Management Plans (LRMPs) and their testing could be facilitated through ORSAs. An official commented that firms' stress tests and the supervisory colleges' views combine with ORSAs to generate a more global picture of systemic risk.

An industry representative agreed with some of these points, but emphasised that ORSAs need to be more consistent. By their very essence, a good ORSA should identify key risks for each firm. A group of five or six insurers were already meeting to discuss common approaches to liquidity stress testing. Asset liquidation and counterparty exposure risks change over time, but the purpose of an ORSA is to identify them. The main job of company CROs is to identify risks, make sure they have the tools to monitor them and that plans are in place if they materialise. A level playing field of common standards at least ensures that everyone is testing properly. Another industry speaker endorsed this view.

Contrasting the ORSA and ICS, a third industry participant welcomed any qualitative assessment of the complexities of different companies' activities. The ORSA is a powerful tool, and the requirement to complete LRMPs could be extended beyond the nine G-SIIs. The G-SII assessment methodology identifies potential demands on liquidity currently, but presents an incomplete picture.

3.4. Recovery and resolutions approaches, and liquidity constraints

The risks banks are facing today are important risks, including major maturity risk transformation issues and foreign currency exposures. Banks provide critical functions so, by definition, a handful of banks going down is a problem. The insurance market does not have the same critical function. After a poll of the panel, no participant believed that in 2020 there would be insurance companies designated as G-SIIs.

An official reviewed the policy measures being taken to mitigate systemic risk. Liquidity guidance protects against risk; stress tests against macro exposures; and recovery plans against cohorts of insurance companies transmitting a shock across the system. The holistic framework is likely to include the possibility of a single entity standing out. If that happens, increased monitoring and extra policy measures will be needed. Discussions on pre emptive elements have focused mostly on liquidity, macro exposures, counterparties and related topics, but less on recovery and resolution, which it is generally agreed should have a fundamental role in this framework. There is an active debate on the issue at IAIS and progress is being made towards consensus. The feedback from firms that have participated in the G-SII process is that recovery and resolution planning policy tools have enhanced their dialogue with supervisors. The question then becomes to which, other than the nine G-SIIs, should they be applied? An official's answer was to consider the proportionality question, because these plans are expensive. The official would be inclined to carry out recovery planning for all IAIGs.

One of the G-SII supervisors has carried out recovery and resolution plans, so was asked for his/her perspective on their validity. He/she agreed that even companies with internal models are intensively supervised, but such plans brought better and more helpful insights. Regulators should strive for including IAIGs in scope, but this regulator was reluctant to go beyond this because of resource concerns.

The experience of the US regulators is that the value of recovery and resolution planning stems from improved dialogue, although proportionality always needs to be under consideration. A cost/benefit assessment would help to conclude whether the requirements for G-SIIs should be the same as for every IAIG. There may be a distinction here between what happens in Europe and the US. Under US law, recovery and resolution plans are 'immense paperweights' including some specific conditions defined by the Dodd Frank Act. The European experience is very different, although industry representatives confirmed that a helpful element of such plans is in increasing their dialogue with the supervisor over the process of undergoing resolution and recovery exercises. At the heart of this is understanding the top risks and demonstrating their company's preparedness to deal with them. Lengthy cut and paste documents do not really work. Resolution, in the context of bankruptcy and its legal consequences, should be triggered by the current rules and applicable capital levels. Being forced into resolution when a firm is far from needing it is not helpful.

An audience member questioned how adequate recovery and resolution could ever be put in place when there is no common European protection scheme. A policymaker related the strong case for an insurance guarantee system in Europe, but also for making the single market work properly. This issue has recently been debated within the Commission and the decision taken that it is not a priority at the moment. EIOPA has just issued a discussion paper on the role of insurance guarantee schemes, which it hopes to use to help the Commission think about the new cycle, next year.

4. Jurisdictional issues with regulation and implementation

4.1. International dialogue, coordination and information sharing to create a level playing field

The industry's conviction in applying a comprehensive risk framework to all insurance companies is that a level playing field is needed internationally. The reality of

business means local markets vary considerably. Customer expectations, product characteristics and distribution models are all different. This specific implementation of the framework and its policy measures would thus have to be decided at the local level. This is the distinction between principles based or global regulation and rules based or local regulation.

An industry speaker commented that it is already challenging to agree on these principles and building blocks at the international level, given the different politics of different jurisdictions. In addition, no supervisor knows the businesses and companies they are supervising better than local supervisors. Finding the right risk indicators and policy measures should therefore be local. A regulator agreed with some of this, but felt that the metrics need to be defined at the international level, otherwise there will never be a level playing field.

A policymaker reported significant challenges to completing this work internationally. All agreed there should be proportionality and that global risk monitoring should be taken into account before applying measures on the nature, scale and specificity of business models. The policymaker did not want to see discretionary powers and the possibility of arbitrary exemptions being given to specific firms by national or local authorities. The complexity of these issues is precisely why nurtured dialogue within the industry is required.

EIOPA has been working on international discussions regarding stress tests for liquidity and capital, and is hopeful of driving this work forward. A regulator noted that macro systemic policies are often applied on top of micro regimes that already exist, but differ across the world. An industry representative felt IAIS is uniquely placed to act as a conduit to share information about what is happening in different parts of the world and an official agreed with these comments. The process is therefore bottom up, top down and then bottom up again, from local regulators to IAIS and then fed back down. The jurisdictional supervisors are closest to the risk and best placed to monitor and identify it occurring in their own countries. However, systemic risk is a global issue, so standards have to be global while implementation rests with the domestic supervisors. This industry representative was encouraged by the approach taken by IAIS and trusts it to enable local regulators to do their best in implementing the ABA. A peer review process could help ensure a level playing field.

4.2. Effect on and possible changes to solvency ii and the current regulations

A policymaker wished to ensure that, when developing macroprudential systemic elements in insurance, care is taken to ensure consistency and that contradictions between the micro and macro approaches are avoided. It is too early for the European Commission to add more macro elements to Solvency II but, if more macroprudential measures are included in the European regulatory toolkit, they must be smart and consistent. Banking includes macro and microprudential measures in the same legislation, which brings greater consistency and clarity. This could be replicated for insurance, but not without answering a number of questions first.

This policymaker was open to considering such questions and sees some themes emerging, but the priority remains to capitalise on the macroprudential measures that already exist in Solvency II and make sure they work first. The Commission will review Solvency II in 2020, but it is too early to say what outcomes are likely. There is a need to look at costs and the impact that potential new macro measures would have on micro measures. At the moment, the Commission does not favour any one measure over another.

5. Infrastructure financing

A specific question was put on infrastructure financing, as insurance regulations include a specific capital calibration, yet their eligibility criteria are thought too restrictive. Only a small part of infrastructure project finance complies when the questioner believed infrastructure projects to be less risky than unsecured corporates. A regulator has found no evidence of such. In fact, infrastructure could entail greater political risks and an insufficient number of opportunities. Another regulator pointed out the amount of cheap money around. When interest rates go up, yields will probably rise too and such projects will become more attractive. The industry will need to make an assessment of the criteria used to define infrastructure asset classes and how they work in real life. It will evaluate, based on recognised recovery rates and advise the Commission on what treatment to adopt.

Benefits and risks of market-based finance activities and ETFs

1. Characteristics of the EU ETF market and underlying drivers of their growth

An industry representative explained that currently 80% of the global ETF market is US based, with Europe representing slightly less than 20%. The main differences between the EU and US ETF markets were highlighted. Europe is mainly an institutional market with those investors representing over 90% of the market, compared to 40% in the US. A second difference is that ETFs are predominantly sold OTC in Europe (70%) whereas in the US they are mainly exchange-traded. Thirdly, regulatory frameworks differ. European ETFs are structured as UCITS but also come under the regulations of listed securities notably MiFID II. They are therefore subject to a broad set of requirements, which creates a very protective framework for investors and makes ETFs compatible with retail investment, the speaker claimed. Convincing more retail investors in Europe to take risk is however challenging, even if this normally goes with more return.

Another industry representative stated that ETFs originally had more of an 'index mentality'; now they have expanded beyond being 'plain vanilla capital market weighted constructs', but that is still where the majority of assets sit today. The utility of the ETF delivery vehicle as an index construct is to create access to relatively low cost diversified exposures that facilitate an institutional-type approach to portfolio management and also offer end-investors higher return than lower-risk cash-like vehicles. This entails a top down asset allocation approach rather than investing in individual securities or attempting to beat the market. The asset-allocation approach of ETFs and their operational simplicity are the main reasons for their growth globally. Another benefit for end-investors is

that ETFs, as hybrids between an investment management and a capital market product, are more flexible in the way they are traded and priced.

The ETF market is changing and entering a new phase following the initial 'land-grab' approach to gain market share. There is now a great deal of competition in the market and securing the correct distribution footprint in order to make ETFs accessible to the widest range of clients is the main challenge ahead for their managers. Ultimately ETFs are a delivery vehicle that can be structured under different frameworks including UCITS or '40 Act structures. The way ETFs trade in the market is another potential area of improvement. Initially the same rules applied to ETFs and ordinary stocks. Over time some trading venues have started realizing that ETFs need their own set of rules, but more thinking is still needed to improve the ecosystem around ETFs.

A third industry representative felt that ETFs are one of the most successful innovations in the investment fund market in recent decades. Their success has been driven by two factors: cost efficiency and convenience. US asset managers in particular have flooded the European market with ETFs and there is very high demand at present for these funds in Europe. ETFs are an appropriate and convenient instrument for the implementation of asset allocation, especially for institutional clients and therefore contribute positively to diversification in the market. Their transparency, cost-effectiveness and liquidity are also likely to attract retail investors. However, they are not a panacea or a standalone product. Product diversification is still essential and should include ETFs as well as more active products.

2. The challenges and risks raised by ETFs

2.1. No major financial stability risks have materialized so far from ETFs

A regulator explained how more and more questions and concerns have been raised about ETFs as their assets under management (AUMs) increased. Many potential risks associated with ETFs have been identified over time, but this has been done so far mainly on a theoretical basis. Some specific risks have been addressed by dedicated UCITS measures (Guidelines on UCITS ETFs) and IOSCO guidelines, such as the counterparty risks related to swaps or securities lending activities that ETFs engage in. Other risks posed by ETFs include liquidity risks, price formation issues and risks related to ETF arbitrage strategies. The existence of financial stability risks was also suggested following the August 2015 flashcrash and continues to be questioned, but there has not yet been real evidence of such risks in connection with ETFs, the regulator felt. One first factor to be considered is the size of ETF markets compared to the total size of the securities market. When looking at France for example, the ETF market is currently too small to pose a risk to the overall market or to financial stability. In addition market mechanisms such as circuit breakers used by stock exchanges[1] have so far proven to be efficient in avoiding a disconnect between the price at which ETFs trade and the underlying Net Asset Values (NAVs). Potential impacts on underlying markets need to be closely monitored nevertheless, as well as potential liquidity risks particularly in stressed market conditions. ETFs have the potential to improve liquidity in the market, but at the same time investors are exposed to the liquidity of the underlyings in which they invest. Additional data provided by MiFID II requirements in particular may help to better understand the relevance of these risks. An industry representative agreed that until now nothing bad has happened in the ETF market despite some stress periods.

An official stressed that although the risks of ETFs appear relatively manageable and controllable in light of the analyses conducted so far, it is essential to consider the 'scenarios of failure' that can arise as a consequence of ETF specificities or of the growth of the ETF market. These scenarios must be assessed without regard to how likely they are, so that relevant and proportionate policy measures can be formulated if necessary. Afterwards, there can be discussions about the likelihood of these scenarios.

2.2. Specific risks associated with the role of Authorized Participants (AP)

An official believed that the key scenario of failure for ETFs is the possible failure of the Authorized Participant (AP) mechanism[2], which is the main distinctive structural characteristic of the ETF market. The main issue with APs is that they are under no obligation to continue their activities for a given ETF. Their incentive, as for many other participants in the capital market, is making profit from arbitrage, another official explained. Largely speaking there is no enforcement regarding APs beyond the contracts they sign, however there is a trade-off in this, because stricter enforcement could lead some APs to leave the market. In addition, the ETF mechanism is not completely dependent on APs since other liquidity providers or market-makers can engage in this area on an agency basis. The first official suggested that a debate was needed about the AP mechanism and the standards that may be necessary to further secure it: e.g. voluntary standards or compulsory standards or better disclosure.

An industry representative explained that APs are essential to the functioning of ETFs: their role is to facilitate the continuous trading of ETFs, which is different from the usual daily redemption and subscription scheme used by other mutual funds. Management companies are indeed not able to issue and redeem fund shares on a continuous basis without the AP mechanism. The speaker noted that their firm is very attentive when selecting APs and that APs sign an agreement with the asset managers they work with, but APs have no special privilege. They have to follow a certain number of rules (for example the commitment to have a limited bid-ask spread e.g. 1.5% on euro stocks). It is however increasingly difficult for APs to make profit out of their activity, which is relatively ordinary trading, mainly due to prudential banking regulations which have led to a reduction of capital-market activities on the books of banks.

Another industry representative added that to become an AP, potential providers must undergo a somewhat rigorous on-boarding process, because they are major counterparties for asset managers and the interaction with them needs to be stress tested. APs should therefore be distinguished from other market-makers, although APs may in some cases, also operate transactionally. APs exist as a middleman, making small amounts of money by facilitating the 'creation and redemption' process. If one of them steps back from its role and there is money to be made in this activity, new institutions will fill the void. This happened in 2008 when many of the largest banks reduced their AP business lines, which opened up opportunities for smaller trading firms. Since then, large banks have returned to the AP business because they have a new approach to their balance sheets after having passed the stress tests, and it is a relatively riskless arbitrage activity.

2.3. Investor and distribution related issues

An industry representative described the challenges associated with retail investment in ETFs. Generally speaking, European retail investors, who are heavily reliant

on pay as you go pension systems, lack financial know-how and are quite risk averse. ETFs are often presented as a do-it-yourself product with no advisory sales process due to their relative simplicity and the passive nature of the product. Their costs are low and they are in some cases offered at zero-cost. Thus investment decisions and responsibilities mostly rest with the investor. The problem is that retail investors are not always aware of the risks they may be faced with such as volatility and related liquidity risks. Although ETFs are appropriate products for retail investors, financial education needs improving and the Capital Markets Union (CMU) action plan needs reinforcing in this area. This issue cannot be totally solved by product or distribution regulation or the development of automated advice offered on robo-advisor platforms. A further issue is the reputation risk for asset managers providing ETFs. Although the responsibility lies with the investors, the asset manager's reputation will be at stake if something goes wrong.

An official did not feel able to give a conclusive answer on whether ETFs are good or bad for retail investors and for the market. Many investor-related issues have been addressed in the IOSCO 2013 principles for the regulation of ETFs, which aim to facilitate discovery and cover two main areas: (i) investor protection issues that have led to ETF classification and relevant disclosures for investors and (ii) issues related to the structuring of ETFs including the management of potential inherent conflicts of interest and counterparty risks arising from physical and synthetic replication methods. The growth of the ETF market over the recent years and the greater diversity of products are however reasons for a renewed approach to the risks they may pose. On investor related issues, IOSCO is considering naming and classification systems, which would build on its work from 2013. IOSCO is also looking at the role of ETF managers in product design and ongoing monitoring, which is especially important for ETFs, which are marketed as highly liquid assets with excellent availability of trading. IOSCO is also seeking to better understand the different types of redemption that exist such as redemption in kind and the responsibilities of ETF managers in this regard. Generally the picture at the global level is very diverse with different types of strategies, asset classes and trading strategies used (i.e. on-exchange or OTC), depending on the jurisdictions. There are also other disclosure related issues regarding the risks and costs of ETFs that need considering, the official noted. Risks concern the arbitrage mechanisms, the risk transmission which can happen between the primary and secondary markets and the role of the APs mentioned previously in particular, as well as some specific issues such as the meaning of trading halts and suspensions for ETFs or the role of HFTs. Cost disclosure issues concern notably trading costs and how NAV or iNAV (indicative NAV) are calculated.

Another official mentioned that the distribution system of investment funds in Europe is often criticized for its high costs. Questions are also raised about the conflicts of interest and the impacts on competition that the vertical integration of banks and insurance companies distributing mainly the funds of their asset management subsidiaries may create. This is considered to be one of the reasons for the relatively high number and small size of funds in the EU and the limited level of cross-border distribution. Proposals have been made by the Commission for improving the cross-border distribution of funds, which should also be facilitated by the European PEPP regime and technology. ETFs are an interesting test case for the European fund distribution system in this context because they are a suitable product for a significant portion of the market. The question is whether European distribution channels are able to distribute ETFs sufficiently widely to the people for whom they are the right product, which would support the achievement of the CMU and reduce costs for investors.

2.4. Other potential risks posed by ETFs

There are several other possible scenarios of failure associated with ETFs, an official stated. One that is not specific to ETFs is herding risk if all investors suddenly move in the same direction. Some sophisticated index labelled strategies also raise questions in terms of investor protection. Another issue to be considered is the impact that a possible failure of the ETF market may have on the liquidity management plans of many financial institutions such as banks and asset managers for which ETFs play a significant role.

Some uncertainties associated with the ETF market need to be addressed as well, the official pointed out. There are some uncertainties around the difference between ETFs and other exchange traded debt products. Some elements could also be more closely monitored, such as the deviation of ETF NAVs from market prices (how many times and how long prices may deviate) and the relative liquidity of ETFs versus the liquidity of their underlyings, which could help to better identify possible fragilities of ETF liquidity. Whether there are any particularities in relation to the stress testing of ETFs compared to other UCITS is another aspect that needs to be further assessed. Some questions are also raised in Europe notably concerning the capacity for direct redemption of funds in periods of stress and whether a specific policy is needed in this regard.

An industry representative added that with ETFs there is a risk of reducing the diversity of corporate governance. Asset managers actively use shareholder voting rights. In terms of fiduciary duty, responsible corporate governance takes account of long-term economic goals and is also a prerequisite for a sustainable Europe. With a rising proportion of ETF companies executing their voting rights in a growing ETF market, there could be a danger of concentrating voting rights at annual general meetings. Keeping sufficient diversification is necessary both in active and passive products as well as in terms of the number of ETF companies in this regard.

3. Data challenges associated with market-based finance activities

Introducing the second part of the discussion on the risks associated more broadly with market-based finance activities, an official outlined that risks affecting the financial sector are developing with a combination of financial imbalances and geopolitical risks. How this may impact the financial industry and the level of systemic risks is being assessed. Many believe that the asset management industry does not multiply risk but helps to absorb it. But when the world is becoming more intrinsically dangerous, absorbing substantial quantities of risk can be problematic.

An official emphasized that market based finance is a very vast and diverse sector that is made up of many different silos. It is important to better understand how the different components of the sector interact to assess risks. But to do that, it is essential to have the data to understand these interactions and where risks lie.

A regulator pointed out that much has already been done to strengthen the market-based finance sector, particularly in Europe and agreed that it is now necessary to focus on interconnections with other parts of the

financial sector, which are important in Europe. This requires better understanding the combined impacts of existing rules on firms and the functioning of capital markets and whether market participants are capable of cooperating appropriately to address potential risks that may emerge. More work is needed on the data that is coming in following the implementation of EMIR and MiFID II and the upcoming provision of data from SFTR and the MMFR. This will help to ensure that the industry's resources are focused on areas of emerging risks or where potential issues are highest.

An industry representative suggested that the authorities should first specify what they are going to do with all the data that is sent to them by market participants. Another industry representative felt that further efforts are needed to improve the data. For markets to be fair and efficient, transparency is needed so that informed decisions can be made. But part of the huge amount of data that is analysed at present is 'garbage'. Efforts must be made to improve the data, identify a common set that all market stakeholders (market participants, regulators, policy-makers, academics) can work on to develop the best level of thinking on the market and processes must be designed to discuss the data on a regular basis.

An official agreed that data is a major priority. From the point of view of macroprudential authorities, there could be a qualitative jump in terms of the identification of risks through the use of granular data, the richness of which is unprecedented. Progress should be possible in the relatively short-term with the implementation of regulations and the investments being made. The data from EMIR is now being used intensively by regulators and supervisory authorities and being discussed by the leaders of these institutions (governors of central banks, chairs of supervisory authorities) and policy conclusions are being drawn up on the basis of this data. Data from AIFMD and SFTR will also soon be available. The official added that it would be useful to discuss with the industry how all market participants can benefit from the data, and it is important for regulators and supervisors to give feedback to the industry on this. However, sometimes the quality of data collected by trade repositories is very bad and it is then difficult to make sense of it.

Another official underlined that the operational risk associated with outsourcing is a major issue facing the financial sector at present, including market-base finance activities. Generally speaking, European financial regulation is based on the idea that a firm acquiring a licence will then perform most of the activities itself. However, this is less and less the case. Firms increasingly use different types of providers to conduct their business and the risks associated with this growing trend need to be appropriately assessed.

1. Euronext uses circuit breakers. Euronext publishes iNAV (indicative NAVs) every 15 seconds and requires trading to be done on the secondary market within a prescribed range, either 1.5% up and down or 3%. Beyond these borders, trading is suspended for 30 seconds and can be renewed.

2. Authorized participants are responsible for acquiring the securities that the ETF wants to hold. In return, authorized participants receive a block of equally valued ETF shares called a creation unit. They do not receive directly compensation from ETF sponsors and have no legal obligation to redeem or create the ETF's shares. Instead, authorized participants are compensated through activity in the secondary market or service fees collected from clients wanting to execute primary trades.

BREXIT IMPACTS AND GLOBAL REGULATORY COORDINATION

Are the contours of the of future EU-UK financial services trade relationship in sight?

1. The remaining options for EU-UK financial services relations post-Brexit

1.1. The UK proposals of the July 2018 White Paper

An official noted that there has been a shift in some of the UK proposals in July 2018. The UK had previously proposed having an arrangement of mutual recognition with the EU for financial services, which it considered to be the most stable and predictable way to manage the UK-EU relationship. By July it had become clear that the UK did not have enough EU support for it to be in a negotiating position that would move sufficiently swiftly. The UK White Paper published in July states that the UK will provide an arrangement that recognises the sovereign processes for the assessment of equivalence that would exist in each jurisdiction after its departure from the EU. In the EU, there are existing processes for equivalence decisions and the UK will have to develop its own sovereign decision-making process on equivalence. This approach will provide the UK and the EU with access to each other's jurisdictions in a way that is sound and transparent and that addresses financial stability concerns as well as the scale of the exposure between the two jurisdictions.

The reason why the UK thinks that it can live with this shift in its position is that the other components of the proposal have not changed, the official underlined. The UK continues to advocate a deep and developed regulatory dialogue between itself and the EU, which is still part of the proposition. Supervisory cooperation allowing e.g. the sharing of information appropriately and cooperation if a crisis arises is indeed essential with the scale of business happening between the EU and the UK, because regulations alone cannot determine an appropriate outcome for both jurisdictions. The EU already has successful dialogues up and running with other major jurisdictions and the same will need to be fixed with the UK, possibly with greater intensity.

For equivalence to work, clarity is also needed for market participants regarding the way equivalence decisions are made and how they may be withdrawn. The predictability of the process is indeed an important factor for ensuring that equivalence can support a substantial quantity of business. Autonomy is also a very important point. The UK does not envisage any supranational authority that would arbitrate decisions in the event of disagreement between the EU and the UK. Appeals about these decisions would be made within each regime i.e. the Supreme Court in the UK and the European Court of Justice in Europe. Thought is needed in addition about the scope of the equivalence regimes, which do not exist for all EU financial regulations since they were never intended for a relationship as developed as the one between the UK and the EU.

Regarding possible other options, the official explained that the White Paper is the only remaining proposal on the table on the UK side, the alternative being a hard Brexit. A hard Brexit in financial services is absolutely not the UK's preferred scenario but it is essential to prepare for it, given its potential impacts on the UK and global markets. In order to ensure continuity in regulatory requirements the UK is on shoring the entire EU acquis into UK law so that there are no differences in the requirements and the compliance of firms between March 29th and April 1st in the UK.

An industry representative felt that although significant progress has been made in the discussions about Brexit, the existing EU equivalence regime would not work for the private sector as it will provide insufficient certainty. Not all EU directives are drafted with equivalence regimes and those that are were not drafted for this purpose. The most important problem is that equivalence can be withdrawn at short notice. The EU should keep the right to withdraw equivalence, but this should not be possible without a notice period because removing this certainty overnight could make the situation worse and this issue is not addressed in the directives. The official emphasized that the predictability provided by existing equivalence arrangements is largely untested and agreed that serious thought is needed about how to ensure this. The use of equivalence arrangements will have major impacts on the business models of UK-based financial institutions because of the scale of the business involved between the UK and the EU and these impacts need to be appropriately anticipated and addressed.

1.2. The EU's position on future EU-UK financial services relations post-Brexit

A policy-maker stated that the EU has been quite clear as to how it sees EU-UK relations going forward. It does not see mutual recognition as the way forward; instead, there would be three components in the relationship. Firstly, there would be a free-trade agreement component, similar to the one the EU has with other countries such as Canada and Japan. The second component is regulatory dialogue, with the likelihood that a more intensive dialogue will be needed with the UK than those that already exist with other third-countries. And thirdly, the EU has a preference for using equivalence as the tool with which to handle interactions with third countries. The UK will have its own equivalence regime following the White Paper proposition, so how the EU and UK regimes fit together will need to be assessed.

There are many areas of convergence between the EU approach and the White Paper, the policy-maker remarked. Equivalence is the basis in both cases and there is an agreement on both sides to keep autonomy in rule-making and decision-making. There is also an agreement to pursue a full and intense regulatory dialogue and to put in place the structures needed for this to happen.

Where there is more reluctance on the EU side concerns the suggestions made by the UK to add certain formalistic elements to equivalence, such as a specified

timeline for withdrawal. Abrupt decisions concerning equivalence will be highly costly, so there is a type of "auto control" on this that would prevent unecessary sudden withdrawal. Many of the other enhancements to equivalence which are being suggested in the White Paper cannot be accepted by the EU either. The EU is not convinced that binding dispute-settlement processes are necessary for example. The current EU equivalence system is successfully used with other third countries such as Japan or the US and should therefore be workable for the UK. The policy-maker added that the EU is now at the end of its proposal phase for this particular cycle and has to prepare for the European elections. It is therefore difficult to see further proposals about enhancing equivalence in this mandate, beyond what has already been proposed in EMIR 2.2. Another issue is that if further proposals were made, their implications for all other third-country equivalence partners would have to be examined, since these changes cannot be made specifically for the UK or related to Brexit.

A market observer believed that the main implication of Brexit for the EU27 in the financial area is the need to ensure financial stability over time and the only way to achieve this is the current equivalence regime. The EU regulatory and supervisory framework is closely integrated with common rulebooks, the European supervisory authorities (EBA, ESMA, EIOPA, and the ESRB) and the role played by the ECJ. For the euro area the Banking Union has moreover been created, but part of the euro market is in London and outside the jurisdiction of the ECB. Before Brexit the EU felt it could live with that situation because the UK was part of the EU framework in place, but a new approach will be needed post-Brexit. Procedures and commitments proposed in the White Paper that may challenge the autonomy of EU decisions are problematic in this regard because if there is an abrupt financial stability problem threatening the EU, then immediate action is needed to change, reduce the scope or discontinue equivalence. Equivalence must remain unilateral, not only in principle but also in practice and the EU authorities cannot be tied by any commitments with regard to these agreements. This does not mean that predictability and transparency cannot be improved, for instance with a better monitoring over time of the evolution of the regulatory frameworks of third countries after they have been considered equivalent. This would help to anticipate and mitigate possible issues and avoid abrupt changes, unless they are absolutely necessary for unforeseen financial stability reasons, but this requires a monitoring framework that does not exist at present.

An official considered that there is potential to increase the transparency of the equivalence processes regarding prerequisites, impediments, potential consequences and decision timelines. Regarding the status of the EU legislative process, there are still more than 30 open dossiers that need processing. However, if equivalence is retained as the basis of the future EU-UK relationship, it is likely that further proposals will be made to enhance it. Examining the detail of the EMIR 2.2 proposal can give a first idea of the nature of those additional elements.

1.3. The need for close supervisory cooperation

An official stated that the EU-UK relationship should remain as close as possible. Detailed assessments of financial stability risks are needed, as well as regular supervisory interactions to ensure effective compliance with regulatory requirements and to avoid divergence over time, which is neither in the interests of the UK nor of the EU. This calls for close supervisory cooperation after a positive equivalence decision has been made and more formal agreements concluded on this between supervisors.

A market observer considered that the framework to implement close supervisory cooperation already exists to a large extent. Supervisory and regulatory cooperation has been considerably strengthened at the global level since the crisis with institutions such as the Financial Stability Board (FSB) and the Basel Committee for Banking Supervision (BCBS). Supervisory colleges also work on a global basis and should be extended to all institutions that need one.

An industry representative concurred with the need for transparent supervisory cooperation. Before and since the crisis there has been close cooperation between the UK PRA and FCA and the Fed and this cooperation should also include other European and domestic supervisory authorities such as the ACPR, BaFin and ECB.

A policy-maker agreed with previous speakers that equivalence agreements should be monitored more closely over time. Equivalence decisions are made in the expectation that rules will remain convergent or become more convergent under G20 arrangements. The fact that private companies are so concerned about predictability suggests however that the sector is expecting and preparing for divergence. In that perspective, Europe will want to maintain its decision making autonomy. The possible financial stability risks associated with the post-Brexit situation with or without a deal also need to be further evaluated, which should be easier now that there is an agreement that equivalence is the only option available. An industry representative pointed out that the private sector is not looking for divergence, because many financial institutions operating in the capital markets are doing so on a global scale and this cannot be done if rules diverge too much. What the private sector is looking for is more certainty and on the contrary the least divergence possible, because that is what is needed to make the financial market operable.

2. Approach for framing and implementing a possible EU-UK agreement

2.1. Approach for framing the agreement legally

An official stated that the obvious legislative vehicle for framing the future EU-UK relationship is the withdrawal agreement, which is about closing out the UK's EU membership. The UK would have within the related treaty an association agreement, a free-trade agreement, or a collection of agreements with the EU that determine the end-state relationship. Indeed, one cannot solely determine the relationship on financial services through the EU acquis and the UK sovereign legislation. What is needed is a structure that draws it together into a framework to ensure coherence and to establish principles and common goals that provide some form of predictability in terms of what the EU and UK are collectively aiming to achieve.

Another official stressed that although there has been a significant shift in the positions to show convergence on the basic option of equivalence for the future state of financial services, the progress on the overall withdrawal agreement is much slower and there is still a risk of having no overall agreement.

An industry representative emphasized that implementation is also a key question and so is how everything will "join together" so that post-Brexit scenarios are actionable. There will be a large amount of work to do after March, but a timetable of different workstreams is needed on which people can agree, sign up to, and implement.

2.2. The need for a transition and implementation period

An official underlined that however prepared the public authorities and private sectors are for a hard exit, it remains a difficult outcome to live with, which is why achieving a withdrawal agreement, getting an implementation period and using that implementation period effectively are essential. In terms of delays, wishful thinking about the Brexit process should be avoided on both sides, because deadlines are not extensible. It is now a matter of UK law to leave the EU on 29 March 2019 and there will be no UK MEPs in the future Parliament.

An industry speaker emphasized that clarity about the transition and implementation periods is essential for the industry. Another industry representative suggested that in terms of implementation a two-step approach is necessary. After reaching a detailed agreement, an implementation period is needed, because the current transition period of one year and nine months looks more like a negotiation period to reach a more detailed framework.

3. Main short and medium-term challenges raised by Brexit in the financial services sector

3.1. Contract continuity issues

An official underlined that in December 2017 the UK had announced that it would establish temporary-permission regimes for its regulators to enable them to help firms over a cliff-edge and allow them to continue to operate smoothly in the UK. Some issues cannot be entirely unilaterally managed however, such as contract continuity in cleared and uncleared derivative markets, insurance, and data, for which there is a need for a bilateral and cooperative solution. A working group between the ECB and the Bank of England has been established to discuss and map out pending contract continuity issues, but it is essential to move now to discussing the solutions that can be achieved between the UK and the EU, to ensure that they work and that unintended consequences are identified and to help clients to plan for these solutions.

A policy-maker stated that the problems associated with a no-deal scenario need to be mapped out before coming forward with solutions and this is currently being done. Solutions should indeed be commensurate with the actual problems that need addressing. When the continuity of contracts was initially examined it looked like a major problem. Further assessments however showed that derivative contracts can be serviced post-Brexit, except for certain events or changes in those contracts. In addition within the 70 million insurance contracts that are potentially concerned by contract continuity issues, a very large number are very short-term.

Despite this, an industry representative was extremely concerned about the enormous level of complexity that has to be handled in a limited timeframe. Although the number of insurance contracts concerned by continuity issues will not be as high as 70 million, these will be the most complex wholesale ones related to the aviation market in particular. These issues potentially impact businesses and households and resolving them will take a great deal of time.

A market observer stated that if a transition period cannot be agreed there will be many operational issues and risks related to contract continuity and repapering in particular. The European Commission must be prepared to enact unilateral equivalence legislation in this case, as the UK has done.

3.2. Liquidity fragmentation and market disruption concerns

An industry representative claimed that their biggest worry in the short-term is fragmentation of liquidity. The largest banks are working on this but the industry as a whole is only as good as its weakest link. It is necessary in particular to ensure that Financial Market Infrastructures (FMIs) have an appropriate Brexit plan in place and that the system is being tested end-to-end. The problem is that there is no one making sure that the whole end-to-end process will work post-Brexit. Entities are making their own adjustments and everybody is hoping that the process will be joined up at the end, but that is unlikely. The priorities before March 2019 are to clarify how liquidity and risk will move post-Brexit, and if the flow between the UK and the EU will be optimal. Arguably many clients of financial institutions are not ready and if an institution is ready but its clients are not, then the appropriate changes to the business will not be made. The key question is what the "forcing function" is to get European corporates to prepare for a hard Brexit.

Another industry representative added that many customers are worrying about market disruption in case of no deal. Some have already taken pre emptive action without knowing the final outcome but it is not clear if they have made the right choices. There are warnings to prepare for a no-deal situation, but for businesses more clarity is needed on what the outcome may be. If the EU and the UK split up and there is regulatory fragmentation, it will increase operational costs for third-country banks and their customers in particular without increasing profitability. Therefore, while Brexit negotiations are bilateral and sovereign between the UK and EU, the cliff-edge and related issues will harm the attractiveness and competitiveness of the whole European market and also impact third country entities. The EU will nevertheless remain a very important market notably for Japan and it is encouraging that an agreement on an economic partnership has been reached between the two. This includes a very strong framework for a financial regulatory dialogue mechanism and it will become bilateral between Japan and the EU27 in the case of a no-deal Brexit.

A market expert noted there will be unavoidable extra costs from Brexit, but hopefully these will be relatively transitory. The level of concentration of the European capital market in London is fairly recent and is the result of the addition of the single market rules and of the euro. This was not the case 25 or 30 years ago, when there were several financial centres in Europe. In the US the landscape is also more decentralised with Chicago and other cities than New York playing a significant role. In recent decades there has also been a large development of markets. If Europe can make a more decentralised market work, there could be a very efficient and open European capital market in 20 years' time despite Brexit.

3.3. Connection with the CMU initiative

Some panellists highlighted the link between the future relationship between the EU and the UK and the Capital Markets Union (CMU) initiative, which is a major objective and challenge for the EU going forward. So far, London has been Europe's main capital market centre, an industry representative underlined, therefore maintaining a close relation between the EU and UK is essential for the CMU. The question going forward however is whether Europe wants a closed and regional European capital market or an open, global market. That will determine the nature of Europe's relationship with areas such as the UK, Asia and the US. The depth of liquidity that Europe will get may be insufficient in a closed market for the purposes of fuelling the European economy given the limited share represented by pension funds in particular. In France and Germany, pension assets are less than 15% of GDP, compared to over

120% of GDP in the US and UK. All major capital markets have developed by being open, and while the private sector wants to contribute developing these markets in the EU, it needs to understand what the plan is.

Another industry representative claimed that an open Europe is needed. Their company has a global booking model which is understood by the main regulators and other European regulators are gradually incorporating this into their thinking.

A policy-maker stated that the CMU will be open, not closed. Openness is possible, as long as Europe can manage financial stability risks in a way that is effective and accountable. An official agreed that the objective should be to achieve an open global market so long as sufficient financial stability safeguards can be put in place.

Tackling the short-term operational and practical challenges of Brexit

1. Progress made over the last 6 months

1.1. Overall progress made in the preparation for Brexit

An official stated that there has been some progress in areas that can be dealt with unilaterally and in the understanding of the issues at stake. But major risks remain in some key areas such as cleared and uncleared derivatives, insurance and data where further progress has been hindered so far by the underlying politics. The UK government has committed to put in place temporary-permission regimes to ensure that, if there is no transition period and authorisations cannot occur in time, EU firms will be able to continue to operate in the UK under this temporary regime until authorisations can be completed. Those statutory instruments have been laid in Parliament already. Quite soon, the UK will also unilaterally lay statutory instruments on contract continuity to ensure that contracts can continue and EU firms can perform on contracts with UK counterparties, and vice versa. Secondly, there is now a better collective appreciation of the scale and impact of the issues that need tackling. Brexit is something new for the financial sector. Given the size and complexity of the sector in the UK the impacts have been analysed in depth by the UK authorities and market participants also have a better understanding of the implications. In some areas, the public sector will need to take action, the official believed, because the private sector cannot solve all of these issues.

Another official stated that there is a fair degree of convergence about the list of issues that need to be dealt with, including contract continuity, access to CCPs and data-sharing. These issues however have to be analysed with more granularity. The problems are not the same across all financial activities and the most critical ones relate to some insurance and derivative contracts. Further analysis is needed to identify precisely the problems that need addressing as a priority and what is at stake exactly. Detailed assessments on contract continuity in particular are still being conducted by lawyers.

A third official stated that 12 months ago, most questions were about the approach of EU supervisors to authorising firms that were going to come to their country. Cooperation between central banks, the ECB and the ESAs has helped to address the main issues in this respect. Progress is also being made on the assessment of contract continuity issues in the group set up by the Bank of England and ECB. This gives hope that these very complex issues can be appropriately tackled.

An industry representative felt that the main issues that need addressing in the context of a hard Brexit are well identified. The financial industry learned from the crisis that it is incumbent upon them to be well-prepared to serve clients in this context and many discussions are taking place with the public authorities about the types of actions that need to be carried out. The issue however that gives the speaker pause is that, with the persistent uncertainty about the final Brexit scenario, the closer any decision comes to the 29 March the more likely a negative outcome is. The financial industry needs to manage this situation in order to accommodate that uncertainty, but the short amount of time remaining is a major concern.

1.2. Current level of preparation of market participants

An official was concerned about the general speed of adaptations to Brexit in the market. Although progress has been made by the larger financial institutions, other players are on average less advanced. Another official confirmed that the larger firms have made 'huge' efforts to prepare for Brexit and should be able to continue providing services with no disruption to their clients whatever the scenario. That will be more challenging in the case of a 'no deal' for smaller financial firms or those that provide cross-border services without an establishment on either side of the Channel. However, even if the outcome on 29 March is a 'no deal', that would not be the end state. Temporary permissions can be granted and supervisors will be monitoring how the situation is evolving over time. Yet, more needs to be done by certain players. Another official also saw a high level of engagement of insurance firms in the preparation for Brexit, whether they are third-country branches or subsidiaries. This involves an enormous amount of management and operational tasks, but supervisors are concerned that there is still a lack of detail about some of the steps that firms are going to take, particularly in terms of trigger points, dates for decisions and time needed to conduct these actions.

An industry representative stated that, from a private-sector perspective, the issues that need to be tackled in the perspective of Brexit are relatively simple and could easily be resolved if they were dealt with one at a time; the difficulty is that all is coming at once, which causes a significant resource challenge and risks are increasing as time goes by. The speaker's firm is in the process of obtaining approval for a new subsidiary in Frankfurt that will regroup the business of five existing branches. This process takes more than 6 months and many tasks that need to be undertaken to prepare for Brexit (more than 40%) can only be started once regulatory approval has been obtained for this subsidiary. This includes for example obtaining access to market infrastructures (e.g. SWIFT, BIC, payment systems…). By the time the authorisation has been obtained, less than 6 months will remain to finalize all these actions in case of a no-deal Brexit. But such transfers are complex, involving multiple issues (asset transfers, customer consents, local filings, etc.). In addition, specific delays are fixed in some cases e.g. regarding authorisations to access market infrastructures or the hiring of local staff when people have to respect notice periods. Some special

arrangements will need to be put in place by the public authorities for dealing with the remaining issues that cannot be tackled in time by the financial industry, the industry speaker believed, addressing both some technical details and some broader issues. However, such measures should only be temporary.

Another industry representative saw a great deal of 'movement' happening, but was frustrated by the difficulty of actually finalising these changes due to the multiplicity of actions that need performing and the current uncertainty about the final Brexit outcome, which increase the level of risk.

The speaker's firm started its Brexit planning one year ago based on the assumption that there would be a hard Brexit, at a time when that was not the most widely-shared option. Their objective when starting this planning was to ensure that clients could be serviced seamlessly, wherever they are based. This led to planning some specific organisational changes to handle this situation, which are now being put in place. The first one is to create an EU-based bank through the merger and transfer of existing entities, which requires an application process and court procedures that are underway and should be completed by December 2018. The second change is to establish a new investment firm to conduct the activities that cannot be performed within the bank and an application process is also underway for that entity. When considering the amount of work that is required for setting up what is in effect a new bank and a new investment firm, there is a cumulative effect that builds up, which further increases the level of risk. Besides the licensing process, a great deal of ancillary activities are needed that are costly and lengthy to implement: i.e. setting up the systems and the operational capabilities of the entities; repapering clients; connecting to the different market infrastructures; facilities work to renovate and expand offices. There is also a significant HR dimension in the project that is often overlooked, with people that need transferring and responsibilities that need redefining.

1.3. Level of preparation of end-customers

An industry representative stated that most customers have not yet really started their operational preparation for Brexit because the evolution scenario is still uncertain and financial institutions cannot provide definitive answers on the choices that need to be made. In addition, some institutions are still in the process of setting up a subsidiary in the EU, which is the starting point. This uncertainty may have detrimental effects for clients, with some of them wanting to start transferring certain assets for the sake of safety, which might turn out not be the most appropriate ones, thus risking to create further disruption in the market.

Another industry representative added that meetings about Brexit preparations often only address the issues that financial institutions are facing, but rarely what clients need to do in this context. Financial institutions such as the speaker's institution are striving to set up new entities in the EU as quickly as possible and are discussing with their clients the implications of these changes for them. The objective is to repaper clients into new EU entities as soon as they are licensed and set up. Clients have not moved much so far, the speaker confirmed, but they will probably do so when the Brexit date comes closer, which is why moving as fast as possible to create EU entities is essential, as well as monitoring the situation very closely.

A regulator underlined that the major industry players are counting on their banks to help them in the transition process towards Brexit. The problem however is that they are often reticent to make the changes needed for repapering until the Brexit outcome is clearer and banks cannot carry this out without them. This is not an excuse however for the financial industry not to prepare these changes and supervisors are highly mobilised and putting a great deal of pressure on them to do that. More clarity on the Brexit scenario and on a possible transition would greatly facilitate this process but that goes beyond the powers of supervisors.

2. Short-term operational issues and implications for the financial industry and the public authorities

2.1. Contract continuity issues

An official stated that Brexit raises significant issues concerning derivative contracts that may have financial stability implications and for which public-sector action may be needed.

Firstly, there is a notional value of £29 trillion of uncleared derivative contracts between UK and EU firms. It is believed that these contracts will still be executable after Brexit but there is a great degree of uncertainty about whether lifecycle events such as portfolio compression, the rolling of open positions or some types of unwinding can still be performed when they concern EU27 counterparties and involve regulated activities, and what the relevant rules will be. This is a major issue because lifecycle events are essential operations used by firms on a daily basis to manage the risk of their portfolios, adjusting positions and dealing with hedges. Some counterparties have up to 10,000 lifecycle events a month for the totality of their derivative contracts and these concern all types of contracts. In addition, some of these actions are compulsory, such as compression, which is required by law in many jurisdictions and if an option in a contract cannot be exercised, then the position ends up being unhedged. Solutions need to be found, the speaker claimed, because there is no sign of these contracts being novated to any large degree and their size appears to be increasing. Also novation is a complex, contentious and time consuming process, because everybody has to agree.

Secondly, there is a £67 trillion value of cleared derivatives between UK CCPs and EU clearing members that is still growing slightly, a notional £38 trillion of which will continue after the Brexit date. If no public-sector action is taken and if UK CCPs are not recognized as equivalent, the EU clearing members of these CCPs will not be able to fulfil some of their obligations under EMIR post-Brexit (e.g. margin payments related to products that are mandated to be centrally cleared such as interest-rate swaps) and they will face much higher capital charges for that business. If a UK-based CCP sees that a sizeable number of its members may not be able to legally perform their obligations and if the board of that CCP believes it faces sanctions if it continues to offer clearing services in the EU when it has not been recognized to do so, then it will not take those risks anymore. The answer will be to 'off load' EU clients, even if this is not simple and takes time, because a non-EU firm must be found to take over the contract and the amount of time left for those changes is diminishing. Reacting to a remark made by another speaker that a 'deeper' analysis of contract continuity issues is needed in order to identify the real risks at stake and better evaluate their scale, the official stated that while analysis is necessary, it needs to stop at some point because time is running out and solutions need to be found in the next couple of months.

Answering a question from the Chair about the compared level of criticality in the case of a hard Brexit of

derivative contracts for which there is a clearing obligation and those for which central clearing is not mandatory, another official confirmed that a distinction needs to be made. Concerning the second category of contracts, for which clearing is not mandated, UK-based CCPs would at least temporarily lose their qualification to clear these contracts with EU counterparties, but they can still be accessed indirectly, possibly in a more costly way. This is not the case of contracts with a clearing obligation, for which the only option will be to conduct the clearing in the EU; relocating these activities is however challenging from an operational point of view particularly if time is limited, despite the existence of a sufficient capacity on the continent to handle them.

A regulator added that there are some fall-back options for uncleared derivatives, including national-level temporary permission regimes, contrary to those for which central clearing is mandatory, which are governed by EMIR and for which domestic regulators have no discretion. The regulator however felt that cleared and uncleared derivative contracts need to be tackled with the same degree of urgency for the sake of simplicity, because the time is too short to handle different classifications. The key issue is not the nature of the contract, but the ability of the counterparties, the CCP or other stakeholders to continue servicing them and the numerous lifecycle events that need to be performed in the course of a contract. Rather than a 'contract-continuity' issue, this is a 'contract-servicing-capability-continuity' challenge. Two extra years or so would be needed to solve the problems related to these contracts, which require a general transitional exemption, the regulator believed. Indeed, nobody would want to employ 'blunt' forbearance which is the only other alternative. The first official added that forbearance is not only undesirable but it would not work, because there is no provision in the EU for no-action letters such as those that exist in the US, therefore market participants would not be provided with a sufficient degree of certainty.

A third official agreed that certain temporary solutions might be necessary, but they should not be seen as an excuse for industry participants not to fulfil their responsibilities in terms of preparation.

An industry representative underlined that the practical approach to Brexit for financial institutions is to transfer assets to the EU. This cannot wait for measures to be taken by the public authorities, because ensuring continuity of service for customers is essential. At present the transfers that are envisaged are limited to derivative portfolios, which is manageable. However, other financial products may be concerned, such as loans and deposits. If such conventional contracts are also exposed to contract continuity uncertainties, the workload will be five or six times greater.

2.2. Other short-term operational issues

An industry representative stressed that data issues in the context of Brexit are significant and need to be fixed, because it is very hard for the private sector to deal with a situation where it cannot share data with a third country. Another industry representative explained that the UK will be compliant with EU data protection law on the date of Brexit, but its status as a third-country may jeopardise cross-border data flows from the EU27 (e.g. used for KYC processes). To ensure that data can be transferred to the UK seamlessly, cooperation is needed between banks and the authorities. An official agreed that data is a matter for concern. This problem needs to be solved horizontally, because it applies to a wide range of issues.

Another official suggested that some other issues need addressing, such as differences across Member States in the way the MiFID third-country regime and the related processes are implemented.

3. Role of the public authorities and actions expected from the financial industry

3.1. Role of domestic supervisors

A regulator stated that supervisors are called upon to take action on three levels in the Brexit context.

The first is operational supervision, which includes interacting with individual financial institutions that want to relocate to the EU to secure passporting rights. Discussions were initially mostly about principles and intentions, but as the deadline is approaching and the probability of a no-deal scenario is increasing, they are moving into much more practical areas such as the necessary headcount in risk management departments in particular subsidiaries. There is no existing 'text-book' approach to deal with these issues. This requires creating new standards and using a more iterative and flexible approach than the traditional supervisory processes, which is a challenge for supervisors. The second level is defining how to approach broader questions such as contract continuity and data transfer from a supervisory standpoint. This notably requires memoranda of understanding (MOUs) to be drafted or amended in order to ensure on-going operational co-operation between UK and EU supervisors, because whatever the status of the UK going forward, supervisors will need to liaise on these questions. Clearing and contract continuity are two issues that cannot be solved unilaterally; they require collective action, preferably European action to provide the degree of legal certainty and stability needed, as there is an obvious potential financial stability threat in this space that needs to be tackled. The three ESAs have a very important role to play in establishing a framework for MOUs on a multilateral basis in particular. The third, and most political, level is the advisory role regarding the broader legal framework going forward. Anticipating the possible impacts of an EU-UK agreement based on equivalence or another concept is very difficult. A transitional agreement would give the industry more time to plan ahead, but it is not the role of regulators to define this and putting forward solutions such as permanent contract continuity would circumvent Brexit, which was a democratic decision. The role of regulators is to mitigate financial stability risk in the immediate vicinity of a cliff-edge situation and the role of the financial industry and its clients is to prepare for this situation.

An official agreed that it is not the job of regulators, but of governments, to 'fix' the Brexit negotiations. Regulators have to deal with the transition, whatever it is, or with the implications and risks of having no transition. Secondly, anything that can be solved unilaterally by the UK already has been. Some problems could be solved by joint unilateral action, rather than bilateral action in a treaty. If there is no deal and no transition, there will need to be MOUs and co-operation agreements between the EU and the UK. Such a sharing of confidential information already exists with jurisdictions such as the US, Switzerland, Japan and China for deciding what the split of supervisory functions should be in relation both to branches and subsidiaries and what may happen in resolution. These arrangements are normal co-operation arrangements between third countries on the supervision of cross-border firms. However, the way this would

be approached in the Brexit context has not yet been discussed because it is not yet known whether possible MOUs would be part of an overall deal between the EU and the UK or whether they would just be ordinary supervisory cooperation arrangements between third countries such as those mentioned previously. In any case such arrangements are needed to handle a worst-case scenario, because otherwise it would be very difficult even to allow EU firms to operate in the UK. This is a matter of normal best practice that needs to be dealt with quickly.

Another official stressed that there is much focus of the public authorities and the industry on what may happen at the moment of Brexit and how to mitigate risks and issues related to that, but what might happen afterwards also needs anticipating and there should be no complacency about that.

3.2. Further actions expected from market participants

An official stated that given the uncertainty, elaborating detailed contingency plans is essential. At present the best guess is either that a transition will be granted in the context of a hard Brexit or that there will be no agreement. In the second case it is very difficult to anticipate the outcome and the EU authorities have said that they would not intervene proactively to solve possible contract continuity issues. Everything should therefore be done to identify precisely in the contingency plans what needs to be put in place in case of a no-deal situation. Discussions over the past weeks indicate that financial intermediaries have started on-boarding clients to their EU-based entities. This is a critical step that needs to be addressed now.

A regulator added that uncertainty is not a reason to 'wait and see'; on the contrary, if market participants are hoping for a contribution from the public sector, then the best way to make their case is first to solve as many issues as possible themselves. That means that the contingency plans that they are working on have to be amplified and executed to the largest extent. There is a question of resources and of timing. Given the challenge this represents, it is essential that all the necessary resources are mobilised in order to react as quickly as possible. This is what supervisors are doing and the same is expected from the private sector.

Another official emphasised that a hope or expectation that public authorities will step in is no excuse for firms not to do everything that they need to do, with the required level of detail. The public authorities are conscious of the potential issues raised by a no-deal outcome and also of their responsibilities in relation to financial stability. However, financial firms remain responsible for taking their contingency plans forward, making sure that these are defined with a sufficient level of detail and granularity, and that they are not just focused on the date of Brexit, but also consider subsequent issues.

An industry representative agreed that the industry needs to commit whatever resources are necessary to address these problems. While there are other key regulatory issues to address for banks such as the impacts on their capital requirements, the main concern at this point is the systemic and cliff-edge risk that might be generated if something goes wrong in the Brexit context.

Addressing increasing financial fragmentation at the global level

Following the 2008 crisis, global cooperation on financial regulation has become increasingly important over the last decade to achieve a resilient financial system. In 2009, the G20 launched a comprehensive programme of reforms, coordinated through the Financial Stability Board (FSB), to increase the resilience of the global financial system while preserving its open and integrated structure. Timely and consistent implementation of these reforms is essential to achieve sustainable growth.

However, global regulatory cooperation is declining and financial fragmentation is worsening in some areas at a time when emerging risks (e.g. cyber risk, crypto assets) require a continued need for global consistent standards. In this context, ways forward were proposed for improving the consistent implementation of global standards.

1. Global activity is slowing down and financial fragmentation is worsening in some areas

1.1. There are good and bad reasons for the slowdown in global regulatory activity

A regulator emphasised that global regulatory activity is naturally slowing down because a great deal has now been addressed, for example in relation to Basel III, which is seen as a significant milestone. However, activity is also slowing down because the world has become, geopolitically, a much more complicated place for regulators over the last few years. There is a feeling that the world is no longer post-crisis but instead pre-crisis, and that it is probably closer to the next crisis than it is to the last. The regulatory engine is sputtering and, as such, the importance of supervision as opposed to regulation is rising dramatically. Even if it is the case that regulation will help with the next crisis, regulators are having trouble keeping the global engine running.

There are therefore both good and bad reasons for the slowdown in activity. Some of the reasons are perceived as being very frustrating in terms of politics interfering as never before in the structure of financial markets. It may be the case that everything in life is political but it can be difficult to understand why technical equivalence should be explicitly politically decided and why regulators seem to have built an incredibly 'baroque' piece of architecture around equivalence. A simpler approach to the global regulatory architecture may be required, particularly because re-nationalising market systems and pools of liquidity processes will leave the world in a poorer place and will not help in preventing and managing the next crisis. After that crisis occurs, politicians will ask the regulators what they were doing and they cannot afford to say that they had stopped trying. It is the regulators' job to keep trying because, as long as there is still a global financial system, it is their job to protect it and keep it safe.

1.2. The Basel Committee on Banking Supervision (BCBS) agenda

An official stated that very little is currently on the BCBS policy agenda. Currently, the main topics are market risk and the fundamental review of the trading book. There is a great deal of incentive to finish with those topics by the end of the year, and they are moving in the right direction.

A very minor, but important, remaining policy issue is the leverage ratio and whether it should recognise client initial margin for banks that provide client clearing services. This is a cross-sectoral issue and the BCBS has worked closely with the International Organization of Securities Commissions (IOSCO) and the Committee on Payments and Market Infrastructures (CPMI), as well as with the Commodity Futures Trading Commission (CFTC) where the leadership shown by Chairman J Christopher Giancarlo's staff has been recognised. The BCBS appreciates that there is more to regulation than banking, and it does take into account payment systems, securities market regulation and insurance.

The BCBS also understands the mandate of the other standard setters and hopes that there is a true appreciation for its own mandate. A great deal of work has gone somewhat unnoticed in the past, for example around the margin requirements that the BCBS worked on with IOSCO, formulating the capital rules for bank exposure to central counterparties (CCPs) and minimum amounts of capital banks are required to maintain against such exposures. This cross-sectoral work is important in any discussion relating to fragmentation.

Promoting full, timely and consistent implementation of the Basel Committee's post-crisis reforms; evaluating the effectiveness and impact of its post-crisis reforms, as they are implemented; and monitoring the emerging risks are three key areas which are high on the BCBS' agenda:

• The first is the full, timely and consistent implementation of the rules, without which the rules themselves are useless. The BCBS has a very formal process to follow up on implementation to see if jurisdictions are indeed implementing the global standards in a full, timely and consistent basis. There seems to have been some deceleration in that regard. In particular, in a few large jurisdictions the net stable funding ratio (NSFR) is not in place nor is the standardised approach for counterparty credit risk. This is because the rules are complex and there is a bandwidth problem for some jurisdictions making it difficult for the national regulators to transpose the rules into national law, rules and regulations. The complexity of the rules means that there are difficulties in ensuring that the standards that the BCBS produce are understandable and operational. Standards, in some cases, sound good from a technical perspective but it is then difficult to put them in place at the operational level. Forward momentum in this regard needs to be maintained.

• The second element is to look at the new standards once the rules are in place, including the leverage ratio, the liquidity coverage ratio, the net stable funding ratio, buffers and a revamped large exposure framework, and to ask what the original objective was, what risks were to be addressed and whether that objective has been met and whether those risks have been addressed. This has to be done from a position of analysis and of data. The concern is that a significant portion of the Basel III framework has still not been implemented. There is concern that there will be significant regulatory rollback. This may not come to pass, but there is also a concern as to whether or not countries will put the rules in place as and when agreed. The BCBS continues to pay close attention to this. This does not mean that everything will be reopened for discussion but rather that the impact of the rules will be assessed once in place.

• The third area is the monitoring of emerging risks. The BCBS is paying very close attention to cyber risk, fintech and to cryptoassets, though they are more supervisory as opposed to regulatory issues. The distinction between regulation and supervision is a critical one. Not everything needs to be regulated and often the better response is a supervisory one.

There is a question as to what the landscape for the banks will look like with these new standards and what behavioural changes will emerge as a result. If banks are not meeting the letter and the spirit and the intent of the rules, consideration would need to be given as to whether a regulatory response is required. Such a response is often difficult and painstaking, such that a supervisory response may be preferable. One particular issue that is being looked at is the window dressing of the leverage ratio and how best to respond to it.

1.3. Some pieces of the regulatory agenda have promoted fragmentation

An industry speaker stated that some pieces of the reform agenda have actually promoted fragmentation such as the complex of rules around recovery and resolution, which have led to ring-fencing, trapped capital and mandates on entity structure. This is understandable because of the concern of firms operating globally but dying locally and the burden that that puts on national authorities and national central banks, but it has naturally led to a set of rules that now inhibit globalisation and that have created fragmentation. An optimistic perspective is that the dialogue that has emerged from the new complex of rules, particularly between the Federal Deposit Insurance Corporation (FDIC) and the Bank of England, is contributing towards more of a supervisory approach rather than a hard rules-based approach.

Another industry speaker highlighted issues around the Intermediate EU Parent Undertaking (IPU) proposal, which requires banks to establish intermediate holding companies and to consolidate all of the EU entities under one holding company. The speaker felt that this proposal does not take into consideration existing ownership or governance structures. The European Commission explains that this will allow for enhanced supervision of non-EU globally systemically important banks (G-SIBs) and for strengthened resolution planning of EU operations of the non-EU G-SIBs. Though these policy rationales are appreciated, it is believed that this proposal will inevitably create fragmentation of capital and liquidity and will lead to reduced operational efficiency. Furthermore, in the context of financial stability, the IPU would undermine the recovery and resolution planning of non-EU G-SIBs. Breaking up the global value chain into regional pieces will not maximise a bank's franchise value but rather create sub-scale non-self-contained operations in a crisis situation. It is also believed that it will undermine global efforts of the cross-border resolution under single point of entry strategies. Ultimately, the IPU could result in reduced efficiency and reduced flexibility in resolution planning. Therefore, global co-ordination is required in this area.

In response to the above concern, a policy-maker stressed that the Commission is not proposing the IPU to be 'nasty' to other jurisdictions. Instead, it was predicated on the belief that it will enhance prudential supervision in the EU and enhance and facilitate resolution. Having said that, the Commission has listened very carefully to what different countries have said throughout the legislative process and progress has been made on a number of issues around legal constraints for banks that have limited footprints in the EU. The Commission believes that, through the co-decision process, there is now a broad consensus on the way forward.

An industry speaker outlined two opposing schools of thought in relation to the fragmentation that the sector is facing. The first is that international standard setting bodies like the BCBS have been working intensely to harmonise rules and regulations for internationally active banks and that there should be appreciation for the fact that many of the key standards in prudential and resolution areas are based on a single internationally aligned framework. The opposing view is that, while key jurisdictions have agreed to international standards, those standards are tweaked in the course of local implementations, resulting in regulatory and market fragmentations. Policy-makers may not be intentionally creating fragmentation but rather that fragmentation occurs as an unintended consequence.

1.4. Financial fragmentation is increasing in the Banking Union

An industry speaker stressed that fragmentation is not only painful for banks but is also inefficient for clients and for the economy at large. In some cases, such as in the new spaces like cyber, it may also be dangerous. While the Eurozone should not necessarily be treated as one jurisdiction, there is concern that the global rules that have been discussed at the Basel table and at the European Commission and that were decided to be implemented are still being implemented at the solo level within each European jurisdiction. Indeed the EU prudential framework does not recognize trans-national groups at the consolidated level but as a sum of separate subsidiaries ("solo approach"). This approach maintains a domestic focus in the way prudential requirements (capital, liquidity leverage, MRELs) are imposed on banking subsidiaries across the Eurozone which is inconsistent with the notion of a banking union.

A policy-maker concurred that there is indeed still a significant amount of fragmentation within the EU and even within the Eurozone in spite of the Banking Union. The Commission deplores this situation and is doing its best to change it. Progress is being made, albeit slowly. A particular obstacle is that Member States have national policy objectives that may run counter to the Commission's efforts to promote integration, for example in relation to consumer protection or the question of who foots the bill in case of a crisis. It should be recognised that many politicians and regulators have been traumatised by the crisis and that that paradigm still remains, even more so at the international level. Regulators need to be realistic in terms of what can be achieved with regards to open markets at the international level. Ultimately, the Commission believes in open markets.

1.5. The global trade repository system is also fragmented, which hinders the transparency in the market pace

An industry speaker highlighted that there has been a recent increase in the number of trade repositories in the world, from 29 to at least 33 or 34. A promise that came out of G20 Pittsburgh was transparency in the marketplace by way of global trade repositories in each asset class reporting to each of the regulators so that they could see where the risks are and how the risks are moving across the globe. This, however, has not happened. Local trade repositories are still being built based upon local rules. The speaker's firm is working with the global standard setters, including the Financial Stability Board (FSB), IOSCO, the Commission, the European Securities and Markets Authority (ESMA) and the CFTC, to come up with a set of standards and clear ideas as to what data would be necessary to identify systemic risk. There is some promise there but there is still some way to go.

As such, it is unclear where the next crisis will come from. Without transparency into the marketplace, regulators cannot identify risk building up in a particular area in the markets. It can be identified on the local level and local market regulators do receive fairly good information from the trade repositories but there is no clarity on systemic risk issues.

An industry speaker highlighted the importance of finding a positive way forward. Transparency is very useful, as is engagement with the industry. It is also important that the objectives be kept in mind. Often, regulations are made without a clear view as to what the end state is. Clarity allows for a prioritisation of objectives. Countries prioritising their national policy objectives will hinder harmonisation. However sharing a common objective can lead to movement in the right direction and trust being built between jurisdictions.

Another industry speaker noted the vulnerabilities existing in regulation and that the sector may already be in a pre-crisis situation, and believed that this should be dealt with by focusing on the implementation of existing standards as opposed to creating a new set of standards.

1.6. Brexit is a significant factor in fragmentation

An industry speaker underlined that Brexit is a significant factor in fragmentation. Two extraordinarily important markets are in the midst of deciding whether their future is one of a global market or a fragmented market. One side forced the issue and the other side has to respond. There are policy principles that the Europeans are understandably protecting and defending but, ultimately, the decision that they have to make together in the discussions with the UK is whether their future is a fragmented one or not a fragmented one. Chairman Giancarlo mentioned this in his speech in terms of experience with equivalence determinations on one model of recognition ultimately creating confidence with one national regulator that the regulator in the other market can be allowed to do what they do without second-guessing them and without the extraterritorial imposition of national laws. Ultimately, Brexit will be a significant statement about whether fragmentation is the path that two important markets want to take in terms of very important parts of the global economy.

2. Emerging regulatory issues require a continued need for global consistent standards

2.1. The benefits of global financial markets

Open and integrated markets in financial services, freedom of location of activity and free trade support economic activity and employment.

An industry speaker stressed that the benefits of global co-ordination and standards should be centred around investors, borrowers and consumers and allowing the flow of capital in a way that is reasonably safe and sound. All of those constituents have the right to expect safe and sound banks, markets and resiliency across jurisdictions. This essentially means that money flows from countries that have it to countries that need it. It allows for wealth generation opportunities and it allows for the ability to manage concentration risks and to diversify risk.

2.2. Global regulation is fundamental for emerging issues such as cybersecurity and financial technology

An industry speaker warned that there are a number of emerging issues on the horizon, such as cybersecurity and financial technology, where global co-ordination is fundamental. In particular, a cyberattack can come from anywhere to any jurisdiction. Technology has no border. Collective consideration needs to be given, from a policy

perspective, to what the right minimum standards are for all participants in the marketplace, whether that be a central bank, a financial market infrastructure (FMI), a bank or a non-bank. Equally importantly, consideration needs to be given to a co-ordinated approach to assessing that those minimum standards are met and what the consequences would be of a fragmented approach to, for example, penetration testing. Ultimately, a lack of co-ordination can lead not just to operational inefficiency but operational risk and vulnerability, allowing the 'enemy', the people engaged in cyber trouble, to attack banks more effectively. The recent FSB paper on this issue is particularly noteworthy, with 72% of the FSB jurisdictions updating their cyber framework, cyber controls and cyber assessment methodologies. Co-ordination is needed in this area.

The same is true with the new financial technology, whether that be storage, communication or computing, which is leading to disciplines such as machine learning and cloud computing. This technology allows for direct access to investors and consumers across borders and it is therefore essential, with this fast-paced development that is occurring outside the regulatory perimeter, that consideration be given to what policy objectives need to be achieved, whether that be financial stability, consumer protection or investor protection. Collective delivery is required here. It is not only about collaborative and effective rule-writing but it is also about having those discussions. There is private sector expertise and public sector policy intent. This is not about what the rule needs to be but about what it is that the sector is trying to create.

The chair agreed, noting that, once laws are embedded, jurisdictions are unwilling to change them. Now, therefore, is the time to co-ordinate, particularly on cyber issues. However, political understanding is required to achieve this and too often it is a case of 'going it alone' and putting a law into place, sometimes to create a 'first mover' advantage. Ex ante co-ordination is fundamental, without which there will be fragmented laws from different jurisdictions that are impossible to bolt together.

An industry representative underlined that there are both elements that create confidence and elements that create concern, noting that much of what has been achieved in terms of the post-crisis reforms was ultimately designed to give market participants and investors, as well as taxpayers, regulators and government officials, the confidence that the financial system should be allowed to operate and to do what it does best, which is to allocate capital to its best use.

2.3. Steps need to be taken to depoliticise those issues where possible

A regulator stressed that fragmentation can result from regulators believing that they are right and that the others are wrong, instead of combining their approaches. However, regulators need to be aware that they 'do not rule the world'. That power lies with the politicians, and indeed fragmentation can be politically driven or politically desired. Brexit is an example of this. The regulatory and supervisory community cannot be expected to cure politics or to hold it at bay.

It is important to stay in the realm of the possible. A good illustration of this is the issue of cyber risk where some jurisdictions around the G20 table believe that they have been cyberattacked by other jurisdictions. In that light, questions need to asked about whether those jurisdictions will share information with each other. Small steps need to be taken to try to depoliticise the issues where possible, which will help to avoid unnecessary and undesired cost.

2.4. The objective should be to minimise fragmentation

An industry speaker stated that the objective should be to minimise fragmentation, particularly in capital markets because the underlying benefit is enormous with regard to liquidity pools, netting of risk and transparency. It is believed that this should be one of the easiest things for the sector to be aligned around. The Capital Markets Union (CMU) is needed because too much of the economy in Europe is financed by banks. Greater diversification in markets is required.

2.5. The industry has taken a leadership position where there is an opportunity for standardisation

Multiple industry speakers highlighted that the industry has tried to be deeply engaged in where it thinks there is an opportunity for standardisation. For example, the industry has written 10 White Papers in the last couple of years on issues such as cybersecurity, how to standardise data and how to better focus on key issues. The industry has also worked on the financial sector profile in order to outline areas in which consolidation could lead to a more harmonised foundation.

The speakers maintained that the industry has taken a leadership position to try to make certain that it is focused on these issues as well as to make certain that it has the right kinds of standards in place and to standardise the data so that the data can be better used for things such as AI and monitoring and supervision of risks.

3. The way forward for improving the consistent implementation of global standards

3.1. Basic principles for proper mutual recognition and addressing conflicts between national regulations

A public decision maker noted that regulatory fragmentation needs to be addressed, but that this should not necessarily be done via additional regulations. National differences should not be eliminated. Each national authority operates under its own democratic oversight and has responsibility to its own depositors and consumers. Full harmonisation should therefore not be aimed for. However, there are many things that can be done to alleviate unnecessary problems. For example, with regard to the equivalence assessment, there should be a benchmark against an international standard as opposed to individual gold-plating approaches country by country. There should be a focus on outcomes rather than specific methods and approaches to attain them. Basic principles for proper mutual recognition should be agreed.

If domestic regulations are to be produced with explicit extraterritorial elements, it may be good practice to engage with overseas stakeholders at the preparatory stage, possibly in an informal manner, as opposed to simply focusing on domestic constituencies.

This speaker presented a process to address conflicting national regulations and supervisory actions. If a bank is faced with conflicting and incompatible regulatory requirements from two different countries in which it operates, that bank can address the issue with both of the regulators – by submitting a letter describing the conflict to the two regulators- with all the responses being published online. Though this may not necessarily solve the problem, it can draw the regulators' attention to the issues that they are causing. Such a process could be agreed bilaterally or be incorporated in a multilateral memorandum of understanding.

An industry speaker agreed, in principle, with this suggestion but noted that in some places information cannot be shared because it is confidential. Legal impediments, therefore, can hamper transparent

discussion and can preclude banks from sharing confidential supervisory information even when faced with contradictory requests from two different regulators.

3.2. Enhancing global equivalence

A regulator stated that, while everything existing in a relationship between jurisdictions has an effect on everything else, there are consequences in complex relationships that may be politically intended but that have negative impacts which go beyond the case in issue. It is extremely negative for jurisdictions to deliberately make it more difficult to access one another's markets despite being well regulated.

The chair agreed but noted that, while there is a supposition of a continuation of global integrated markets, there is in fact a shift towards bilateral determinations of access, which creates a matrix of complexity and which makes no sense. The argument is that this leads to global standards being implemented in inflexible ways.

A policy-maker underlined that, in many areas, international standards have not been sufficiently developed and that there is, therefore, a strong case for relying on equivalence. Though this might be an imperfect system to manage bilateral relationships, much like democracy it remains the best option available, and it creates the possibility for an open market. The policy-maker noted the regulator's concerns above but emphasised that 99.9% of the equivalence assessments are technical, sober and objective. Exceptions might arise but it must be borne in mind that there are issues that are more important than financial regulation.

3.3. Is regulatory and supervisory deference the best way to ensure harmony between regulatory regimes of cross-border markets?

Deference is a regulatory approach that can be applied to swap trading venues, central clearing houses and swap dealers, which expands the use of equivalence and recognition and therefore focuses on achieving comparable regulatory outcomes and not rule-by-rule exactitude.

A regulator cited Chairman Giancarlo's observation that there is currently an important opportunity, which did not exist before and which may not exist in the future, whereby the large swaps markets of the world are intellectually in a similar place. If there is a commitment by all of these swaps jurisdictions to apply the same regulatory approaches, regulatory co-ordination could be achieved in this area of the financial market. This, essentially, is deference, and the opportunity is tantalisingly close.

Deference refers to the tools that jurisdictions use, whether that be equivalence in Europe, substituted compliance or the use of exemptive power in the United States. It is a belief that peer authorities recognise the importance of each other's interests in the markets and therefore say that that authority has responsibility for its market and should set the rules for its market. It also underpins trust. Regulatory and supervisory deference is essentially about whether one authority has the confidence that the other authority, through supervisory power, rule-making, enforcement and other regulatory devices, will safeguard their markets in a way that will achieve the same regulatory outcome.

The chair noted that Chairman Giancarlo had differentiated between domestic issues of market structure and trading on the one hand and, on the other, the stability aspects, which is an important distinction of the scope of deference. In addition, the initial approaches on equivalence were outcome-based and, as such, did not involve a line-by-line examination. Ultimately, it is a political judgement of whether a jurisdiction that is trading swaps in the swaps market with the United States broadly follows the same type of rules.

The regulator was in general agreement with this statement but maintained that outcomes-based deference was not a political decision but a regulatory one. It was accepted, however, that there is more than one way to achieve an outcome. Each jurisdiction has unique legal systems, unique market characteristics and unique institutions. It would be difficult to insist upon exactly identical approaches. Instead, jurisdictions can accept that they each have their own methods that lead in the right direction, which is essentially the goal of a deference based approach. For example, the CFTC's main interest is in the parts of the financial system that have a systemic risk on the US market. In that respect, the case for having the stronger hand of the CFTC is much more legitimate and intuitive. Beyond that, it does not make sense for the CFTC to dictate that other jurisdictions should follow the CFTC's preferred approach.

A policy-maker stated that the Commission has promoted deference in derivatives markets. Looking at outcomes rather than line-by-line analyses of third country legislation is understandable but, for some markets, a word can make a significant difference in terms of competition distortions, in terms of investor protection and, in some cases, in terms of protecting financial stability. For this reason, in the absence of global granular standards, the Commission does not want to take any risks and instead wants to have a very robust equivalence process that indeed should not lead to political decisions as much as possible but only to technical regulatory decisions. That is what the Commission does in the vast majority of cases.

The answer to all of this is promoting granular detailed international standards in the future. Because of this, global co-ordination will become even more important. The Commission is prepared to be active in fostering international co-operation, but this needs to be realistic. Difficulties can be seen in insurance, for example, in terms of building an international standard and determining who is systemic and who is not. There is a great deal of work ahead but the Commission is determined to do this work and to therefore, after some time, get to more open markets.

An official commented that a recently concluded EU/Japan economic partnership agreement (EPA) incorporates close regulatory dialogue in financial regulatory areas. Those EPA clauses are not necessarily binding but it is expected that both the EU and Japan will have a dialogue in the early stage of rule-making rather than after the rule-making, which is a big step in formalising the necessary co-ordination.

4. Conclusion

The chair stressed that there is now an opportunity to develop global co-ordination as much as possible. Jurisdictions should avoid internal regulatory and legal difficulties and should trust each other, exchange ideas and give each other the heads up of where they are going. Ex ante co-ordination would reduce a great deal of the fragmentation that the industry and, eventually, the consumers will have to pay for. Bank resolution still has a long way to go.

It is important to note that Christopher Giancarlo's comments should apply not just to swaps but to other areas as well such as money laundering and terrorist financing, as the same principles apply. This should not be a narrow sectoral discussion but a much broader based discussion on deepening global co-ordination, which could lead to a better world.

CMU IMPLEMENTATION

Building an effective CMU for the EU27 post-Brexit

1. Progress made in the implementation of the Capital Markets Union (CMU) action plan

A policy-maker stated that progress on the CMU action plan is not as advanced as it could be. So far, 39 of the 70 action points from the initial CMU action plan and the mid term review have been delivered by the Commission, which indicates that the job is more than half completed. The 39 actions include legislative proposals, 13 of which have been adopted by the Commission but are not yet through the co-legislative process, which means that they have not yet actually been delivered and that some issues remain to be discussed. The Commission has nevertheless delivered a large part of what it had committed to, that is to say the main building blocks that would allow a European capital market to develop. The CMU can only be facilitated in Brussels, but it is up to the private sector and the Member States to actually develop these markets.

A public representative stressed that the European Parliament's main priority is to conclude the legislative work now underway in order to leave as few pending legislative files as possible to the next Parliament. Three main legislative proposals of the CMU action plan have been completed: STS (simple, transparent and standardised securitisation), the Prospectus Regulation and EuVECA/EuSEF. The European Parliament has voted on four other texts related to the CMU: EMIR 2.2, PEPP, CCP recovery and resolution, and the Common Consolidated Corporate Tax Base (CCCTB)[1]. There is still work underway on nine files, some of which are quite far-reaching: the ESAs review and proposals regarding covered bonds, crowdfunding, SME growth markets, sustainable finance, the cross-border distribution of investment funds, cross-border payments, investment firms and the NPL secondary market. It is still possible to conclude the majority of these files by the end of the current legislature, the public representative believed. This should be the case of the PEPP proposal in particular, regarding which there are differences of views between the Parliament and the Council, but none that cannot be solved. It will probably be more difficult to finalize the ESAs review, which raises several political questions, by the end of this term of office although it would probably be possible to reach an agreement on a less ambitious approach.

A regulator considered that the building block approach adopted by the Commission is the appropriate way forward. It is important to realise that capital markets are much less homogenous than the banking or insurance sectors. Efforts are being made since the 1970s to further integrate European capital markets, but progress will always be step by step in this area with a certain element of diversity, unlike the Banking Union which was implemented in one step. An industry representative felt that the CMU agenda is still "alive", which is positive, even if the project needs some improvement and support. Everybody realises that this is not a short-term project. The Financial Services Action Plan (FSAP) that the CMU is building on was launched 20 years ago. Much of the "low hanging fruit" has already been picked with the CMU actions underway. Now there are some more challenging issues to address but it is important to pursue work on this project.

2. Political challenges impacting the CMU

A policy-maker observed that everybody in the EU27 is officially in favour of the CMU and talking about its potential benefits, but there is a gap which needs to be closed between this rhetoric and the action of effectively implementing the related proposals. When negotiating even voluntary codes of conduct, there are often massive levels of resistance, partly from Member States and partly from the industry. The Commission can make proposals, and has done so, but if they are not passed into legislation and not reflected in market activity, the CMU will never be fully implemented. A regulator agreed, noting that building a true union requires abandoning certain elements of national sovereignty and going towards more European approaches, which some authorities are not ready to accept. Another regulator agreed that CMU means sharing responsibilities among EU supervisors, which requires changing the way supervision is organised at the national and European levels, notably concerning the role of ESMA. This should be an outcome of the ESAs review, a large part of which focuses on moving towards more convergent and consistent decision-making at EU level.

An industry representative also felt that CMU must be a priority not only in words and political declarations, but also in practice. There are still challenges in terms of national will, with some policy-makers still questioning the need for a European CMU agenda in the capital markets area. Some growth is happening in EU capital markets when considering the figures of debt issuance in the euro area compared to bank loans (although there has not been much growth in equity issuance). This is a positive development, but it should be further assessed how much of this growth is a result of monetary policy rather than financial regulation or market trends.

Another industry speaker felt that Europe should get to grips with the profound transformations happening at the international level such as Brexit and deregulatory trends in the US. CMU is still considered by many as a "nice to have" project, but these transformations are making it essential. Hopefully the international context will make the CMU appear as a vital project, as was the case for the Banking Union following the crisis, which was implemented in a matter of months.

3. The implications of Brexit for the CMU

3.1. Towards a greater distribution of financial centres in Europe

A regulator considered that the UK's "unfortunate" departure from the single market means there will be more barriers in the future between the UK and the EU27. Additionally, Brexit will change the structure of the European financial market, which is at present very

concentrated in London. There is an on-going trend of relocation of some financial activities to multiple places across the EU. The supervision of these activities is also being split up across different authorities with a risk of ending up with less consistent supervision, particularly if there is an element of competition among financial centres. New tools and approaches are needed to make sure that there is sufficient consistency and convergence of supervision across the EU27.

An industry representative felt that with Brexit the discrepancies in regulation and supervision between EU Member States will be much less tolerable than when most of the capital market was concentrated in London. The CMU will ultimately have to be a harmonising force across EU countries and help to remove domestic barriers. Impetus is however needed at the level of Member States to foster more convergence, otherwise these changes will not be possible.

Another industry speaker believed that the greater distribution of capital market activities across different financial centres in Europe would not be an issue, even though the consequences of Brexit need to be further assessed. This was the case before the City concentrated most of the market and financial competences thanks to the passporting system and the euro in particular and Europe was prosperous then. Additionally, technology creates new opportunities for interconnection and reduces the need for physical aggregation. These changes will increase competition within the EU and provide alternative options. There is an element of rent associated with the concentration of activities in London, the cost of which Brexit will help to reveal.

A policy-maker emphasized that one attraction of having a single financial centre in the EU was that it was de facto supervised by one supervisor and was under one legal framework and one judiciary system. Europe is probably moving to a different world now with multiple points of entry, but in order to be consistent with the single market, there should not be multiple terms. This requires more supervisory convergence. Europe can indeed produce a single rulebook, but if that single rulebook is not implemented consistently across these different centres there will not be a single market. But conversely, if all participants work together on improving the fundamentals of EU capital markets and supervisory convergence, then Europe is in a position to build over time a reference capital market that can also be very open to other global markets.

3.2. Brexit makes CMU all the more important

Several speakers stressed that Brexit increases the necessity of the CMU for Europe. A policy-maker emphasized that there are several reasons for this. First, without the CMU and the UK, Europe would mechanically become even more dependent on banks. Additionally, there is a risk management element to this. An economy the size of the EU27 cannot have the bulk of its capital markets outside its jurisdiction. This means that some level of rebalancing is needed and the CMU project is an important part of that.

An industry speaker agreed that the departure of the UK from the EU is an important catalyst for the CMU agenda. Now that a first inflection point has been reached with the 39 proposals made by the Commission, the priorities ahead for the public and private sectors need defining bearing this in mind. A regulator noted that CMU is a relatively recent project. It was launched when the UK was still in the EU. Some adaptation has been made to the project since the Brexit vote but more is needed.

3.3. Connectivity and openness of the CMU to global markets

An industry representative suggested that connectivity between the EU, the UK and beyond is very important. While Brexit may well be about "burning bridges" between continental Europe and the UK, if Europe wants to be a reference financial centre for the world, CMU cannot go in the same direction, but should on the contrary help to reinforce bridges with the rest of the world. Beyond the question of Brexit, if the EU wants to be an attractive global financial centre, it must be open to foreign institutions and investors. Another industry speaker noted the comments made by a speaker in a previous session about Europe having to decide whether it wants a closed European market or a European capital market which plays on the global stage. A third industry representative underlined that with Europe moving to a system of distributed financial centres, the equivalence regimes governing relationships with third countries need to be reviewed. Equivalence should not be a backdoor for accessing the single market, but a proper flexibility tool. This regime allows potentially everyone to operate within the single market, but this should be done on a level playing field in order to safeguard the integrity of the single market, which is a fundamental pillar of the EU political project.

4. Future priorities for implementing the CMU

4.1. Streamlining and integrating CMU with other European projects

A public representative stressed that streamlining the different initiatives designed to support the funding of the EU economy is essential in order to achieve a really integrated European financial market. A comprehensive policy approach including the CMU, the Banking Union and the EU Invest initiative, together with a review of banking and insurance prudential regulations and taxation and insolvency laws, would provide combined benefits with a multiplier effect. This integration of the CMU with other programmes such as EU Invest was in the philosophy of the Juncker plan from the beginning, but it has not produced its potential benefits so far and without this it will not be possible to achieve all the desired outcome for the CMU. EU Invest, which is a merger of all the financing instruments of the Union into one common fund, could be very powerful. The priority however is to streamline the CMU with the Banking Union because banks will remain crucial for the financing of corporates and SMEs and also as intermediaries in capital market activities. In this perspective, it is essential to break the "political vicious circle" which has so far prevented the completion of the Banking Union and the removal of the barriers to a better allocation of capital and liquidity within the Eurozone. If the Banking Union is completed with the proposed backstop and guarantee on deposits in particular, there will be a stronger element of integration. Achieving this will contribute to CMU because both projects are interconnected. There is no need for a new CMU action plan with a new list of priorities the speaker felt; what is necessary is an effective implementation of the CMU legislative proposals already on the table, which requires granular legislation and consistent implementation across Member States.

4.2. Addressing the fundamentals of the CMU

A policy-maker stressed that since the projects to integrate EU capital markets started in the 1970s there has always been a question about whether Europe should be addressing the fundamentals of the market. These are insolvency law, taxation, ownership rights, consumer

protection and supervisory convergence. In the CMU action plan, these issues are being addressed but only on certain aspects. This is because these fundamentals touch domestic sovereignty and are the areas where it is most difficult to make progress. However, if Member States and the Parliament wish to work in these areas, the Commission will propose appropriate legislation. Obtaining a tripartite agreement between the Parliament, the Council and the Commission could be an effective way to move forward on some of the fundamentals such as taxation and insolvency, as it could help to set the stage for these difficult political decisions. If this is not possible, the Commission will continue to focus on eliminating the frictions on the surface of these different issues to the greatest possible extent. The Commission has for example made one proposal on insolvency in the context of the Banking Union. It is a very modest proposal, based on voluntary action. Yet it was still resisted by a number of Member States who considered it as interference in their rules. We must be realistic. It is essential to address the fundamentals, but these are the most politically sensitive areas to tackle, on which the Commission needs strong political support.

Insolvency laws: Several speakers underlined the importance of working on a more unified EU insolvency framework. A regulator explained that this is essential to facilitate Europe wide debt issuance and the possibility of pooling European debt into securitised vehicles. Progress is needed in that direction once the on-going pipeline of work on CMU is achieved. A public representative agreed, but stressed the complexity of doing so because of national sovereignty. Europe can consider this as a 'pooling of sovereignty', but there must be cooperation among Member States otherwise there will be too much resistance. The speaker suggested that a parallel multilateral mechanism could be built as an intermediate step before a unified insolvency framework, noting that this approach is being used in respect of NPLs.

An industry speaker emphasized that working on an EU insolvency framework will require discussions with Ministries of Justice, who in most countries have their own intellectual framework, different from Finance Ministries. Taking Justice Administrations onboard a project such as CMU is quite challenging, but there will be no choice but to further involve these authorities in the future, because topics such as immigration, security and anti terrorism coordination will have to be priorities for the next Commission. Moreover, if these fundamental legal issues are not addressed, Europe will be subject for the organisation of its capital markets to the will and actions of global markets and foreign jurisdictions. Another industry speaker agreed that the dialogue on insolvency needs to be between Justice Ministers and possibly Prime Ministers. However, the challenge is deeper than that. This issue touches on some highly sensitive political questions such as real estate repossession from households, which will be difficult to tackle for the European authorities.

Post-trading: Two panellists stressed the importance of addressing post-trading issues and notably the Giovannini barriers in the context of the CMU. Progress has been made on these barriers and thanks to TARGET2-Securities (T2S), but the European Post-Trade Forum (EPTF) has since extended the list of areas remaining to be addressed. These include corporate action and general meeting processes, the application of client asset segregation rules, inconsistency of legal frameworks and the inefficiency in withholding tax collection. The two speakers encouraged the EU authorities to tackle these issues in order to move towards more unified processes, without which, some of the harmonized legal blocks required for the CMU would be missing.

Taxation issues: An industry representative considered that the harmonisation of taxation is the most important priority after insolvency, post trade issues and global connectivity. Although it is a very delicate issue, levels of taxation are something which should be easier to fix once taxation processes have been unified at the EU level. Another industry speaker stated that creating a single framework for capital gains should be considered. Tax harmonisation should start in this domain, rather than financial transaction tax. A public representative agreed that tax is always a difficult subject, emphasising the importance of the tax bias between equity and debt. CCCTB will be the first important tool to address this at the EU level. A regulator stressed that taxation is one of the Giovannini barriers in the post-trading area on which the EPTF group has made proposals that need to be taken into account. The regulator added that France in particular would be supportive of examining the question of debt and equity taxation in particular and further assessing how it may encourage the development of capital markets.

Supervisory convergence: A regulator highlighted the importance of supervisory convergence to reach an effective CMU. The effectiveness of a regulatory system indeed depends on rulemaking and also on supervision and enforcement. Significant progress has been made at the European level on the regulatory side with the completion of the single rulebook and the movement from directives to regulations, but this has not been the case in the supervisory and enforcement areas, where proper instruments to make supervisory practices converge are still missing or are not properly used. The level of detail of rulemaking has increased as a consequence, for example with additional Q&As and guidelines published by ESMA. These issues are addressed in the ESAs review, but the regulator remarked that making progress on these topics appears not easy. It now seems as if we need to wait until the next crisis for significant changes to be made to the supervision of capital markets at the EU level, which is what has previously happened with the Banking Union. Making these changes in an orderly way would be clearly preferable. The regulator emphasised that the proposals that have been made concerning ESMA in particular are modest in the sense that they fit within the existing framework of the ESAs. They are only about trying to provide ESMA with the necessary tools to make supervisory convergence more effective and moving a few direct supervision areas to ESMA. Most day to day supervision would stay at the national level. The existing tools at the disposal of ESMA for assessing national supervisory practices (i.e. peer reviews) also need enhancing with more independence, the speaker believed. National supervisors would form part of the teams in charge of these assessments, but the lead must be at the European level for independent assessments to be credible.

Consumer protection: A regulator emphasised the importance of consumer protection. The CMU also requires changing the saving behaviours of retail investors and households, with a stronger focus on capital markets, which requires appropriate investor protection. Regulations such as MiFID II and PRIIPs will help. Achieving the PEPP is also important. Pension plans can be an important driver of a more active participation of retail clients in the capital markets.

4.3. The need to review MiFID II and Solvency II

An industry representative felt that MiFID II is having many unintended consequences that need addressing. A first example is the objective to move liquidity from dark pool and OTC markets to lit and transparent ones which has been bypassed by systematic internalisers, which have created small backdoors that have ended up channelling large volumes of transactions. A second issue is equity research, which is essential for supporting investment decisions with comments on performance and benchmarking. The new system put in place for funding equity research may solve some conflicts of interest on the paper, but has so far resulted in a situation where no one is ready to pay for it anymore.

The industry representative also believed that Solvency II should be at the top of the CMU agenda. The capital charges associated with equity investment must be reviewed, otherwise no insurance company will be able to invest in equity. This is especially problematic in a changing environment where interest rates are due to go up. A public representative agreed that the treatment of equity in capital charges over the long-term needs improving and stressed the importance of the Solvency II review on which ECON is working to define a common position. The upcoming delegated act will be an opportunity to anticipate some elements that might be conducive to CMU. If this is possible, the Commission might be encouraged to take action. At the same time, insurance companies must be better equipped to address volatility in the market.

4.4. Developing SME markets

An industry representative explained that there are different SME markets in continental Europe. Technology SMEs must be considered separately because of their specific profile. They benefit from very strong public support in Europe through the combination of tax benefits, direct subsidies, real estate subsidised by local governments and training, resulting in a strong 'national' dimension of the sector. Despite this support only 10 to 20% of them are strong enough to survive. These remaining companies then require more funding and attempt to raise private equity, consolidate with an industrial company or go to the market. In the case of the latter option, strong technology markets are needed. European equivalents of the NASDAQ, already exist, but critical size is necessary; there must be enough issuers and a sufficient number of investors ready to invest in this asset class as well as appropriate equity research. In contrast to the EU, listing in the US is more expensive and requires presence and visibility in that market. Liability risks for board members are also higher in the US.

The listing of other types of SMEs on public markets is more culturally driven, but it will be increasingly difficult for these companies to be exclusively financed by debt. Many of their leaders also have an incomplete perception of the market environment, because they have never seen an interest rate rise or believe that the money supply of banks is inexhaustible, which is not the case. When the market moves to a more normalised way of pricing debt and equity, particularly in a globalised world, the arbitrage between financing growth with own funds or going to the market will change.

4.5. Sustainable finance

A public representative considered that sustainable finance is another essential area that is being worked on in the context of the CMU. However, finance will not become sustainable solely with financial regulation. Sustainability must also become a priority in terms of governance and be embedded in all the areas of legislation so that it becomes a major component of the political strategy of the Union. A regulator considered that sustainable finance should be one of the key priorities of the next Commission and Parliament, because it will shape the future of the financial market together with other innovative areas such as technology. It is important to have a European approach on these objectives from the outset, because otherwise we will end up with a fragmented situation.

1. The Common Consolidated Corporate Tax Base (CCCTB) is a single set of rules to calculate companies' taxable profits in the EU. With the CCCTB, cross-border companies will only have to comply with one, single EU system for computing their taxable income, rather than many different national rulebooks. Companies can file one tax return for all of their EU activities, and offset losses in one Member State against profits in another. The consolidated taxable profits will be shared between the Member States in which the group is active, using an apportionment formula. Each Member State will then tax its share of the profits at its own national tax rate.

Effectiveness and integration of the EU fund sector

1. Development opportunities of the EU fund sector

An industry representative underlined the importance of considering the needs of retail investors, when assessing the development opportunities of the EU investment fund sector. The average EU household holds approximately 10% of its financial assets in funds and three times as much in cash accounts, which currently generate negative real returns. Funds on the contrary generate positive returns over the long-term. Secondly, longer life expectancy is increasing the need to plan for the long-term in a context where the role of pay-as-you go schemes is diminishing. This long-term investor outlook creates many opportunities for the fund industry. In addition, the funding needs of the EU economy represent further opportunities for the fund sector, as capital needs deploying in the economy. It is unlikely that the banks and the public sector will be able to entirely fill this gap. The real economy and the financial industry are also becoming more aware of the need to think with a longer term and more sustainable perspective and the fund industry can help to channel and allocate the capital that is needed to support that approach.

An investor representative believed that the fund industry is in a strong position to support the objective put forward in the context of the Capital Markets Union (CMU) initiative to shift more money from cash to the capital markets. Significant changes have taken place in the fund industry such as cost reductions, efficiency improvements, an enhancement of product ranges and an improvement of the regulatory level playing field.

Another industry representative emphasized the opportunities for the EU fund sector created by the European Commission's sustainability action plan. Many EU-based asset managers have indeed been at the forefront of developing environmental, social and

governance (ESG) investment approaches and more than 80% of the EU sector's assets are embedding ESG criteria. New technologies also present a key opportunity that asset managers need to take on-board.

A third industry representative noted the stability of the EU fund sector and the growth in particular in the demand for and supply of private equity and infrastructure financing. These positive trends will hopefully continue and should be taken advantage of to develop the sector with the support of an appropriate regulation.

2. Challenges facing the EU fund sector and areas of improvement

2.1. Cross-border distribution and supervisory convergence

A regulator stressed that investment funds are probably the financial sector where EU product regulation has been the most successful, with UCITS, which has become a standard at the global level and a model of regulation. Another regulator agreed that the EU fund sector is in a good position in terms of regulation, but felt that there is still room for improvement, notably regarding cross-border distribution within the EU. For example, the passporting regime of the Alternative Investment Fund Managers Directive (AIFMD) does not seem to function optimally, with unnecessary requirements and fees added by some national competent authorities (NCAs) that hinder the cross-border distribution of these funds across the EU. There is a question as to the appropriate level at which that issue should be addressed. Given the strength of the regulation of the sector, now is the time to move towards more supervisory convergence, the regulator believed. This does not require transferring all the supervision to ESMA but rather implementing the recommendations that have been made in the review of the European Supervisory Authorities (ESAs), which the speaker fully supported. It may however be prudent to clarify first a certain number of regulatory issues at the EU level in order to facilitate supervisory convergence. This does not require implementing new regulation but eliminating hurdles to the consistent implementation of existing rules.

An investor representative suggested that the fund sector should be the starting point for further developing an integrated EU capital market. This however requires investors to be provided with the products they need. A regulator expressed support for the idea of using funds, one of the most integrated sectors in terms of regulation but one of the most disintegrated in terms of supervision to test the implementation of further supervisory convergence with the backing of the different EU institutions. The regulator noted that there is a difference in the buying power of investors across the EU: in certain countries consumers have the possibility to invest in a wide range of products, but in others, the range of products is limited by banks or insurance companies that mainly distribute the products of their asset management subsidiaries.

An industry representative supported the principle of supervisory convergence but stressed that this should not mean carrying out all supervision at the EU level in a similar way. The principles of proportionality and subsidiarity need to be maintained. Cross-border distribution involves managing a certain level of complexity and the NCAs in Luxembourg and Ireland have built significant expertise in dealing with that complexity over the years.

Another industry speaker stressed that the existing EU fund framework is appropriate to ensure the continued success of the sector and is supported by significant supervisory experience and expertise at Member State level that fosters certainty for both fund managers and global investors. Many international asset managers choose the EU as a domicile for their funds because of this experience and expertise in supervision and the certainty it provides. The ESAs may support the NCAs in further developing and implementing best practices, but imposing direct supervision does not seem appropriate.

2.2. Issues raised by PRIIPs

An investor representative considered that some regulations that affect retail investors and the fund sector still need improving. It is essential that retail investors understand, at the point of sale, the products that they are buying and their costs. PRIIPs (the packaged retail and insurance-based investment products regulation) aims to provide investors with the information they need for making appropriate investment decisions, but it raises significant concerns, as it may result in restricting the range of products that retail investors can invest in. The possibility that UCITS and PRIIPs requirements could merge somehow in 2019 is also raising many questions amongst investors. This is unfortunate because the point has finally been reached where many retail investors are starting to understand how UCITS funds work and how to compare costs and performance data, even though some difficulties subsist, and PRIIPs may create some confusion in this context. PRIIPs has also resurrected the debate about product costs (i.e. what are the product costs that need disclosing and how they should be disclosed), but there has already been a detailed assessment of these questions in the context of MiFID. The costs to disclose have been defined in an ESMA ruling, as well as the way to implement cost disclosure requirements. Another concern is that retail investors who finally decide to take the step from holding cash to investing in capital markets are sometimes dragged into non listed products that have implications that are difficult to really assess and monitor, even for supervisors. Listed products or investment funds at least follow a common framework.

A regulator agreed that PRIIPs has given rise to unintended consequences. The intention was sound, but the project has somewhat derailed along the way. In particular, the coalescing of PRIIPs and UCITS packages that this may lead to is unwanted. This needs to be further assessed and resolved as soon as possible. Another regulator agreed that the interactions between UCITS and PRIIPs need clarifying and solving in a pragmatic way.

2.3. Brexit implications and competitiveness issues

An industry representative emphasized that the UK's decision to leave the EU creates further challenges for the EU fund industry. A first potential issue relates to delegation rules which allow UCITS to benefit from cross-border access to the world's foremost portfolio management talent within and outside the EU. This needs to continue in order for UCITS to maintain its position as the global fund vehicle of choice. If portfolio management has to be undertaken in countries selected for 'political' reasons, portfolio management talent will be diluted. A second risk arising from Brexit is an increased cost of delivering fund products to investors, which will impact not only EU investors but also global investors in UCITS products. Currently, European investors benefit from a full spectrum of product offerings. However, if distribution between the UK and the EU is disrupted, the increased costs of offering all fund products in individual Member States together with limitations already occurring as a result of PRIIPs will inevitably lead to a

more limited range of products offered, particularly for investors living in the less wealthy EU States. A regulator commented that it is however inevitable that costs will increase because of the element of EU disintegration that is inherent to Brexit.

Another industry representative agreed that the UCITS gold standard that has been established in Europe should not be threatened by changes in rules. In addition, regulatory or supervisory evolutions should not change successful business models unless there are very good reasons to do so. Outsourcing and delegation are key components of the sector's success and bring benefits to investors. Significantly changing this will undermine European champions and reduce investor access to certain asset classes.

Moreover, a third industry representative stressed how important it is for the EU asset management sector to remain competitive at the global level. There is indeed a decline in the number of large European players in the asset management space. 10 years ago, 10 of the top 20 worldwide asset managers were based in the EU. Now, only five are. It is essential that the European sector should remain efficient, and the way regulation is adopted and updated plays a role in this.

3. Possible need for regulatory evolutions in the fund sector

3.1. No need for additional fund regulation in the EU in the short-term

The panellists considered that the priority is not to propose new fund regulation in the EU but rather to optimize the existing framework and its consistency across the EU.

An industry representative stated that EU fund regulation is generally perceived to be 'ahead of the curve' at the international level, for example in terms of liquidity tools, and this advantage must be maintained. UCITS and AIFMD, the two cornerstones of EU fund regulation have already proved their capacity to ensure the resilience of the sector during the tumultuous post-crisis period and following the results of the Brexit referendum. Before making any further regulatory changes, the EU authorities should first wait to see if any further actions are envisaged at the global level. The Financial Stability Board (FSB), after having recommended improvements of the fund framework at the global level following the financial crisis is now assessing the implementation of the newly adopted fund regulations across the different G20 jurisdictions. In the US, the Treasury has called for a 'lighter touch' regulation in the fund sector, which should also be borne in mind.

A regulator stressed that UCITS V and AIFMD have put the EU fund sector in a better position. These frameworks have led to an improvement of the efficiency and the depth of EU fund markets and a reduction of the cost of investing which have allowed the broadening of investment opportunities and the enhancing of the allocation of capital in the EU. Some hurdles however still need eliminating at the cross-border level. An investor representative also emphasized that the current obstacles to cross-border distribution, product availability and delegation need eliminating. Fostering a truly European fund market will eventually lead to lower prices and better products.

Another industry representative suggested that asset segregation and reporting requirements for example also need clarifying, as well as the consistency of the terminology that is used, which creates uncertainty. For example, terms such as 'investor', 'beneficial owner' and 'ultimate beneficial owner' which are often used in an interchangeable way should be specified in order to improve legal certainty particularly in a cross-border context.

3.2. Reviewing the legislative approach used in the fund sector

An industry representative was concerned that the incoming Commission and Parliament might be tempted to launch new legislative actions at level 1. Instead of reopening UCITS or AIFMD, which already constitute an efficient framework and possibly 'reinventing the wheel', there should be more focus on level 2 and 3 measures to adjust some 'technical details' of the existing regulations and improve their convergence across the EU. Most of the remaining practical issues that market players and investors are suffering from can indeed be solved at level 2 or level 3, the speaker believed. More generally it is necessary to better differentiate what is addressed at each level in order to optimize legislative processes and the use of the respective competencies and experience of policy-makers, regulators and supervisors.

A member of the audience underlined that while the US Treasury was able to assess the whole post-crisis legislation and make suggestions for changes in one step, this is more difficult to do in Europe where every single piece of EU legislation has a different review clause with a different due date. The asset management sector alone is directly regulated by eight pieces of legislation alongside other ancillary regulations that also impact the sector. This multiplicity of rules also requires serious consideration.

The industry representative also criticized systematic review clauses. There may be political reasons for such clauses and requests for an early review made by some stakeholders who have not obtained all they wanted in the previous version of the text, but these systematic reviews are very difficult to manage for market participants because, due to the length of EU legislative processes, reviews are often launched shortly after a regulation has been implemented. This is the case for EMIR for example. In addition, making reviews less systematic would allow ESMA to play a greater role in the improvement of EU legislation on its own accord.

Another industry representative added that Q&As drafted e.g. by ESMA can solve many issues. Speeding up the pace of Q&As is however necessary. Another improvement in terms of legislative approach would be for new principles to be tested all along the value chain, including with intermediaries, before a regulation is enacted. Once the rules are enshrined, it is indeed difficult to amend them. One area where this needs to be done for instance is time limits, which create significant difficulties and constraints for the industry, especially when processing historical data.

A regulator agreed that Q&As are an effective tool which allows tests to be performed along the value chain. However, whether such tests should involve the private sector still needs to be determined. In addition, Q&As cannot be a substitute for legislation, because they do not provide the same safeguards. An investor representative was in favour of asking the consumers and the industry for their input during the consultative work led by ESMA, particularly in relation to the drafting of Q&As.

Developing EU securities markets: SME listing package, corporate bonds

1. The importance of developing SME equity markets and IPOs

An industry representative underlined, with a description of the benefits provided by initial public offerings (IPOs), the economic importance of developing SME equity markets, which should be one of the key objectives of the Capital Markets Union (CMU). IPOs have a very positive social impact as job creators and thus contribute to economic growth. A number of studies show that 90% of all revenue and staff growth occurs after a company lists or completes a successful IPO. IPOs also provide investors with positive investment performance (i.e. 'alpha'). Studies show that IPOs through multiple cycles, on average, outperform underlying benchmarks by as much as 500 to 700 basis points. This is therefore an important investment tool not only for institutional but also for retail investors.

However, over the past 20 years, there has been a significant decline in IPO volumes. Issuance numbers have decreased by 70% since their peak in 1999, particularly for SMEs. There are both structural and regulatory reasons for this decline. On the structural side, there is an abundance of private equity and venture capital in the system, which means that companies are staying private for longer. From a regulatory and efficiency perspective, the IPO process is still cumbersome, involving extensive manual processes, and also very costly (in some markets the IPO fees are between 6% and 7% before legal fees).

A regulator stressed that the diversification of the funding sources of SMEs is an important objective of the CMU. Developing instruments and funding structures that may support the innovation and growth of these companies is absolutely essential. MiFID II introduced the concept of SME growth markets but there has not been a significant uptake of these markets so far. An industry representative added that 75% of what are considered to be growth companies are working with intangible assets, which requires a specific funding approach involving private equity and public markets.

2. Main obstacles to the development of SME equity markets

2.1. Liquidity issues

Several panellists stressed the importance of liquidity for the development of SME equity markets.

'Both sides of the equation' (i.e. investors and issuers) should be looked at in terms of the development of SME markets, a regulator emphasized, and liquidity is particularly important when it comes to attracting investors. There is also a link between the liquidity and reputation of stocks which is crucial for market confidence because the absence of liquidity may lead to a downward pressure on market prices and significant losses in stressed market situations. This may happen for example if several funds are over-invested in SME stocks and many redemptions happen at the same time. Usually, only a limited number of investors are impacted by such events, but this has negative impacts on the image of these markets.

Another industry representative agreed that liquidity issues have significant implications because SMEs are part of an ecosystem that includes not only the listed SMEs but also mutual funds and other investors investing in these stocks. The limited liquidity of SME stocks however means that caution is required in relation to the development of SME markets. There are at present only 3,000 listed SMEs out of a total of 3 million in the EU but having many more could create systemic risks if these are illiquid. The obstacles to enhancing liquidity in SME markets have to be eliminated for a further development of these markets, even this is a challenging task, the speaker emphasized.

2.2. Other issues related to research availability and cultural factors

Several other issues that hinder the development of SME markets were mentioned by the panellists. An industry representative was concerned by the difficulty of funding research on SMEs following the implementation in particular of MiFID II rules that require the unbundling of research costs. Brokers are reducing their research activities because they are no longer profitable enough and analysts are disappearing from the market. Research needs to be incentivised, especially in the SME segment, where it is a key driver of investment decisions. A regulator stated that although there is currently a great deal of debate about the impact of MiFID II on research, it is still too early to measure the effective outcome of these measures and monitoring of this should continue. It is also necessary to distinguish the quality of research from the quantity produced. What is needed is sufficient good quality research that covers the right type of companies. Research needs to be sufficiently spread out as opposed to everyone reporting on the top 50 companies. An industry representative added that 'real' research needs to be re-developed, as opposed to research paid for by the issuers, which raises objectivity issues.

A regulator also highlighted the importance of cultural factors. Most SMEs are not inclined to seek funding on the capital markets. Efforts should be made, including with incentives, to change that mind-set and make capital markets more attractive for SMEs.

3. Proposals made for developing SME equity markets

3.1. The SME listing package, a first step that needs completing with more structural measures

Several speakers welcomed the SME listing package proposal recently made by the Commission aiming to make MiFID II SME Growth Markets[1] more attractive. SME Growth Markets (SME GMs) have so far not generated much enthusiasm with only three venues registered as such, out of the 40 that could qualify in the EU. According to the Commission's impact assessment this is due to the insufficient alleviation that is provided at present from Prospectus and Market Abuse Regulation (MAR) requirements, the lack of authorized mechanisms to promote trading and liquidity on SME GMs and an inadequate definition of SME GM, which uses a relatively low market capitalisation threshold indicating that these markets are mainly focused on micro-caps and illiquid securities. In order to address these issues and increase the attractiveness of SME GMs, the Commission proposed to reduce the administrative burden and cut red-tape faced by SMEs listing shares or bonds on SME GM, by introducing targeted amendments to the Prospectus and MAR regulations as well as technical adjustments to MiFID II.

This proposal was considered to be a first positive step by the panellists but requiring further action for it to sufficiently support the development of SME equity markets in the EU.

A regulator believed that further simplifications need introducing in the field of market abuse. More could have been proposed for example with regard to certain types

of insider lists and manager transactions. More could also be done in the field of prospectuses. An industry representative was favourable to the proposal made in the SME package of a simplified prospectus approach when a company moves from a junior market to a regulated market. This is a process that already exists e.g. in the Nordic region.

The regulator however suggested that more fundamental policy measures would be needed to develop SME markets in addition to the regulatory improvements to MAR and MiFID II proposed in the SME listing package. More structural measures are needed to tackle liquidity issues, promote SMEs as an asset class both to institutional and retail investors, create a more functioning SME ecosystem that may support initial listings and also their ongoing development, as well as provide appropriate incentives.

Another regulator agreed that the impact of simplifying requirements (e.g. a simplified prospectus) can only be partial. More needs to be done on other key points such as reputation, image and liquidity and other tools than regulation are needed for tackling these issues. It is crucial in particular to find the right balance between flexibility and a minimum level of rigour in terms of controls and disclosure obligations in order to ensure investor confidence. For example, market operators and regulators should try to discourage immature projects and very poorly structured companies from listing on public markets.

An industry representative agreed that regulation does not create markets, but facilitates them. While regulation creates a framework, it is the market stakeholders that need to develop collectively the market within this framework. The different channels through which SMEs can be provided with funding (i.e. business angels, family offices, private equity, venture capital, IPOs…) should not be considered as competing with one another, because 'the more, the merrier' and companies should have as many alternatives as possible to finance their growth. One positive 'disruptive' element that can be added is that some IPOs are now handled by crowdfunding platforms which have a MiFID broker licence. This brings the new technology and digital direct access of these new platforms to the client base of more regulated markets.

3.2. Measures to enhance the liquidity of SME equity markets

A regulator mentioned that some measures are proposed in the Commission SME listing package concerning liquidity (creating a common set of rules on liquidity contracts for SME GMs in all Member States in parallel to national rules). Time will tell if these measures are effective, but the fragmentation of liquidity also needs tackling. The quality of liquidity increases if there is concentration around a single trading point. The development of SME GMs seems appropriate in this regard. Creating a single SME market for the whole of Europe is not the right way forward, but further developing regionalised or specialised markets for different types of SMEs should be considered in order to further concentrate liquidity.

Another regulator stated that liquidity is difficult to improve in SME markets, because by definition the companies listed are small and the free float in the market is also limited. Proportionality has been introduced in the rules and requirements concerning these markets in order to provide as much flexibility as possible to facilitate the access of SMEs to public markets, but rigour is also important given the risks involved. Some actions are needed regarding liquidity providers, as proposed in the SME listing package, but the impact may not be significant because the commitments that can be expected from them are limited in practice. Another option could be to impose a minimum free float that could be enforced by regulation or the market. Making sure that the average performance of companies listed on SME markets is sufficient is also important from a reputational point of view. The regulator also remarked that solutions to mitigate downward pressure due to significant fund redemptions exist, such as creating side pockets and suspending redemptions.

An industry representative was against imposing free float requirements for SME listings at the EU level, because defining a minimum level that would work in all markets across the EU is difficult. It should be up to the local market operators to decide what the appropriate level should be. The industry representative also considered that creating pan European SME markets or unifying all existing markets is not the right approach because of the local specificities of each market ecosystem. What is needed is building layers of consistency and harmonisation on top of already existing and developing local markets. This is the approach that has been taken in the Nordic countries where best practices are shared among the seven stock exchanges that operate in the region and which have quite different characteristics in terms of size and maturity. A pan-European market is no substitute for the lack of well-functioning SME markets in each of the EU27 countries.

Another industry representative called for a stronger focus of EU initiatives on the development of cross-border retail investment in the EU. This is currently not happening, particularly because of post-trading barriers that make cross-border transactions very costly and many retail clients prefer to purchase US rather than EU stocks as a consequence. There is a need for an additional retail workstream in the CMU action plan aiming in particular to make post-trade more efficient and less costly within the EU27.

3.3. Maintaining an appropriate balance between retail and institutional investors and re-developing research

Some speakers emphasized the importance of maintaining a combination of retail and institutional investors in SME markets. Retail investors can help to stabilize the market when there are tensions on liquidity, an industry representative stressed. However certain conditions need to be fulfilled for attracting them.

A first condition for developing retail investment in SME stocks is the availability of appropriate research on these securities. The need for the authorities to promote research on SMEs and the development of specialised brokers was advocated by several speakers. Industry-driven initiatives can also be helpful. An industry representative outlined that their organisation, a stock exchange, is running a project with the local institute of financial analysts aiming to offer independent research, free of charge, to 'orphan' companies that are not covered by any research. The institute is responsible for selecting the research staff and ensuring proper governance.

Secondly, MiFID advice and information rules need to be appropriately enforced. Certain intermediaries choose not to provide any advice on certain types of investments in order to avoid incurring any responsibilities, a regulator underlined. Also, rules need to be calibrated so that the access of retail investors is not blocked off. An industry representative whose company owns an online broker however mentioned that they are not allowed to advise their clients on investments. In addition, investors using these platforms prefer to make their own decisions based on independent research that they conduct or are provided with.

3.4. Providing appropriate fiscal incentives

An industry representative stressed that public financial support is crucial for encouraging more listings on public

markets. The best incentive that could be given to the development of SME equity markets would be an equal fiscal treatment of equity and debt. At present there is an asymmetrical situation in most European tax systems, which favours debt over equity due to the deductibility of interest expenses for issuers. This is increasingly hard to justify in a financial system that is inundated with debt and where there is strong support for developing equity financing. Different mechanisms have been proposed to reduce or eliminate this distortion. One of them would be for companies to be able to deduct from their ordinary profits the return on equity, as is the case for interest paid on debt instruments. Another potential fiscal obstacle to the development of SME equity markets is the contradictory situation that is being created by politicians proposing to impose a financial transaction tax while encouraging the development of alternative financing sources to banking.

Another industry speaker emphasized that incentives to encourage investors to invest in SMEs, including fiscal ones, are essential. The Swedish investment savings account, which has now been copied in Norway, Denmark and Finland provides an interesting example of incentives for retail investment. Institutional investors should also be encouraged to invest in SMEs, for example by way of local requirements for a proportion of pension capital to be invested in SMEs.

3.5. A public policy initiative to develop IPOs

An industry representative emphasized the need for a public policy initiative aiming to improve the IPO market structure. Some of the building blocks needed for redeveloping the EU IPO market are in place. One of the best examples of democratised venture capital is in the EU, the industry representative emphasized. The Juncker plan has indeed successfully allocated up to €350 billion of venture related capital to 700,000 SMEs and the IPO pipeline is considered 'excellent' within the universe of these companies. Not all of these SMEs will be eligible to a potential IPO, but this initiative should help to find 1,000 or so companies that ultimately will be.

The industry representative gave some examples of successful IPO reforms that have been implemented in other jurisdictions. In the US, President Obama signed into law the first iteration of the US JOBS Act in 2012 ('Jumpstart Our Business Startups'), which combined a number of acts and initiatives around capital formation reform. In 2012, a new category of emerging growth companies (EGCs) was created and issuance rules were adapted for these companies. For example, responsible relief is given from certain financial reporting standards and auditor rotation rules, which would otherwise be very expensive for such SMEs. Since, there has been a major upswing in the number of EGC IPOs. Their volume has been multiplied by three to four since 2012 and they were up another 38% in 2018 alone. It is estimated that this increase in IPO volumes has resulted in significant job creations in the US, which was one of the key objectives of the JOBS Act (+1.5 million new jobs). Measures to support the development of IPOs have also been proposed or implemented in Canada, Hong Kong and Australia. Australia for example is contemplating an all-electronic online IPO platform.

4. Developing corporate bond markets

A regulator outlined that the corporate bond market has developed over the last few years but this is partly due to monetary policy and it is uncertain how sustainable this trend can be in a changing market environment. Issues in the corporate bond market are similar to those at play in the SME equity market i.e. liquidity, cross-border access on the investor and issuer sides, retail involvement…

Another regulator stated that liquidity is an issue in the corporate bond market. Some domestic regulators have been encouraging issuers to issue on electronic platforms, but that has not been very successful so far. Having more active liquidity providers would be a useful improvement. The regulation of competing instruments, trading rules and ensuring that there is an appropriate mix of institutional and retail investors are other important elements for the corporate bond market.

An industry representative expressed dismay at the lack of development of retail bond markets. It is much easier for an issuer to issue bonds with a high denomination for the wholesale market only and to stick with that, and therefore there is no incentive to create a retail bond market in the EU. The only retail bond that exists in the Nordic markets however is successful, trading on electronic order books with a market maker. This is therefore an untapped opportunity which needs considering with the upcoming normalisation of interest rates and for which some support is needed for developing the market. Another opportunity to consider is the sustainable bond market which is recent but growing very quickly with the increasing awareness of environmental, social and governance issues. This segment now represents 10% of the total Nordic corporate bond market for example.

A regulator noted that caution is required regarding SME fixed income markets, because many of these securities are risky. A prudent approach would be to reserve these markets for institutional investors, especially regarding initial phases. This has been done, for example, in the Spanish alternative fixed-income market (MARF), which was created with the objective to offer an alternative to bank financing and is evolving satisfactorily. In a second phase it might be opened partially to retail investors.

1. SME Growth Markets (SME GM) are a new category of trading venue that was introduced by MiFID II in January 2018 with the objective to raise the profile and visibility of SME Markets across the EU. In order to qualify as an SME GM, at least 50% of the issuers whose financial instruments are traded on the venue need to be SMEs, defined as companies with an average market capitalisation of less than € 200 million. The listing rules of SME GMs must also satisfy certain quality standards in order to guarantee investor confidence, including appropriate admission documents and periodic financial reporting. SME GMs are subject to the new Prospectus Regulation, which has introduced a reduced disclosure regime (the EU growth prospectus) for SMEs which have no securities admitted to trading on a RM. SME GMs are also subject to the Market Abuse Regulation (MAR), which provides two alleviations for these markets: issuers can disclose inside information on the trading venue's website rather than on their own website and SME GM issuers are exempted from maintaining 'insider lists' on an ongoing basis.

Can existing market infrastructures sufficiently support the CMU?

1. Progress made in the implementation of the CMU and the regulation of market infrastructures

1.1. Progress made in the implementation of the CMU

An official felt there has been good progress on the Capital Markets Union (CMU), but much remains to be done. Most of the legislation related to the CMU is not yet in force, so it

will take time to see whether the industry makes use of the new opportunities. The European integration of financial markets is a step by step process that started many years ago with the Financial Services Action Plan (FSAP) and many different elements of it still need putting together. Infrastructure is a part of it and some components such as TARGET2 and TARGET2 SECURITIES have been provided by the Eurosystem.

The CMU initiative is designed to offer new opportunities for financing the economy, as banks are deleveraging, and also to enhance capital allocation and risk sharing across the Union, the official explained. An industry representative added that financial market infrastructures (FMIs) play a key role in supporting the objective of the CMU to further develop funding capabilities in the EU. There is also an objective in the CMU to further integrate EU financial markets, which has implications for financial market infrastructure, a public representative remarked. Another official stated that the goal of CMU on a macroeconomic level is to be able to absorb macroeconomic shocks from the private sector. To do this, efficient infrastructures are needed because FMIs provide the plumbing of the financial system through which funding resources are channelled to the economy.

1.2. Progress made in the regulation of Financial Market Infrastructures (FMIs)

A public representative stated that since the financial crisis several pieces of legislation aiming at strengthening EU market infrastructure have been adopted. Making infrastructures more resilient was a priority for the EU after the crisis.

A regulator considered that Europe is still in the early stages of the implementation of much of its trading and post-trading legislation. Much has been done by the public and private sectors to implement these new regulations and to roll out TARGET2-Securities (T2S), but in some areas such as the CSD Regulation (CSDR), the process has not reached the final stage of implementation and quite a few market adaptations are still going to happen following the implementation of T2S. These new regulations are changing trading and post trading market structures with greater cross-border consistency and harmonisation. However, there is still a considerable amount to be done. Harmonization work started more than 16 years ago with the Giovannini barriers and is still not finished. An official agreed that a considerable amount of effort has been spent on drafting and adopting these legislations, but it is now very important to ensure that they are implemented consistently throughout the EU.

1.3. New opportunities and challenges related to technology

The opportunities that new technologies offer in the context of securities markets were underlined by several panellists. Technology can notably play a role in increasing efficiency and developing capital market activities on a domestic and cross-border basis.

An industry representative however emphasized that new technologies such as fintech and blockchain cannot help to further harmonize legal rules e.g. applying to post-trade, and that further harmonisation of these rules will be needed to leverage the potential of these new technologies. An official added that with the development of new technologies the European authorities must move faster in adopting new regulations or changing them. It should be possible to build on the existing capital market framework to develop in the future more focused and faster to implement legislation, if needed.

2. Main pending issues regarding the regulation of trading and post trading infrastructures

2.1. Enhancing transparency in the trading area

Concerning the trading layer and the role that it may play in developing more capital market funding and liquidity, an industry representative emphasized that transparency is the starting point. It is at the heart of price discovery and efficient markets and also reduces market abuse, thus raising trust. At this stage however transparency has not yet been fully delivered when considering what has been achieved with MiFID II in particular and some issues still need addressing.

Another issue, the industry representative stressed is that beyond the necessary consistency in the implementation of rules across jurisdictions, there also needs to be consistency across regulatory dossiers impacting trading activities. In particular, how liquidity is provided in markets is very important. For example, the market making requirements in MiFID are not appropriately reflected in the investment firm review and this may impede liquidity. Taking a step back to check that the different rules applying to a given area are consistent and fit together is important for achieving the CMU.

2.2. The need for a further harmonisation of post-trading rules

An industry representative stressed that safety and financial stability are improving in the post-trading area, with the on-going implementation of the new EU regulatory framework for FMIs. The second objective which is to further harmonise rules and processes is 60 to 70% completed. This is a key objective in the CMU context because insufficient harmonisation increases costs for issuers and investors. The European Post-Trade Forum (EPTF) is continuing and completing the work initiated with the Giovannini barriers in this regard, but it is unfortunate that the EPTF published its report before CSDR and T2S were fully implemented, because these new initiatives may generate new barriers. In addition, the EPTF recommendations still need implementing.

A key question that remains to be tackled, the industry speaker felt, is whether increasing consolidation and competition in the post-trading space is still an objective of the EU and what the appropriate level of consolidation to support the CMU may be. CSDs in particular are a business based on economies of scale, but with 30+ CSDs in the EU27 it will be difficult to reap all the potential benefits of economies of scale, despite the improvements provided by the CSDR and TARGET2-Securities (T2S). These initiatives should normally facilitate the consolidation of CSDs in the EU and the development of competition between them, but the lack of harmonisation of securities law and of tax procedures is blocking these evolutions. Although post-trading processing costs are only a small part of the total cost of cross-border securities transactions, the speaker believed that legal and fiscal harmonisation objectives should be reconsidered notably in the context of the EPTF, because this would facilitate cross-border securities transactions in the EU. The question is whether there is a political will to go beyond the national interests of Member States and their local CSDs.

An official observed that with the CMU there is also a question of whether the EU has sufficient capital markets for the size of its existing infrastructure. The answer is probably no. The goal is therefore to increase the size and liquidity of markets in order to diversify the sources of funding for companies and savers.

Another official considered that in the context of the digital economy, it is important to consider whether

these fragmented infrastructures are able to survive because in other areas of the industry fragmentation e.g. of payment systems does not work on a sizeable and harmonized platform such as Amazon. This could also be an opportunity to reconsider the concept of the '29th regime' in the area of market infrastructures in order to overcome the fragmentation of the legal environment.

2.3. Strengthening the third-country regimes of EU market regulations

A regulator emphasized that a sound regime is needed for third-country market infrastructures wishing to access the EU market. EMIR 2.2 (the review of requirements for the supervision of EU and third-country CCPs) is the most important priority. With Brexit, it is essential to finalise this proposal as quickly as possible. The Parliament has adopted its report, so it is mainly now a task for the Council. There must be a regime in place to deal with Brexit in the CCP space in a timely way and this will also apply to other third-country CCPs.

An official stressed that a broadening of the third country regimes applying to market infrastructures is needed. For example, in CSDR there is a recognition regime for third country CSDs but it only applies to notary and central maintenance services. There are no third-country rules for settlement services for example, which means that third country CSDs can provide these services freely with no level playing field whatsoever. Similarly, the inconsistency of MiFID third country regimes for trading venues is also an issue. Those are problems which are important to tackle in the perspective of Brexit, following which a substantial part of the market infrastructure servicing the EU27 market will be outside its borders.

An industry representative explained that the third country regimes of EU legislations should provide a healthy balance between access to markets and preserving prerogatives in terms of financial stability. These regimes need improving, however they are split across many regulations. In addition to CSDR and MiFID, there are missing parts regarding third-country access rules in AIFMD and UCITS in particular. Brexit requires these changes to be made, but they are also necessary for managing relations with other third countries such as the US and Japan.

A public representative believed that the problems mentioned are consequences of a 'horizontal' policy area (i.e. third-country access) being addressed using 'vertical' regulations. The concept of a review clause could potentially be used to address some of these problems. Another issue is that third-country regimes were conceived for jurisdictions that do not have the level of business with the EU that the UK has in the financial sector and that it appears to want to maintain.

3. Improving supervisory convergence at the EU level

A regulator emphasized that improving supervisory convergence, as proposed in the context of the review of the European Supervisory Authorities (ESAs) is essential in the market infrastructure space where consistency in the implementation of rules needs improving. EMIR and the discussions around EMIR 2.2 have demonstrated that the collective supervisory effort made in the context of CCP colleges is achieving positive results, but stronger coordination is needed because colleges sometimes take different approaches. It is clear that moving to a single European supervisor for all European financial markets will not be possible in the short-term. However, it is necessary to consider where greater coordination makes sense. An area where this is particularly the case is the interaction with third country market infrastructures where providing a single point of contact and real consistency in how to access the European market is essential.

An official emphasised that the single rulebook must be applied in a consistent way. Before discussing a single supervisor, it is necessary to discuss a single way of supervising and interpreting rules, which is the main role of the ESAs. In the ESA review, there was much debate about direct supervision, but the most important objective is to achieve further convergence in supervisory practices. Whether there should be a unique supervisor for the EU or one for each Member State is secondary. This having been said, market infrastructures are probably the type of financial institution that is by nature the most cross-border. The type of central supervision that has been put in place for systemic Eurozone banks with the SSM would make even more sense for market infrastructures at the EU level. However, the debate about EMIR 2.2 demonstrates that this is a contentious subject. It is desirable to move towards single supervision in the long-term, the official believed, but this must be done progressively. In any case, it is not institutional changes but attracting more business to Europe that will help to develop capital markets and achieve CMU objectives and that will ultimately give rise to needs for more unified supervision.

An official acknowledged that the SSM is a success. The interactions between the National Competent Authorities (NCAs) and the Supervisory Board of the SSM are fruitful and help to improve supervisory decisions. Although this has made supervisory processes more complicated and lengthy, the outcome is better than it was before. What the SSM experience also shows, the official emphasized, is that it is possible to centralise supervision without unifying the market. The structure of banks in Germany, for example, is completely different from France. The SSM experience shows that it should be possible to move towards a more centralised supervision of market infrastructures, while respecting national specificities, different market functions and different business models.

4. Possible implications of a no-deal Brexit for EU market infrastructures

4.1. Challenges raised by Brexit for the completion of the CMU

A regulator suggested that Brexit is an accelerating factor for the completion of the CMU. The EU27 needs to ensure in particular that it has the necessary market infrastructure in place that it is sufficiently safe and efficient and able to deliver the level of transparency required.

In the perspective of Brexit, a key question to address is whether there is the need for a globally relevant financial centre in the EU27, an official stressed. The EU will be losing with the UK its only significant financial market at the global level. No other market in the EU has the size, liquidity or variety of products that are available in London or New York. However, the EU has the potential with the totality of companies, investors and professionals present across the continent and the corresponding liquidity to create a market that can compete on the global scale. This can potentially be achieved by integrating existing financial marketplaces in the EU into a network linked up by digital means. This is an objective that the EU should strive for beyond the CMU.

4.2. Short-term challenges raised by a possible hard Brexit

An official advised the industry to hope for the best and prepare for the worst. Preparedness is very important for the industry and for public authorities. In addition, there

will be a cost to Brexit in any case and these costs might be higher in a no deal scenario. If there is a very hard Brexit, setting the right priorities for the EU will be essential and in particular any issue that could trigger financial stability risks will have to be addressed. Clearing is the area with the highest financial stability risk and for which solutions need to be found. A regulator considered that implementing EMIR 2.2 is therefore the most important priority in the short-term because CCPs will be a central element in the management of a possible hard Brexit.

An industry representative stressed that there would be short and medium term effects of a hard-Brexit on the whole of the value chain. Preparing for this at the industry level involves different assessments and actions. First, market infrastructures must assess with their members the possible impact of Brexit on market liquidity, which is important for orderly price discovery, and also the readiness of end-clients, in order to identify possible legal or technical measures that may be needed to mitigate any negative impacts or uncertainties. Since at present, more than 50% of the EU's liquidity in the trading space comes from the UK for equities and derivatives, it is essential to avoid a sudden change. Secondly EU based FMIs are in contact with the UK authorities to discuss their future status in the UK. Lastly, some FMIs are developing new services for example for the clearing of euro-denominated interest rate swaps that are relevant in this context.

Another industry speaker described the difficult situation that certain UK-based FMIs servicing EU clients are facing with Brexit. A hard Brexit raises the question of how to ensure continuity of service. For CSDs this notably involves checking the CSDR provisions on grandfathering and third country recognition.

An official did not believe that the dependence of EU counterparties on UK infrastructure would last in the longer term, irrespective of the Brexit scenario. Ultimately market participants will need to adapt to the changing environment and the regulatory landscape. Although market participants need to prepare for changes in the short-term, these changes should mainly be transitional.

LONG-TERM INVESTMENT AND SUSTAINABLE FINANCE

What measures are necessary to increase long-term institutional investment in the EU?

1. The main impacts in terms of financial stability, economic resilience, sustainable growth, the innovation and sustainability challenges of insurers' long-term investment strategies

1.1. Long-term institutional investment in the EU

An industry representative noted that insurers have €10 trillion invested in the EU economy, making them the largest institutional investors in the region. These investments are approximately 75% in general-account assets and 25% in unit-linked assets. Insurance companies are long-term investors because of the nature of their liabilities and their asset-liability matching strategy. They are natural candidates for long-term investment in line with the objective of sustainable growth.

The EU economy shows underinvestment in infrastructure, which consumes 1.8% of gross domestic product (GDP) today, 20% below the pre-crisis level. The public sector is financially constrained, with investments by the public sector representing 2.7% of EU GDP, a 20-year low. Equity funding is low compared to the US. EU stock-market capitalisation is 80% of GDP against 166% in the US. It is obvious that the insurance sector can provide some solutions to these challenges.

Another industry representative agreed and added that around one million people in Europe work full- time in the insurance industry. As is known but sometimes forgotten, it is a pure service industry, a people business. The insurance industry has a mission statement that it does not stand for itself alone but must serve European civil society, or the European idea, and competitiveness in the interest of global competition. Sometimes the sector 's potential contributions are not reflected enough in the political agenda of the EU, especially in terms of the Capital Markets Union Action Plan of the Commission.

An official reflected that Europe's frame and environment is good, with stable growth over the last two years. Austria is always competitive with Germany regarding growth, which is at a rate of 3.2% versus 2.2% at the European level. The environment is good but a task for the future is to make it stable and sustainable. It is important to keep in mind making the base free for long-term investments at the European level, especially for companies such as life insurance and pension funds, as well as matching the duration of their liabilities and assets.

1.2. Potential issues facing the sector in the future

An industry representative stressed that Solvency II although it may not have many fans in the industry, has brought positive developments. However, he highlighted two issues posed by the framework. Firstly, it is proposed to have the level of the risk margin reduced to 3% coming from 6% currently, to set free around €110 billion from balance sheets which are not employed and are missing in the overall growth of the European economy. The second issue is equities. Capital requirements for listed and unlisted equities are high, at 39% and 49% respectively. It is proposed to reduce them to 22%. The clear message is not to develop a political agenda on the one hand and regulations on another. They must be tied together. Things developed will not work unless they are agile and connected. If they are split and separated, this does not serve European development in a global market.

An official noted that discussing sustainable finance at the European level makes also sense on the liabilities' side. When investing over the long-term in sustainable finance, it is important to consider natural catastrophes which will create demand for insurance companies to solve problems in this form. Solvency II reviews are starting, with one on the level of standard regulatory capital and another expected in 2020. This discussion creates a chance to see how it might influence the situation in the insurance market.

2. The evolution of insurer portfolio investment strategies in the EU and globally

2.1. The corporate bond market

An industry representative advised that the evolution of insurance investments in the past 20 years shows three elements. First, thanks to the euro, the corporate-bond market has developed substantially, and roughly half of insurers' bond investments are in corporate bonds, which is good for the EU economy. As interest rates have fallen since the financial crisis, insurers are looking for higher-yielding, less liquid and more diversified assets and, therefore have a stronger interest in infrastructure and private loans which brings economic benefits as well.

2.2. Equity

The second feature is on the equity side. While equities represented roughly 20% of general-account portfolios 20 years ago, today they represent only 10%. That can be explained by three factors. The first is volatility in the European equity markets being higher than in the US or Australia. The drop between the high and low point, both between 2001 and 2003, and 2007 and 2009, was 60% in Europe over two years, which explains both investors' prudence and the somewhat high calibration of equities in terms of capital in Solvency II. The second is accounting, as the introduction of International Financial Reporting Standards (IFRS) has led to market-value accounting, which means that equities have to be impaired to market value with induced volatility in the P&L.

2.3. Unit-linked investments

An industry representative advised that insurers' reduced equity investment is, in part, compensated for by the fact that unit-linked investments have increased. Roughly 50% of unit-linked assets are related to equities. Although the risk is borne by policyholders, over the long-term, equities are a good investment for policyholders. The issue is that equity culture is low in Europe and market-conduct regulations are not conducive to equities. Regulations in most countries would limit the allocation to equities for

a prudent private investor to 30%. However, a 30-year-old should invest 75% of his or her assets in equities. People do this in the US and benefit. These issues are in the way of further developing equity investments.

3. Influences of the recent accounting standards and Solvency regulations on the evolution of these strategies in different geographic areas and in the EU

3.1. Sources of discrepancies in EU investment strategies

Information in the statement and an overview about previous years' difference between countries in bonds and equities is shown in an Insurance Europe survey.

An official agreed that equities are going down, but it is not significant and not expected to be. Countries like Sweden, for example, have nearly 30% equity in insurers' assets, so there is a gap across countries. Markets show some insurers are de-risking and others are re-risking, so there is no common line of development. It is different if an institution is only in life or if it has other parts, so this must be analysed. Reviews must be transparent in terms of mechanisms. The first Solvency II review, which runs until the end of this year, is on capital requirements and is a level II, specific, technical part, including rated equities. For the long-term, there is perhaps a chance, with regard to InvestEU, to find a way to further boost long-term investment. Solvency or the IFRS may not suffice to solve the problem, as it includes transparency, consumer protection and other areas. Alternative solutions are needed.

An industry representative noted that it has taken more than 14 years to develop Solvency II. Depending on their strategy and region, insurance companies have developed different strategies for handling investments and risks. When introducing Solvency II, the Commission provided two chances for review: in 2018 and 2020. This is wise. The overall nature of Solvency II the role-model framework globally, is conservative. Responses of Members' of Insurance Europe to a survey show that 96% of CEOs of European insurance companies think that Solvency II has improved risk management and governance, 89% say data quality has been enhanced substantially and 76% report a strengthened asset-liability management. That shows the positive effects. On the other hand, 50% say that Solvency II has contributed to a negative effect on the ability to offer long-term savings products. Insurers are not short-term traders. The demographic situation in Europe is alarming and something must be done.

3.2. The American insurance industry's perspective

An industry representative advised that the European Solvency framework is more onerous than the US. Consolidated supervision has existed in Europe for more than a decade, while there is still no consolidated supervision of insurance companies in the US; it is state-by-state. Capital requirements are more onerous in the EU than in the US. The US has given up on systemic-risk oversight for insurance, so it is a different environment. Prudential supervisors are doing what they think is right to protect the solvency of insurance companies. They are focused on stress-testing, systemic risk, and recovery and resolution plans. This should be balanced with a growth agenda pursued by the Commission, the Council and the Parliament to reinvigorate EU investments.

4. Priority evolutions of EU regulatory and accounting standards and political challenges

4.1. Main necessary features of the Solvency II reviews

An industry representative advised decreasing the Cost of Capital (used to compute the Risk Margin) to 3% by 2020 at the latest, or preferably this year. Finding a solution for the equity situation, such as reducing from 49% and 39% to around 22% would also free capital needed by Europe and support the political agenda around the CMU.

Another industry representative agreed. Solvency II was developed as a new regime to improve how risk is managed; not increase capital. Yet insurance companies have accumulated more capital because of Solvency II. It is necessary to measure that with reviews, and 2018 and 2020 present opportunities. The Commission did not want to move on equities in 2018, but it would be a missed opportunity to wait until 2020. Risk-margin reduction from 6% to 3% would benefit Europe by allowing additional equity investment by insurance companies of around €100 billion. This is a concrete measure. It is possible to wait until 2020, but it is unclear why one would wait if the opportunity exists and is supported.

4.2. The pan-European personal pension product (PEPP)

An industry representative noted that moving the PEPP agenda forward would be beneficial, because pension investments are substantially in equities.

4.3. Accounting standards deserve further attention

Accounting is arcane and complex, but the industry supports comments made by the European Financial Reporting Advisory Group (EFRAG) to the International Accounting Standards Board (IASB) on the IFRS 17 Directive, although they have not retained all measures recommended by the industry. There are two additional recommendations: the expansion of the scope of the variable fee approach beyond direct-participating business; and the treatment of realised capital gains and losses to reduce earnings volatility.

4.4. Facilitating infrastructure investment

There is also an appetite for infrastructure investments and loans, which should be considered in the regulation. An official noted that Solvency is gaining fans but there is a need for additional discussions.

Much has been done by the European Commission to allow better treatment of infrastructure. Additional measures could apply it to non-Organisation for Economic Co-operation and Development (OECD) infrastructure investments, because insurers invest beyond the OECD.

Another measure relates to crowding in rather than crowding out private infrastructure investors. InvestEU, a new programme which should include current forms of investments, should be open to the banking and insurance sectors in order to foster successful and sustainable long-term development. There are many players involved, starting with the European Investment Bank (EIB). It is important in this respect to avoid crowding them out. A clear governance set-up is needed to ensure they fit.

4.5. There is room for improvement across Europe but there will be dense political discussions

An official advised that there is room for improvement across Europe, as is shown by Sweden, which has nearly 30%. He agreed that there is a need for measures to ensure in which form this can be done and make clear the long-term and overall impact. In Austria's four remaining months of Presidency, nearly 50 files are to be negotiated, one-third on financial markets, so there will be important discussions about the required measures. The risk margin makes it a difficult decision. The PEPP is a priority under the Austrian Presidency. There is a need to discuss the form for introducing it into the markets as this will be key for the sector for the long-term stabilisation of pensions.

On infrastructure, an official agreed that there is room for insurance investments and the discussion around InvestEU could present a solution to bringing these assets from insurance to investment. Europe's long-term vision

is towards digitalisation, acknowledging traditional ways of employment and new forms of data in infrastructure, aspects requiring the support of the insurance sector. There is contact at the European level with Ministers, and there is a broad, common view on it.

An industry representative advised that there is still some mistrust on the part of regulators relating to insurance companies' actions over the last 10 to 15 years. Lessons have been learned. Feedback from CEOs is that there is a common understanding that business must be managed and monitored in a better and more granular way than it was 25 or 30 years ago. The idea behind IFRS 9 and 17 is good overall and is supported, but issues remain to be discussed before it becomes effective on 1 January 2021. More trust is desirable. Regulators and the industry have experienced what went wrong and what can be improved. A company does not thrive by cutting costs or by treating clients in a bad way but by having people request they manage risk because of a belief in their competence and skills.

An industry representative highlighted the political agenda. The Capital Markets Union plan is highly supported, and the demographic situation must be taken care of. There is global competition. No one is afraid of competition between traditional European insurance companies. It is competition from outside Europe, relating to tech giants and platforms, which begets a discussion of a level playing field for all market participants. Interaction is good, discussion is necessary and this is why the Commission proposed two reviews in 2018 and 2020. The right measures must be taken because there is a population to serve. This is the mission and why insurance companies exist.

5. Regulation of new market entrants

An official stressed that there is competition from Insurtech and Fintech, which are playing in a regulatory field that has not been well defined. It is important to find a solution that does not struggle with new models coming into insurance but creates a common frame. Recent discussions about digitalisation and its influence on business have stressed that traditional businesses are protected by regulation but that is not the case when new entrants have no regulation of any form. Austria started a fintech advisory board, including start-up members from Insurtechs and from insurance/banking systems, with the authority to work out sandbox. This is a chance to discuss topics developed on a traditional basis for insurance, banking and regulatory. It provides room to breathe and strengthen a common solution to ensure that Europe's vision is fulfilled.

Improving financing prospects of EU infrastructure projects

1. Infrastructure, economic and financial trends

1.1. Global infrastructure financing needs and challenges

An industry representative noted that infrastructure needs are rising globally: the funding gap is believed to be €18 trillion. China's infrastructure needs are €2 trillion, and the US's is €1.8 2 trillion. In the last 10-15 years spending has actually declined. 11 out of 20 countries of the G20 have reduced spending on infrastructure since 2007. US infrastructure spending is at its lowest level since 1964. The majority of the funding gap is estimated to be in surface transportation, 12% in energy, and roughly 3% in aviation. Funding sources are being diversified away from the government in many parts of the world. Private funding of 50% goes into energy, 25% goes to transportation and 15% to utilities.

An official stated that €40 trillion of assets are invested globally, which is approximately 8% of total investable assets. Out of the €40 trillion, approximately €10 trillion is currently in the hands of the private sector. Out of this, €5 trillion is equity, and €5 trillion is debt. 50% is in North America, 25% is in Europe, and 10% is in Asia. If the next 30 years are examined, 50% of infrastructure is supposed to come from Asia. The rest is in emerging markets, which includes Africa.

An official explained that since the beginning of the 21st century listed equity infrastructure in Europe and the US represent approximately 75% of the €5 trillion previously mentioned. The other 25% is unlisted equity, which has been developing over the last 20 years.

In Europe, and the US, these secondary markets are currently in a boom period due to Financial Institutions being sure that there is a financing gap in traditional financing sectors in terms of big numbers and no crowding in of the broader source of financing that is seen in the markets. There is a potential problem stemming from the non-performing bank loan regulation, which questions whether bonds can replace bank finance in the renewable sector, especially wind.

1.2. Sources of financing

An official added that the project finance structure is driven by an appetite for long-term assets with stable and predictable cash flows. Utilities and financial investors such as banks and institutional investors are trying to match the actual risk appetite of the different players in the market to the risk profile of infrastructure. Consequently, it is important to get the right players in, and it is unlikely that institutional investors such as pension funds will become major players in the greenfield phase of projects in emerging markets. Utilities are facing many challenges: renewable energy is driving the market to a redefinition of their role. There is also a potential issue with their regulation, and an issue regarding whether bonds can replace bank loans due to the amount of non-performing loans in the banking sector in the EU.

An official stated that there is a lack of trust among different players in the sector, but more importantly there is a lack of trust between the public sector and the private sector. This is due to a problem with assessing the additionality of the projects facilitated by public intervention, a lack of mutual understanding, transparency and communication, and a lack of data. All of this makes Infrastructure a very opaque asset class.

An official noted that infrastructure financings include the new projects, which emerging markets need. The financing needs of infrastructures projects involve a primary phase, which includes M&A products, and a secondary phase which consists of a market refinancing of primary financings. An industry representative added in this respect that Moody's and the World Bank suggest that projects in emerging and developing markets perform in line with projects in developed markets. An official noted the G20 will discuss a new database for better

understanding notable risks, returns, and possible policy initiatives.

An industry representative explained that in the US 77% of infrastructure funding is from states and municipalities, compared with 23% from the central government. This has given rise to a large municipal market in mini bonds. The US is achieving a good mix between municipalities, states, central government, and private sector alternative asset managers providing funding. In 2017 €80 billion were provided by alternative asset managers, compared with €55 billion in 2016, and roughly €30 billion in the preceding 10 years.

An industry representative stated that in 2017 assets under management were €420 billion globally, compared with €50 billion in 2006. The growth for infrastructure assets under management was 42%, compared with 8% growth for real estate assets under management. Capital raised by alternative asset managers showed the US totals as €35 billion, Europe €22 billion, Asia €1 billion, and the rest of the world €6 billion. The largest investors were pension funds, which in 2017 held €80 billion in infrastructure. Sovereign wealth funds held €45 billion. Alternative managers held €42 billion. Insurers held €22 billion. Private pension plans held €10 billion. Investment demand far exceeds supply. In recent years, as a result of the extraordinary monetary policy, investors have shifted toward illiquid, high-yielding assets, away from their traditional investment options.

2. Status of the Juncker Plan

2.1. EFSI/EFSI 2.0

A public representative believed when the investment plan was launched there was quite a high degree of scepticism throughout Europe. The level at which the plan currently stands came as quite a surprise to many.

An International Financial Institution (IFI) representative stated that the EIB is very pleased with the outcome of the Juncker Plan. Over the past three years it has exceeded the target. The initial target was to induce €315 billion of supplementary investments, and by the end of the summer it totalled around €340 billion. 70% of the investments the EIB induce are privately co financed. 25% of the projects that the EIB is supporting with the Juncker Plan involve the participation of national promotional institutions throughout Europe.

An IFI representative noted there are projects in every European country. Countries hit by the crisis benefitted the most, and 80% of the beneficiaries are new customers to the EIB. The EIB has increased its high-risk lending from €4 billion to €20 billion, and closed €20 billion high-risk investments into crucial infrastructure. Without the support of the Juncker Plan the bank could not have done this. Projects would not have been carried out in the way they have been. The EIB was supposed to bring new products to the market and strike a balance between creating new projects and not crowding out partners.

The EIB is cooperating with many sponsors of infrastructure projects in order to get the procurement right and ensure that the project reaches the market. That is important when it relates to countries that do not necessarily have track records of privately funded and privately implemented infrastructure. Clients are sensitive when they have capital, and delivery certainty is important. Sometimes this creates difficulties because the EIB needs to explain its political constraints and motivations.

An industry representative stated that National Promotional Banks and Institutions (NPBIs) largely share the view that the Juncker Plan is a success. Investment targets being exceeded have played a major part in the recovery of investment in Europe apart from traditional sectors such as transport and energy. Now there are co-financing of structures between the EIB and the respective NPBIs, in addition to two specific pan-European funds Marguerite II and the Broadband Fund. In certain countries like France, there are also intermediated loans to finance social infrastructure or smaller projects. It is the first time that a financial instrument has been deployed over a very wide scale in Europe, which is consistent with the way national bodies intervene in their own economies. This success was made possible thanks to the cooperation between the European Commission, the EIB, and NPBIs around Europe.

An industry representative stated that public financing institutions, banks and institutional investors are complementary to finance infrastructures which are essential to social and economic development. Banks should partner with public authorities in financing digital infrastructure and energy transition. NBPIs may provide equity and banks may finance the debt side alongside the EIB. Europe has created a very efficient ecosystem that relies on close co-operation between private and public sectors.

A public representative believed the objectives of the Juncker Plan were to reduce the investment gap in Europe and to create 2.1 million jobs in the EU. That investment gap has been reduced, as investment levels have almost returned to pre-crisis levels. However, job creation is not at the level that had been envisaged. 750,000 jobs have been supported, but the target of 2.1 million was too much to ask for.

2.2. Possible improvements

However, an industry representative stated that the Juncker Plan is less efficient for certain kinds of projects such as smaller ones. In certain sectors the Juncker Plan only financed 4% of projects in the social infrastructure sector as the setting up of investment platforms is very time-consuming.

There are currently very few investment platforms in Europe. Technical assistance should also be reinforced on the ground closer to the projects, and it is important to build up a pipeline of projects. NPBIs are looking for new projects to increase infrastructure investment but avoiding crowding out existing infrastructural projects. Currently projects must be risky otherwise they are not financed by the EFSI.

A public representative noted that some of the issues with the first EFSI proposal include a relatively narrow geographical reach, as a large number of projects are concentrated in a limited number of member states. This has to do with the efficiency of how certain member states operate the EFSI.

The EFSI is reaching its political expectation but it is important not to be complacent. Significant gaps remain in the investment of key areas of infrastructure. There could be a more ambitious objective going forward, as Europe still lags behind the US and Japan. Work remains to be done on cutting down regulatory burdens for investors as well as reducing the dependence on bank-based financing, including through the completion of the Capital Markets Union, in order to provide more options for businesses and projects.

3. Necessary evolutions of the banks and insurance regulatory frameworks

An industry representative stated that if it passed into EU law, Basel III will jeopardise the way infrastructure is currently financed in Europe. For a long time,

infrastructure finance has been a private instrument held by banks. Banks have developed internal models that enable the adjustment of capital requirements to the level of risk finance and very large databases. By introducing Basel III, capital requirements for the risk taken will significantly increase for banks, particularly the regulatory capital required for the best risks. This increase will be imposed retroactively on the existing credit portfolio of banks, and this is expected to cause a significant reduction in the volume of financing provided by banks.

An industry representative reported there will be a deterioration in the quality of bank portfolios since Basel III will push banks to finance riskier projects where the margins will be high enough to get sufficient returns. Consequently, those financings will move to shadow banking which are less experienced in understanding the risk and less equipped to monitor related assets.

An official shared the view of an industry representative on Basel III. A report will come out at the end of 2018 on the impact of financial regulation on infrastructure financing. At present a lack of data negatively weighs on Basel III calibration. There is an initiative to gather the EIB, World Bank and the private sector to fill the gap and gather more evidence for regulations, investors and transparency.

An industry representative believed the data in the infrastructural world will help calibration, but it should not be limited to banks. While sophisticated insurance companies can develop dedicated internal models, capital charges are a problem for standard institutional investors. A World Bank study suggests that if Moody's default analysis and expected loss analysis for infrastructure is used then the implied capital charges on Solvency II should be halved.

4. How to define the long-term challenges and issues often associated with the involvement of investors in infrastructure financing

4.1. Infrastructure investment specificities in the EU context

An IFI representative stated that it is difficult for some countries to take related investment decisions since they have a long-term impact. It commits the country to expenses for future generations and immediate benefits are not always gained. Furthermore, infrastructure financings form a complex asset class and require much knowledge and experience, notably to value the investment in less attractive cycles and phases by assessing the actual impact on the economy.

This complexity is magnified in Europe which has a scattered investment environment, where smaller countries are different from larger ones. Countries have very different ratings and very different legislative backgrounds. In this context, the EIB has been a success story because it brings trust and knowledge of how to deal with the various specificities of its partners.

4.2. The impact of a changing monetary policy on infrastructure investment

An official stated the sudden reverse of Central Bank policies can be disruptive with implications for long-term investors since it impacts returns on the asset side of long-term investors on bond markets, and also returns on the equities side. Volatility was experienced in the early part of 2018 following movements, particularly in the US. One question is on the ability of investors to absorb the increased supply of assets, given that the Central Bank's balance sheet has taken over €11 trillion of assets from 2007 to 2018 and stopped quantitative easing. The analysis made of the largest funds over a longer trend is a major diversification toward new asset classes and new geographies due to the growth in assets under management driven by demographics and the change in pension systems that is seen in advanced countries, and also in emerging markets. The diversification toward illiquid assets such as infrastructure, unlisted equity or debt is a trend that is expected to be seen in the market going forward. The potential appetite which is there is higher than the current investment in the market.

An industry representative added that in the context of qualitative easing led by the ECB the cost of debt has decreased. As a result of that, return required by equity investors has also decreased. It is clear that in the recent past spreads on debts have compressed, and consequently the profitability of these instruments for banks and for investors has decreased.

An industry representative explained the evolution of prices dictates that when the cost of capital decreases, the price of an asset increases. Symmetrically, if interest rates increase it is likely that the cost of capital will increase also. This will negatively affect the price of the asset. If an investor wants to exit and sell an asset they will incur a loss, and it is the same for a bond. However, if investors hold assets until maturity they will get the return they initially expected.

An industry representative noted that the rising interest rate environment in Europe is a question mark, as there is a great variety of instruments. Banks will find a way to address the issue with interest rates. The other aspect of rising interest rates is whether there have been 'tourist investors' who extended into a world they did not properly know. Many infrastructure projects are in the BBB or BB range; the share and ratio of BBB to BB is now at the highest level ever. Many of these projects will not survive downgrades. Many funds are actually closed end funds or do not invest with exit options, which is not going to force illiquid instruments to be liquidated. Conversely, rising rates and the subsequent repricing of the market will most likely open opportunities for opportunistic funds. Demand exceeds supply, which will hopefully smooth the process.

An industry representative reported that in the recent past the price of infrastructure assets has increased but there is no bubble. Indeed, infrastructure projects have an economic rationale. The cash flows of the assets offer a higher visibility in the long-term; the price of such assets is largely the net present value of those cash flows. Currently the financing structures remain reasonable and the risk profile of such asset classes has not changed.

5. InvestEU and upcoming Commission priorities

A public representative noted that the InvestEU programme is focused on a set of key EU priorities and policy areas, including sustainable infrastructure, research and development corresponding to the next EU multi annual budget. It is important to minimise overlaps and duplications, and therefore to have a single point of contact under InvestEU which merges all existing instruments into one large guarantee instrument.

An industry representative believed that the EU needs other market players that can create confidence. NPBIs which are gathered in the European long-term Investors Association are ready to play a more active role in the InvestEU programme. Introducing multiple implementing partners will be key in fostering innovative financing solutions. Addressing the remaining investment gaps and suboptimal investment conditions requires locally adapted solutions in which NPBIs will use their respective market knowledge to cater for local, regional

or national needs with a European dimension. Involving NPBIs in the process will offer a higher degree of visibility for Europe and for European action on the ground and will help to align EU and national policy objectives.

An IFI representative noted that the EIB feeds concern over a certain number of points, especially regarding the possible lack of a bridge between the private and public sides. It is important that the outcome of ongoing negotiations should yield a very stable possibility for the EIB to deepen the role that had been designed for the Juncker Plan.

How can sustainable investment be a major economic driver for Europe?

1. Sustainable investment and related changes in the economic model are in Europe's economic interest and accompany the evolution of the mind-set of European citizens

An official underlined that the situation concerning sustainable investment has changed dramatically. Very significant changes must take place over the next decade in the financial sector. Mobilising €180 billion per year to achieve a climate and energy transition is a major challenge, along with reorienting the financial sector towards sustainability. However, on the side of the real economy, there must be a change in economic model. Firms are used to the linear economic model where you produce, consume and throw away. The European Commission is promoting a circular economy strategy, within which there is a virtuous circle in terms of extracting resources, designing products, consuming them and recycling. This can bring significant environmental benefits: Europe will reduce CO_2 annual emissions by 4% by becoming more circular. It can also bring very significant economic benefits, because companies are stronger if they are more circular, because they are more resource efficient. The European Commission has quantified this as saving €600 billion per year in terms of efficiency. That means Europe can increase its turnover by 8% through becoming more circular and efficient. There is also a very exciting social dimension behind this, because these are the jobs of the future.

The European Union is pursuing this agenda by identifying for change key sectors in the real economy. For example, the EU has reformed its waste legislation. There will have to be very significant investments in the coming years. Europe should move towards becoming a zero waste society, where all waste is a wasted opportunity. The waste of one company can become the raw material of another, so there are many opportunities for investment. The European Commission is setting targets around this. It is working significantly in electrification, transport and energy. Regulators can also play a very important role. It is essential to pass on the message that this change is not something that is being done for the environment; it is in Europe's economic interest. This is a huge challenge which Europe can transform into an opportunity.

In the last Davos report on these risks, it was striking that eight out of the 10 major risks identified by the business community were related to climate and environment. The task is to transform these challenges into opportunities: by collaborating with the financial sector; by undertaking work in European institutions in terms of reform, taxonomy, green bonds and work in the real economy in areas such as transport and energy; and by identifying the key sectors for change. It is also very important to realise that there is not only a shift in the mind set of the financial sector but also in Europe's citizens. 95% of Europeans are saying that environment, sustainability and climate change are priorities. Two out of three European citizens say they would like European institutions to do more and for these issues to be taken more seriously. This is an area where citizens are ready to make personal commitments and personal sacrifices, because they feel it is the right way to go. Despite the complexity of the transition, it is essential to work quickly. The various strands of work, including the reform of the financial sector, the circular economy, the implementation of the Paris Agreement and the Sustainable Developments Goals (SGDs), are already taking place.

Another official agreed, noting that Brussels does not create things; rather, it mobilises the economy to create things. An industry representative suggested that it is important for the EU to take into account industry initiatives and client behaviour when creating its taxonomy. Otherwise, such a taxonomy might destroy some of the progress that has already been made by market participants.

2. The growth of the green bond market: many factors are developing positive externalities

An industry representative emphasised that the green bond market is growing by 'leaps and bounds'. The pace of growth was approximately €100 billion per year. However, the total annual investment grade issuance is between €1 trillion and €2 trillion, which means the green bond market is 'a drop in the bucket'. Industry is seeking to mainstream the market, but this takes time. The green bond market has proved to be an excellent conversation starter, especially on the investing side. It has been an excellent tool for provoking in depth conversations with issuer clients in the capital markets. Having this dialogue with clients means being able to push them further and get them to think more deeply about what it means for their company to be green and how they can be aspirational. The green bond provides the market with this format.

At present, the most common type of green bonds is 'use of proceeds' green bonds, which are a second order mobilisation of capital. The investor buys a green bond issued by a bank or a corporation or a government entity and the issuer invests in wind or solar, instead of the investor directly investing in wind or solar. The industry must move the conversation to green bonds that represent a first order mobilisation of capital. This type of bond might involve different kinds of investments: infrastructure; renewable energy projects; asset backed securitisations of residential mortgages which meet certain energy efficiency requirements or for homes with solar panels; or other environmental asset backed securities, which could be backed by electric vehicle leases or solar leases. Bonds are also being brought to market by pure play green tech companies. When the Green Bond Principles were published five or six years ago, these pure-play green companies were not yet even at the IPO stage, let alone the stage of issuing rated debt.

The industry is moving, and the market should try to keep pace with it.

The Green Bond Principles have worked very well, but it is important to continue to define what categories of investment count as green. The ICMA has taken the original five or six broad categories and divided them into 10 categories with multiple subcategories, providing clarity. However, it is now time for the European Commission's Technical Expert Group on Sustainable Finance to define a taxonomy. This taxonomy should be aspirational. It should focus on climate mitigation, climate adaptation and the restoration of environmental resources. This will give us a real definition of which categories count as green. At the same time, it is important to avoid restricting the words 'sustainable finance' to this aspirational notion of green which addresses only climate and restoration. That is where ESG comes in; Sustainable Finance should be inclusive of financing from issuers with good ESG scores. For example, take the manufacture of a hairbrush. The manufacture of hairbrushes does not address climate change or mitigate CO2 emissions in the atmosphere, but there are many ways in which this process can be carried out in a more sustainable way.

3. Moving towards sustainable investment in the private sector

3.1. From now on a financial firms' business model has to encompass sustainability

An official noted that the companies which are more competitive and which perform better are those which have integrated sustainability into their business models. Competitiveness and sustainability are two sides of the same coin. If sustainability is not a part of a firm's business model, it will not survive. The economy and the environment must travel in the same direction. The task of regulators is to establish a regulatory framework which is coherent for this goal.

An industry representative explained that a previous session at the conference had concluded that the financial services industry was undoubtedly becoming more aware of sustainable finance. From the perspective of the asset management industry, the industry representative agreed with this assessment. The industry representative felt that sustainable investment is having an impact on capital allocation, which can be seen in price discovery around equities and equity benchmarks. The action plan refres to 'low carbon benchmarks', but mainstream benchmarks are already de carbonising. This is happening because capital is already being allocated by asset managers away from carbon intensive industries to industries which have low carbon emissions. For example, 15 years ago it would have been impossible for a fund manager to have invested in renewables as opposed to integrated oil companies. Today, the cost structure in the integrated oil companies is rising and their tax rate is increasing because of environmental legislation. Asset managers now view the integrated oil sector as a bad sector in which to invest.

3.2. Shifts in saver behaviour are driving change

An industry representative felt that one important market dynamic is the perspective of clients. In asset management, the demands of clients are driving change. This is true in all asset management companies. There is a social movement taking place amongst the client base. It started in Northern Europe, particularly among the Scandinavian countries, and it is spreading, not so much in the United States, but certainly to Asia. In Japan, GPIF, one of the largest pension funds in the world, has converted all of its equity mandates to ESG related benchmarks. That has profound implications for institutional business around the world., Some people question whether there is sufficient momentum for this to continue however, even without a regulatory push, clients are driving the industry in this direction; it is not going to stop.

4. Outstanding challenges in the transition

4.1. Driving change in reluctant jurisdictions

A participant noted the point raised on the social pressure for sustainable investment existing in Scandinavia, Japan and Asia, and how asset managers are reacting to this and altering their investment decisions. The participant queried what is being done in other geographies such as the United States, where there is less client pressure on asset managers and other financial institutions. The industry representative felt it is difficult to change part of a firm's investment process. However, the pressure observed in some parts of the world has transformed the whole investment process. The industry representative noted that considerations around sustainability in investment take place across their firm's entire range of products.

An official felt that the basis for work on sustainable investment is the Paris Agreement. Other factors have affected this dramatic transition, such as the SDG agenda, but the Paris Agreement is the fastest ratified agreement in the history of international agreements, and it was ratified by the whole community. It is true that the United States has abandoned the agreement, but there is an increasing interest from US industry and individual states to move in this direction. There have been several letters from companies to the US administration advising against its approach. Europe is having many discussions with other countries and regions. These issues are being discussed with China, Japan, Latin America and Asia. The official noted that they had recently attended a meeting in Tallinn where many different countries discussed how to approach this issue in the context of the UN framework on the subject. When others realise that they are not acting and that they should act, Europe will welcome them. In the meantime, Europe must cooperate and act as quickly as possible.

4.2. Testing and adjusting the envisaged taxonomy and better disclosure are prerequisites to aligning advisors' and customers' interests and adjusting fiduciary duties

An audience participant welcomed the news that the industry is adapting its investment process and that some regulation is already in place. The audience member outlined how the regulation calls for a suitability assessment by the advisor, that proposed investments should meet a client's ESG preferences. Without a very clear, simple and understandable taxonomy, clients will give complicated and diverse preferences. An industry representative stressed that this is the part of the action plan the industry is most concerned about, because it does not have an answer. ESG preferences must be married with a clear objective to satisfy a client's financial preferences. When serving two masters, the chances of failing one or both increase substantially. There should be pilot schemes. If the industry does not have the capacity to test the taxonomy before advancing with it, the industry will struggle. An official felt that this problem could be reduced to the extent that the client's and the advisor's interests are aligned. If the advisor is forced to go one way and the client still wants to go the other way, there will be a problem. However, the taxonomy is not just for the industry; the taxonomy is also to allow investors to express clearly their preferences. An investor may not want to go down the sustainable route; they will have the option to

say so. However, if an investor does want to do this, they can explain how.

Another industry representative noted that this question means asking investors whether they have any interest in layering ESG across their investment decisions. Care needs to be taken in the regulation in terms of this issue about ESG and fiduciary duty. Additionally, there should be more disclosure. A great deal of work is being done to take ESG into account on the investor side, but there should be some standardisation. However, this standardisation should go across all types of securities and not simply be restricted to those seeking a green stamp or a green label.

Regulatory implications of sustainable finance

1. Progress made towards achieving sustainable finance

1.1. The European Commission's legislative proposals

While the Commission had launched a sustainable finance initiative some time ago, an official noted that the political importance of the subject has increased exponentially. In March 2018, the Commission adopted an action plan, which listed 10 different legislative and non legislative actions in the area of sustainable finance. On 24 May, the Commission adopted legislative proposals on taxonomy, investors' duties and disclosures and low carbon benchmarks. A policy-maker observed that in recent years there has been an important change in policy-making: while sustainability has been an ad hoc matter only occasionally addressed in legislation, this has dramatically changed with the High Level Expert Group (HELG) reports and the Commission's action plan, which is very welcome. However, although the price of CO2 emissions is rising, it remains relatively low. Given the lack of time for the European Parliament to address this due to the elections in April 2019, there is some concern that the European Commission's proposals will not be able to bring about a sudden change in the mind set of the financial sector. The European Parliament found a broad majority for an initiative report. It is important to advance the work on sustainable finance quickly to make it credible. It is too soon to say what will happen politically, however, because the Council is a 'different beast' from the European Parliament.

1.2. The changing mind-set of the financial industry

An industry representative agreed on the need to change the mind-set of market participants. This is not due to political expediency or ideology; it is due to science. Europe must accelerate the quantum of finance going to the low carbon transition in order to avoid what will happen on earth if the global temperature exceeds the two degree target prescribed in the Paris Agreement and the consequential social, political and economic fallout. However, great progress has been made within the financial services industry. The green bonds market, which is the poster child for green finance, grew this year to $200 billion in worldwide issuance. This might seem impressive, but it pales into insignificance against the $90 trillion issued globally across the bond markets. A regulator shared the optimism over the momentum of change taking place in the industry, expressing agreement with the assessment of industry representatives.

Another industry representative felt the industry is certainly not starting from zero. The banking industry is not only considering the risks posed by climate change but also thinking of the opportunities it presents. The transition to low carbon is the investment opportunity of the 21st century. All of the banks are at some point along this journey. Some of them are more advanced than others, as some jurisdictions are further ahead than others. In the green finance sector, every conference brings together academics, scientists, ratings agencies and investors, because it is essential for all participants to work together to identify how the industry can move at the same pace. The industry representative noted that it was now a myth that investing sustainably leads to lower returns. Companies with solid ESG credentials have a tendency to outperform the market in both fixed income and equity. The industry speaker stressed, however, that clients do not always agree with this. This demonstrates why the industry requires more disclosure, data and transparency, because a number of decisions are not being made based on the result of evidence being fairly weighed. The industry representative opined that it would be very unhelpful for anyone to leave the room thinking that ESG was a P&L erosion strategy.

An official felt it clear from the comments made by all participants that there has been a change in mind-set in the financial industry. However, there is still some concern about the extent and the durability of this change. If this mind-set change has happened, the issue becomes a question about how to manage the transition to a new equilibrium. It must be quick, but it is also going to be complex. This is a familiar financial sector problem about moving between equilibriums in complex processes. There is nothing new there, but it may be more complex than usual. If it is going to be iterative, the industry must start now and move as fast as possible.

Another industry representative outlined the scale and timing of their shift that have been seen. Five years ago, over 99% of their assets were invested along traditional benchmarks without ESG considerations. Today, of the €530 billion they manage, €370 billion is ESG aware; €130 billion is ESG integrated; and €25 billion is SRI in its various forms; and then approximately €6 billion is impact. The industry representative felt the market is not far away from 'escape velocity' in ESG investments. Reaching critical mass will create an irreversible internal dynamic for the industry and its clients. Remaining constraints include the attitudes of particular clients, the need for more impactful public discourse and the internal retraining of investment teams. Additionally, the industry must be able to provide proof for each investment process to demonstrate that ESG is truly integrated.

1.3. The need to increase the pace of change

Turning to the energy sector, an official noted that in December 2016 the European Commission proposed a 'Clean Energy for All Europeans' package, in which it proposed targets for Europe to reach by 2030: a reduction in greenhouse gas emissions of 40% by 2030; developing an energy supply containing 27% renewable energy; and achieving a 27% increase in energy efficiency. In one year, the European Council and European Parliament have shifted these targets from 27% to 32% and 32.5% respectively. This demonstrates the speed of change, even amongst policy-makers. More broadly, the transition in energy and

mobility will be fast, but it is not going to be predictable. Considering the investment needs in the energy sector, the European Commission has estimated that from now until 2030 the industry requires around €200 billion per year. The industry does not need €200 billion per year, however; it needs trillions. An industry representative outlined the stark warning in the recent report by the International Commission on Climate Change. If the industry does not make this change by 2030, the world will not achieve these targets. The challenge is there. The electorate are asking why this is taking so long.

2. Challenges and opportunities created by the transition to sustainable finance

2.1. Managing the transition to sustainable finance

An industry representative felt the legislative proposals put on the table about taxonomy, investors' duties and disclosures, and low carbon benchmarks are the correct place to begin the shift in mind-set and advance the sustainable finance agenda. It is not possible to expand and accelerate sustainable finance unless the industry knows what it is, and currently there are no universally accepted definitions. Another industry representative suggested that the political world and the science world could help the industry by explaining where investment is necessary.

The issue of duties and disclosures is about risk/return versus clarity and transparency. It is important to monitor outcomes in terms of what the industry wants to achieve here versus the overall transition. The carbon price is currently around €23 a tonne. It is widely assumed that the price should be around €40 80 a tonne to influence investment decisions and encourage this shift in behaviour. The industry representative considered that there should be an end of fossil fuel subsidies. There must be a level playing field. The industry must discover which of the different power generation technologies provides the best economic return, especially in respect of low carbon and low-cost technologies which can provide secure energy. Public policy must play a massive role in terms of taxing negative externalities, and the market can do the rest. If the industry attempts to direct too much capital without the correct policy framework and without taxing the externalities, there will be a substantial risk of capital misallocation. Carbon benchmarks are a useful addition to traditional benchmarks, but public policy must support this framework. An official felt the industry must concede that there are some areas of finance where innovation and voluntary approaches will thrive. Additionally, the industry must consider how to green the brown sector.

A third industry representative noted that the focus on carbon alone would risk the misallocation of capital and let policy-makers 'off the hook'.

2.2. Complexities inherent in the transition to sustainable finance

It is important not to create an overly complex regulatory burden

An insurance industry representative stressed that financial services firms are increasingly taking sustainable finance very seriously. The challenge with taxonomy emerges because this is not something that can be added on to the fundamental metrics concerning risk and return. Additionally, the insurance industry considers a very wide range of other risks outside of investment and underwriting. On one level, investment is relatively mechanistic. The industry applies a set of benchmarks supplied by a data provider, and a decision is made whether or not to invest. The industry must have a taxonomy, but it must be simple. It is important not to create an overly complex regulatory burden for industry. Small and medium sized companies, which are the bedrock of the EU economy, will be swamped by this kind of regulatory requirement when they should be the engine of growth. In the industry representative's experience, companies discuss strategies to achieve climate targets very seriously, but these plans do create other operational, business and strategic risks.

High-carbon industries are also very much part of the solution

It is a natural expectation of the electorate, politicians and the finance industry to avoid investing in brown or high carbon industries. Companies in high carbon industries are seen as barriers to sustainable finance, but they are also very much part of the solution. On any analysis of a two degree world, the world will still be burning fossil fuels, though in different proportions, different geographies and different ways. Many activist investors and NGOs demand that companies decarbonise their portfolios, but of course market participants cannot simply decarbonise their portfolios, because this would create many other challenges concerning credit and transition risk. The industry representative noted that the industry is already considering the taxonomy. In part, difficulties arise because firms have been talking to their customers. Institutions have come up with diverse strategies for how they will change their industries.

There is also another suite of industries which are hard to decarbonise and which drive the infrastructure of the economy such as iron, steel, cement, glass, agrochemicals and petrochemicals. These are the fundamental building blocks of the global economy. They will be very hard to decarbonise simply because their basic processes require fossil fuels and no alternatives currently exist. In Europe, homes are heated using gas.

If a 'too binary' approach is taken, it will exclude the sectors which most engage on sustainable finance

Hydrogen presents a very important opportunity: hydrogen can be bled from natural gas supplies to reduce carbon emissions. This requires foundational technology to appear in terms of creating a low carbon hydrogen supply chain. Carbon capture, use and storage can help here, but there is already an EU directive which has fundamentally stalled the delivery of Carbon Capture, Utilization, and Storage (CCUS), because it has created tremendous barriers in terms of the risks that must be apportioned across the supply chain or business model. The industry representative felt this is a 'fantastically complex' story. Financiers, investors and underwriters must play their parts in helping people to navigate this area and execute this change quickly. The industry understands the challenges around developing a taxonomy. The taxonomy is often the tool which automates the investment process. It will be a complex task to create a simple taxonomy which does not create a regulatory burden for the industry but at the same time achieves the outcomes it seeks.

Another industry representative reiterated the point made by a previous speaker that three quarters of the work of transition must be done by the non carbon sector. It is very important that the industry does not reduce the discussion around taxonomy exclusively to the carbon heavy sectors. It must be broader than that. If the industry does not take a broader approach, it will not be able to deliver portfolios or investment returns that provide the right balance between risk and return. It is not possible to do that with a very narrow set of investments. A third industry representative cautioned that a binary taxonomy could prove challenging for the industry. Whether an organisation presents good or poor credit risk

is not considered in a binary way. Credit agencies provide ratings from AAA to High Yield. If a 'too binary' approach is taken, there is a danger that this will exclude the sectors which most need to engage on the journey to sustainable finance. An inflexible or prescriptive approach will stymie innovation in the market.

Integrating climate risk sets the tone at the top of the organisation

A fourth industry representative suggested that there has been a change in terms of operational processes, which provides a hint as to the shift in mind-set. To demonstrate this, the industry speaker pointed to the fact that some institutions have integrated climate risk into risk appetite. While risk appetite should not be the 'alpha and omega' of a risk management framework, in this case it has very clear advantages. Integrating climate risk sets the tone at the top of the organisation and thereby sends a message to the organisation about the importance of it. Second, climate risk is being increasingly introduced to mainstream investment and credit policies. In every lending decision, there are ESG criteria, which is a bit different. Finally, some institutions are undertaking transversal portfolio analysis, which looks at climate risk across an organisation in terms of physical and transition risk and identifies areas of risk concentration and potentially moves portfolio allocation in the right direction. The industry representative highlighted the extreme degree of uncertainty associated with transition risk. Even if the risk is known to be large, an organisation cannot know how large it will be, when or how it will specifically affect a position.

The industry requires a taxonomy that allows asset managers to progressively integrate all ESG factors

Another industry representative considered that the industry is not too late to start the process. Noting the Chair's somewhat joking comment that the process is complex, time consuming, laborious and iterative, the industry representative responded that there is no way to do it differently. In terms of the asset management industry, asset managers are the custodians of their clients' money. Within their client base, there are investors who will not appoint an asset manager if they mention ESG and there are investors who will only appoint an asset manager if they demonstrate strength on either a subset of ESG or the entire process of ESG integration. There is a change happening in the client base, however. There are more in the latter category than the former category, and there are quite a few in between who take the approach of wanting to wait and see which approach is more convincing. Clients can be educated, however. The asset management industry also sees its stakeholders as part of an iterative process. The industry cannot focus solely on green issues and carbon; the taxonomy must be broader. The industry requires a taxonomy that allows asset managers to integrate ESG factors holistically. If market participants focus on the 'S' and the 'G' in ESG, this will also encourage the right behaviour in terms of the 'E'. Many parts of the financial sector will soon be providing proper disclosures. In addition to disclosing carbon content and other ESG considerations in the portfolio, asset managers should also be required to explain why they are doing what they are doing and what their rationales are. The industry representative noted that the market has a longstanding capability to consider nuance and pricing in risk/return. It is essential to consider different industry sectors and to understand the appropriate criteria in order to assess them.

How ESG risks could translate into credit risk

A regulator outlined how the pension and insurance sectors could play an important role on the asset side in terms of assisting this transition. The problem for the insurance sector, however, is on the liability side. All market participants are interested in an insurance sector which covers and correctly prices risk. Recently, there has been an increasing trend of damage caused by extreme climate change events. In the end, addressing this is about measuring risk appropriately and having the right quality of data to measure the risk. It is difficult to price catastrophe risk when past data is no longer reliable. It is essential to take account of future trends in this area. This necessitates a better and more appropriate form of risk management.

An official explained how ESG risks could translate into credit risk in some areas, such as stranded assets. Additionally, new regulations on buildings might cause problems. Member States will soon announce their plans to meet the energy efficiency targets which arise from the Energy Efficiency Directive and the new legislation on buildings. The governments of several Member States have indicated that parts of existing building stocks could not be renovated and would have to be demolished and replaced. The industry must consider this problem. In some areas, there will be credit risk related to transformational change. DG ENER is working with parts of the financial industry in this area.

2.3. Challenges to address to refocus from a short-term toward a long-term time horizon

An industry representative felt the asset management industry has for many years hidden behind fiduciary responsibility to achieve the maximum financial return, noting that this has changed significantly. Initially, firms were concerned that the only benefit of ESG would be risk reduction, but there has been a realisation that focusing on ESG factors holistically potentially lengthens investment horizons. This can achieve significant financial returns above and beyond what normal financial analysis provides.

A policy-maker felt aware of such conflicts of interest, suggesting that there could be conflicts of interest within companies between short-term and long-term interests. This was the conclusion of the High Level Expert Group on Sustainable Finance. The policy-maker suggested that it is necessary to change the focus in the industry from the short run to the long run and not just focus on money; the transition can be much broader. The transition to sustainability can change people's lives. People do not only have to focus on money; they can do much more than that. The financial sector often puts different areas of investment, such as green bonds, into 'corners'. It is now necessary to mainstream green investments. There is a similar concern regarding taxonomy. Concepts are discussed with the narrow scope of green issues and climate change. These things do not have to be limited in this way. Europe can use a different way of thinking here.

The financial sector cannot look backwards and understand all the risks; risks cannot always be standardised. Industry participants must look forward, throw away their models and use some common sense. This question is not about what can be done by looking back; rather, market participants must look forward. There is a conflict of interest between money making and the broader view. If a company does not have any conflict, it is probably not on the right path. This is not only true for participants in the financial market; it is also true for policy-making. The policy-maker felt that the taxonomy was considered as a way to promote green and punish brown portfolios, expressing their view that it could do more than this. Yet the taxonomy could touch on land grabbing, violations of human rights, tax avoidance and the issue of governance.

An industry representative explained that much time is spent on dealing with supervisory and regulatory issues, which are mainly issues of the past. Given these time constraints, it is difficult to consider long-term objectives. When regulatory capital is built on a short-term horizon and is the main constraint in a business, it is even harder to go beyond the long-term horizon. There is also a particular tendency in rule making to remove uncertainties through the use of short-term measures. In any case, when dealing with long-term issues, there is always a substantial amount of uncertainty. To address this uncertainty, it is important to look at a range of options, and analyse the choices that will be more appropriate for a long-term model. Another industry representative explained how an insurance group once had short-terms for its boards, and the short-term performance targets they set had contributed to the short-termism of investment professionals. Now, however, they have re focused the business and developed a longer term view. For this group, this means fundamentally changing its pricing proposition, and this is starting to have an impact. The industry representative conceded that this is a circuitous route, however. The insurance group is offering its customers very cheap access to its beta exposure[1] and is only sharing the value being created over long-term performance periods of 3 5 years. This means the firm is incentivised to generate value over the long-term, because it will not be paid if it only generates short-term returns. Rather, it will be paid if it meets its targets for 3 5 year rolling returns. In that way, the financial group has incentivised itself to invest in the right way.

Another industry representative suggested that the time horizon issue is about understanding what firms need to invest in. In terms of prudential regulation and longer term returns, investment becomes a much longer term issue on the scale of asset liability modelling or strategic asset allocation of a portfolio to achieve a longer term sustainability goal, because typical liabilities for pension and insurance companies may be in the order of decades. In these industries, investment might be infrastructure or corporate and sovereign bonds. Insurers hold those assets to maturity; they do not trade out of them in the vast bulk of the portfolio, which mitigates the prudential risk. The time horizon issue also depends on the objectives of an investment fund. However, in terms of short-term day to day trading of assets and equities and so on, firms can still use ESG criteria and see decent returns.

On a practical, day to day basis ESG has become a core principle. Pillar 2 could be built into risk management thinking, and disclosed. Some of the challenge with stress testing is the scale. Yet, the climate part of the 'E' in ESG is clearly an extremely long-term topic. Transition risks might happen much more quickly, because they can arise from policy errors, but these will typically emerge over decades at least in respect of stranded assets. This is not going to be solved by conducting an ORSA analysis in the insurance industry or a stress test in banks that is based on a single year. Pillars 2 and 3 could be useful for risk disclosure, but exactly how this disclosure occurs will be vital.

3. Incentives within the transition to sustainable finance

3.1. The need for incentives within the transition to sustainable finance

A regulator noted that prudential regulators are examining incentives closely and trying to address the points raised by the industry. An important aspect here is transition risk, which arises because any change in the system of prudential regulation leads to significant questions around how to manage existing brown portfolios or portfolios in which firms are improving the sustainability of high carbon assets. ESG factors or risks are not creating new categories of risk, because these can be mapped or translated into traditional risk categories such as credit risk, operational risk, reputational risk or business model risk. The challenge arises in the measurement of risk and how to incentive banks to manage these risks. In this perspective, prudential regulators are attempting to contribute to work on taxonomy and definitions. Once the industry has measurements and data, an analysis of how this transition impacts the prudential position of banks can be incorporated, and then changes to the regime can be proposed and integrated.

Given the risk of stranded assets, a policy-maker opined that there could be nothing more logical than to introduce a green supporting factor or brown penalising factor. This relates to the question of stranded assets, which has already had an impact on the financial sector. This does not need to be restricted to the capital charge; it could also involve exposure limits, which is exactly what the European Systemic Risk Board advises. Before considering these measures, the industry should develop carbon stress testing. Supervisors have a crucial role to play here. Boards must set an example to their companies; in the financial sector, the boards are the supervisors. Every supervisor, European or national, should take this on board. It is crucial for making this change.

An industry representative turned back to the idea of ESG interdependency and outlined how the financial industry could look more broadly than green. Philosophically, all of the participants in the discussion would agree on this. In respect of the complexity in ESG, the industry representative suggested that the situation is already very complicated, and the process must be iterative. Climate provides the industry with tangible business cases and a set of data that it can disclose; through this process, ESG can be mainstreamed and integrated into businesses. The industry representative praised the contributions made by an official and another industry speaker on the genuine complexity of climate change in the real economy and how the finance industry should react to it. The industry must disclose against a very complex situation and sequencing will be very important. In terms of taxonomy, if the industry assessed climate change adaptation first and then moved on to the other pillars in the scheme, it would provide an opportunity to test the industry's systems and assess what is decision useful in what is being disclosed. The industry should not lose sight of what it is trying to accomplish: the channelling of capital into more sustainable finance. This is not an exercise in itself but a means to an end.

Another industry speaker agreed with the comments made by regulators, stressing that this issue is fundamentally a pricing problem within the markets. The industry is trying to solve it by looking at regulations. The industry representative conceded that it might appear strange for a risk officer in a financial institution to praise regulations, stressing however the importance of proper regulations in the protection of policyholders and investors. The industry representative felt that fixing a pricing problem is like the prisoner's dilemma. It cannot be fixed through either Pillar 1 or Pillar 2 of the regulation, because the price must be fixed by the market itself. Externalities such as subsidies in the brown economy or the carbon price being too low will dramatically shift the allocation of capital in a micro way, transaction by transaction. If there is a green supporting factor, the prisoner's dilemma is that

the industry is pushing on another button. The regulators will require financial institutions to put more capital aside (for transition risk regarding existing assets), which bizarrely will make players not wish to risk their capital on energy transition financing needs. If the industry uses a brown penalising factor, it is the same prisoner's dilemma. The consumer and the producer need the relief and the guidance in terms of these changes in the pricing of externalities. The industry representative quoted Deng Xiaoping, who spoke about 'crossing the river by feeling the stones'. The process of transition could not be stopped and the industry must complete it. The industry is partway across the river. With its customers, it is trying to feel the stones and learn how this process is going to happen.

An industry speaker from the audience noted that the revised Basel III rules published in December included Loss Given Default (LGD) input floors, which would adversely affect renewable energy investments. A regulator stressed that the European Commission is aware of this issue. LGD floors are taken exposure by exposure rather than at a portfolio level. On the other hand, the LGD floors introduced in the Basel III framework are calibrated relatively modestly. Clearly, an LGD floor hits the very low risk components of the portfolio. If it is done on an exposure by exposure basis, it will hit individual low risk exposures. When the framework was designed, it was not designed with ESG in mind.

3.2. Problems with specific green supporting or brown penalising factors

A regulator agreed with the comments made by a policy-maker on the importance of mainstreaming ECG factors. The EBA is studying how this will impact the prudential regulatory system. The EBA has looked at how ESG factors and the risks of transition could be factored into the prudential framework. The most obvious first step is to consider a differentiation of Pillar 1 requirements based on ESG factors, which leads to the green supporting factor. At this point, the EBA's view is that Pillar 1 requirements are not the right place to address this issue, because the purpose of Pillar 1 is to ensure the resilience of the banks and not to incentivise or encourage certain portfolio allocations. Additionally, in respect of methodology, Pillar 1 requirements are calculated with a short time horizon, which is not suitable for assessing many longer term ESG risks. The EBA is relatively sceptical about accelerating the transition by introducing a Pillar 1 incentive in the form of a green supporting factor. Equally, the brown penalising factor has similar characteristics, but there is a greater rationale to assist the transition gradually by introducing differentiation on the brown side.

This leaves open the question about the correct tool to use. There are two other areas with better possibilities in the regulatory system. First, there is movement towards market discipline, which means disclosure, market discipline and incorporating ESG factors into the governance assessment of banks. Here, it is important to lead from the top and address the public disclosure of banks from the top all the way to their different business lines. While this is a promising channel, it is also insufficient. Secondly, this holistic assessment could be incorporated into the Pillar 2 framework of risk assessment. If the taxonomy stabilises somewhat, it would be possible to incorporate a longer term ESG assessment into the supervisory review process for banks. Another option would be to incorporate ESG factors into the stress testing framework, which could allow supervisors to assess an institution's resilience against the longer term future risks that may emerge from sustainability issues. In any case, a quick and accelerated transition cannot be solved by the silver bullet of a supporting or penalising factor. In the EU, there is evidence that the introduction of the SME supporting factor did not materially improve credit availability to the SME sector in the EU, so it is important to be somewhat cautious.

Another regulator supported this view, noting the existence of several examples in the insurance sector. On other panels during the conference, industry representatives have made requests to decrease further the capital requirement for equity, or the accounting treatment of it, or to enlarge the scope of last year's specific treatment of infrastructure. The discussion cannot be reduced to partial alleviation of the capital charge. If the capital charge is alleviated without evidence and without being associated with the embedded risk of certain investments or lines of business, this will not be sustainable, because in the long run the risk arises anyway. An official agreed that incentivising Pillar 1 could have distorting effects. The industry should consider the brown penalising factor further. Pillar 2 is an area to explore on both sides of this question.

1. The return of a portfolio that can be attributed to the market as a whole.

European retirement needs: prospects of the Pan-European Pension Product (PEPP)

Europe's population is ageing. In 2060, for every retired person there will be two people of working age, compared to four today. This has led to reforms intended to make future public pensions more sustainable and often less generous.

On 29 June 2017, the EU Commission set out a legislative proposal for a pan-European Pension Product (PEPP), a simple and cost-effective 3rd pillar retirement framework which will be portable across EU Member States. The PEPP is designed to give 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. It will also create new opportunities for providers to tap into a European-wide single market for personal pensions estimated to grow from €0.7 trillion to €2.1 trillion over the next decade, assuming tax incentives for PEPP, compared with a growth to €1.4 trillion over the same period without the PEPP. PEPP is a voluntary framework for a 3rd pillar pension product and will complement existing state-based, occupational and national personal pensions, neither replacing nor harmonising national pension regimes.

1. The PEPP from the Council Presidency standpoint: the main achievements following the vote of the ECON Committee of the European Parliament

An official noted that after the recent ECON vote on PEPP at the European Parliament and the general approach taken by the Ecofin Council in June, trilogue negotiations

will begin on this topic. The Commission's initiative was a good legislative proposal but when 28 members are asked, 28 answers follow. The third pillar is fragmented, as there are different ways of providing pensions in different countries. The main achievements of the file at the Council and the European Parliament are the same: it aims for a simple product that is standardised, safe and transparent, with solid information regimes. It is also flexible, meaning a broad range of providers and possibilities of tackling local markets. This would mean increased competition, to offer the best deal for consumers. PEPP labelling will ensure recognisability across Europe and an EIOPA database with PEPP features across Europe will benefit providers that want to enter certain markets. These achievements are a major step forward for the personal pension market in the EU.

An industry representative endorsed the principles outlined and fully agreed with them. Progress has been made from the inception of the first proposal and the contributions from the EP and the Council. It is a milestone for consumers and a successful trilogue. It is not perfect however, and it was noted that it is important to have a framework where providers can start to develop products off.

2. Portability

The PEPP should be an easily portable product that can be taken from one Member State to another with no obstacles. Savers should be able to continue contributing to a PEPP when moving between Member States.

On the portability service, the Commission proposes in Article 13(3) that compartments must have been set up for all Member States within three years after entry into force of the Regulation. The compartment feature will ensure that PEPP is easily portable and enables providers to adapt their product to the requirements of each Member State, so that savers can benefit from the tax incentives of their Member State of residence. This is an important feature, but some providers, particularly smaller ones, have expressed concerns about the difficulties of complying with the obligation on compartments. Solutions can be found to address these concerns, such as encouraging partnerships with other eligible PEPP providers, or creating a central EU database with information on the specific requirements of each Member State.

2.1. The view of the European Parliament: partnerships are the way forward

A public representative noted that the PEPP is not only a pan-European personal pension product encouraging more people to save; it is a fundamental part of the CMU. This is important a) to make sure that more than the 27% of citizens across the EU who currently have this personal pension to save, and b) to enable providers to make adequate business proposals in this area with so much potential. An independent study accompanying the original Commission proposal estimated the current market at about 700 billion in this area; this will hopefully double in the next decade.

One of the priorities looked at by the European Parliament was portability. The original Commission proposal was for each provider to provide a compartment for each of the other Member States after three years. That was not agreed, and the view is that it is important to try to obtain that, but it is more important to establish partnerships and utilise existing partnerships. Even where there is no partnership or compartment, it is important that there should be no fee for switching in order to provide consumers with sufficient options.

It is essential to get saving to people who live in a constituency and who come from other Member States. At some point, they will leave and go home or somewhere else. The market will grow if opportunities are provided, and compartments will be provided if flexible enough. To over-regulate from the start would be a disaster. There is no intention of waiting for PEPP 2 or PEPP 3; this must be done right away. Flexibility is needed, as is being as non-bureaucratic as possible, so that the market can develop.

2.2. Pragmatism is needed to organise portability

2.2.1. Competition is required

An industry representative noted that regarding portability, it is important that providers should have competition. Smaller providers in smaller countries will probably start at a domestic level and grow the PEPP from there step by step at a pan-European level. It will be an incremental revolution, similar to the Undertakings for Collective Investment in Transferable Securities (UCITS) a base, which evolved over a 25-year timeframe and now is the largest asset class sold globally. It became a truly trusted brand on a worldwide level. That would be precisely the vision for the PEPP. For that to happen, it is important that a minimum standard of Member States in which providers have to offer it is not set, but that the market is allowed to develop step by step.

The Chair asked about the meaning of 'step by step' for the European dimension of the PEPP and the various compartments initially proposed by the Commission. An industry representative stressed that there should be no minimum number of compartments. It should be able to start with one country. Over the next five or 10 years, it is doubtful whether a single provider will be able to offer the same PEPP in all 27 markets. It is not a matter of setting a goal to say it is pan-European only if it is offered in a minimum of 15 markets. It is pan-European if it follows the mobility needs of the citizens who want to exercise the portability of the product. That is how to define 'pan-European' portability.

2.2.2. Answering the concerns of small providers

An industry representative agreed on several points: The PEPP is about being pan-European and about competition. It must be in the interest of customers, wherever they are in the EU, to provide them with a true pension product. Pragmatism will be needed to organise portability because markets are different from one Member State to another, in terms of size, maturity and needs. It is not at all obvious that a customer will need 27 compartments in one year. That kind of customer is not well known. It would be possible to offer eight to 10 compartments from the outset. It would be difficult and even counterproductive to oblige any company wishing to issue a new product to do so in all 27. The response would be to stand by and wait to see whether there is customer need before answering, but not launching to market. That would be a pity for the success of the PEPP.

A pragmatic approach is needed, with a minimum number of compartments, perhaps combined with the idea of partnerships. That is an interesting idea as some insurance companies are not active in all markets. Others are worldwide and do not have that problem but those in a couple of Member States, except for big groups, need to know each other better to do business together, and partnerships could be a first experience. A few compartments, some partnerships, and time to adapt to customers' needs is proposed.

2.2.3. Encouraging partnerships

A regulator advised that the PEPP must be a pan-European product; otherwise, the current situation will

not change, with different products in different countries. Ensuring that there is a proper way to sell cross-border and take advantage of the Single Market is supported and is in the product. Second, to deliver this for European citizens and make the difference, people must be able to save in the same product around Europe. Labour mobility will increase in the EU, so this is essential. A more pragmatic approach can be built up, instead of having one-size-fits-all at the beginning. Partnerships are a good idea. The European Parliament's text on this is welcomed, in terms of EIOPA's involvement and looking at how it evolves.

The Chair noted that partnerships seem to be an attractive solution but wondered if, in practice, there would be an obligation for the partner to take a customer who moves to a new country. After an economic downturn, situations may arise where it is no longer attractive to take liabilities from other Member States. The questions are organising partnerships and whether the Commission should do that at level two. A public representative considered that EIOPA should do it. EIOPA has been given a responsibility to bring forward a scheme to allow that to happen, and there is a market for this, particularly for smaller providers. Larger providers with a reach in several Member States will not have that problem. For smaller providers or even in IORP, which is a contentious issue for the Council, there are opportunities for EIOPA to give provision. If the service is provided and there are opportunities within the industry for this, it will be taken up.

3. The PEPP labelling

In the legislative proposal of the Commission, the authorisation of a new PEPP product would be granted by EIOPA. EIOPA would authorise PEPPs and maintain a central register for them across the EU. National Competent Authorities (NCAs) would remain in charge of supervising PEPP providers. EIOPA would be empowered to withdraw authorisation in case a a PEPP product no longer matches the requirements of the PEPP Regulation, to ensure high quality standards for the PEPP label.

3.1. The view of the European Parliament: the importance of an EU PEPP label granted by EIOPA

A public representative noted that the EIOPA route is attractive for branding. Whilst NCAs know their local market and have a greater understanding of the risk and the players, this product also requires a stamp that shows it is a European entity that not only ticks the box but also complies with the product. It is not so important in well-developed markets for personal pensions, but it is essential in those parts of the EU which have a less developed personal pension market. Launching a pan-European product requires a thumbprint of support. After much discussion at the ECON Committee (EU Parliament), what is included in the text is the validation and bulk of the localised work to come from the NCAs, with EIOPA authorisation within a strict timeframe. That is a huge responsibility for EIOPA and it will have to scale up. A discussion with the Council on this fundamental point is likely, but Parliament believes strongly that there must be a pan-European agency behind it for this to be a pan-European product; otherwise, its reach will not be significant.

3.2. The importance of the PEPP label granted at European level to ensure the pan-European nature of the product

A regulator advised that the pan-European nature of the product is closely linked to how it is seen from an EIOPA perspective, as the European body that ensures that this product truly has a European stamp. By involving the NCAs, these elements of authentication are fundamental for the credibility of and trust in a European product, and should not be underestimated. The Parliament's comment about an initial validation by NCAs followed by EIOPA and supervisors around Europe having a stamp on it is therefore welcome. When Europe builds something together, it is not against Member States, but for all European citizens. Everyone is in this project and a signal must be given to European citizens by having a stamp that people can trust, so it is important to make sure that there is an element of certification or authentication at the central level, and that EIOPA can ensure that supervision is done in a consistent way.

There cannot be a situation where, after two to four years of selling a PEPP throughout Europe, weaker supervision is discovered in some countries which creates problems for European consumers. EIOPA needs to ensure that there is a proper level of supervision and coordination around the supervision of the PEPP. It is fundamental for this product to have a truly pan-European nature.

The Chair stated that the Commission agrees with comments on the need to have European validation of this European product. EIOPA is first and foremost the collective wisdom of the 27 national supervisors. They need to understand that they do not lose sovereignty in EIOPA; they exercise it in a different manner. It is hoped that the Member States will be convinced of that in the negotiations.

4. The default investment option

PEPP will be a new product on the market. It will have to be both attractive and trusted by consumers and providers. The Commission proposes that providers should offer up to five PEPP investment options, including a default option. Providers may also offer a coverage of biometric risks. The default investment option must ensure capital protection either by a guarantee or by other risk mitigation techniques, such as a life-cycle investment strategy. Irrespective of the type of capital protection, providers must ensure that the default investment option enables savers to recoup at least the capital invested[1]. A life-cycle investment strategy does not provide a capital guarantee (which implies greater risk), but it may well deliver a better return because the investment policy is less conservative in the first part of the investment period. Most assets in life-cycle strategies are invested in higher risk/higher return assets, with a switching mechanism to more conservative investments shortly before retirement[2].

4.1. According to retail investors, true capital protection implies that the notion of 'capital' must be calculated on the basis of the amounts saved before the deduction of all accumulated fees, charges and expenses directly or indirectly borne by investors, and if possible in real terms (offsetting the negative impact of inflation over time)

If legislators decide to opt for a capital 'protection' feature that only allows PEPP savers to recoup the nominal capital invested net of all accumulated fees and costs without offsetting inflation, they will ensure the guaranteed destruction of the purchasing power of pension savings. Worse: savers will be misled to believe that, on the contrary, this constitutes 'protection'.

An expert advised that anyone putting €100 into a basic PEPP capital guarantee will, 40 years later, have something worth €27 at best. That is not the worst case. It is called the 'capital-protection scam'. There needs to be at least a prominent warning about accumulated fees, given that this is capital net of all accumulated fees, which is one explanation for why it is not €100 but €27 at best in the end.

It is also before inflation, so the purchasing power of this guarantee will be severely negatively impacted over time by these components. According to this speaker, this default investment option must be the safest. It is important to protect pension savers, walk the talk and at least warn and educate them that this does not mean that their money will be returned in 30 or 40 years. This position is known, and others know better what was voted on, but it is understood that the ECON text of the Parliament is worse because the so-called capital-guarantee protection has disappeared from the articles themselves, although it is still in the recitals. Article 37 talks about the basic PEPP and no longer mentions capital protection but states that there is an objective to recoup the capital. It is an objective, not a guarantee.

Article 2.21 is worse, however, as it contains a new definition of 'capital'. It starts with the Commission's nominal contributions, so the problem of inflation is still swept under the carpet, net of all accumulated fees and charges, and investment return. A slight amendment to this new investment return was proposed: 'if positive'. It was rejected, which means that there is now an objective to get capital that can be zero in the end. A negative return, with accumulated fees on top, means that the capital-protection guarantee could be zero. Perhaps this is a misreading, but from the Commission's proposal, if it is positive, the capital protection from the Commission should not survive the trialogue without a prominent warning that fees and inflation can severely eat into the real value of this so-called protection. If not, it will be the worst case of mis-selling in the expert's 15 years' experience, and in the entirety of financial-policymaking at an EU level.

4.2. Capital protection from the EU Parliament standpoint

A public representative reminded the audience that it was publicly stated within the text from the beginning that a default option or a life-cycling or capital-guarantee approach as maximum choice to consumers in the basic PEPP offered was wanted. A fee cap was not part of the original Commission proposal, for many reasons, including that it does not encourage competition for lower fees below the cap, because people move on to where the fee is, whether it is 0.5% or 1%. The concession or compromise made was to amend the objective of Article 37 to capital protection, so as to avoid making it impossible to include a life-cycling approach in a basic PEPP. What is crucial is the fact that the largest number of providers could be involved in providing the kind of products that people need. The original Article 37 was open to the interpretation that it would be an absolute capital guarantee. That caused concern and required clarification. If further clarification is required, it can be done in the trialogue.

The information given to consumers who will buy this product is not undermined. Article 37 was changed because the asset management section of the market would have been excluded from this product if it was interpreted exclusively as a capital-guarantee product.

4.3. Savers should be fully aware of the characteristics of their default option and of the differences that might exist between guarantees and other risk mitigation techniques

Three ideas were highlighted:

- The decision to have one guaranteed and one non-guaranteed product is fine;
- Inflation cannot be guaranteed;
- The legislative text creates a level-playing field for both asset management and the insurance sector.

A regulator advised that it is necessary to keep PEPP simple and achieve something that people understand. An over-engineered proposal to consumers will have the same destiny of many other products that are not understood. The political decision to have one guaranteed and one non-guaranteed product is fine. It is critical to have an upfront warning that a product is guaranteed or not. Everything in the key information document (KID) should be done for the PEPP.

The minimum guarantee for capital protection is that contributions made to the product will be recouped. Fees and charges should not be deducted. That is the minimum, as every consumer will understand not receiving less than the contributions that were put in. That should be the capital protection guarantee. That said, the inflation point is over-engineering. The insurance industry, for example, will not be able to develop a product with a guarantee on inflation for 20, 40 or 50 years. It is nice to say and, if there was a way to do it on a sound basis, it would be supported, but it is important to be pragmatic. Capital protection should cover the contributions that are made, without deducting fees and charges and without taking into account inflation. A requirement to guarantee inflation will go too far.

A lifecycle should include a clear definition of the objective. It is not guaranteed but there is an objective that goes in the same direction (i.e. to recoup the same amount as the one guaranteed by the capital guarantee). The objective should not be lower in terms of a capital guarantee. The only difference is that it is not guaranteed, and having or not a guarantee is an individual choice. In developing the PEPP framework, three words come up: safe, transparent and cost-effective. Safe means different things to different people. If the retirement income of a saver is largely dependent on a third-pillar pension product, then a guarantee is important; however, many people have appropriate second pillars, so for them a guarantee is not fundamental. The type of product can be chosen but this needs to be clear and transparent upfront to consumers. Politics works by compromises, but it is important not to over-engineer. It should be in simple terms that people can understand.

An industry representative advised that a general message is to pay attention to stamp the product at a European level so that it is understandable. The aim should be for one product, not two or more. It is impossible to guarantee inflation. Fortunately for customers in many Member States, the eurozone exists and has been built to ensure that it is a low-inflation zone. It is not Argentina or Venezuela. However, it cannot be guaranteed.

The level of guarantees granted relies greatly on the level of interest rates. The problem that the definition faces is the current low level of interest rates for several years. It is not out of pleasure that the guarantee was invented after having deducted the fees, which is a market trend today in guaranteed traditional life-insurance products. It is because revenue could not be granted to customers if these fees were not deducted. It was said that a 100% capital guarantee is without the deduction of fees. The position should be reserved. The rationale is understood but, if it can be done under normal circumstances with "normal" interest rates, there will be situations where the regulator will advise that it should not be done as it will jeopardise stability.

What is compared must be comparable and clear to people. The objective is not to give back 100% of contributions; it is to do much better over time. Even for default investment option with a guarantee, objectives should be clearly set out, along with life cycling techniques. The difference could be in the financing of the guarantee.

It is not clear which system is more competitive, it will be reviewed, and competition will follow. With life-cycling techniques, savers have always a risk and they can bear unlimited losses (even losing all their capital, because there is no floor). This must be set out clearly.

An industry representative noted that the major achievement of the draft is in creating a level playing field for asset-management and the insurance base as it currently stands. That allows more providers to offer services. The focus should be on allowing the customer maximum choice. Not to decide for them but enhancing consumers' financial literacy to make an informed decision, as they can only exercise choice if they have information. The simpler it is and the more options that are open, the better for the end-investor. An official stressed that this refers to a default investment option. When many providers are allowed to offer it, it clearly means something different. If it is put in a definition, such as guaranteeing capital or guaranteeing nothing, it is a better way to allow those two options.

The Chair noted that a way forward on this subject is the co-existence of different products, with competition between them and proper information for consumers. It will be seen how that can be achieved. Competition in this field has not always worked to the benefit of consumers, but hopefully it will in the future. There should be a prominent warning that the capital guarantee does not cover accumulated fees nor the negative impact of inflation on the real value of the capital, and both have a significant negative impact over time.

5. Decumulation phase and the type of out-payment options

According to the Commission's proposal, the type of decumulation options proposed to savers is up to the providers' choice (annuities, lump sum, regular withdrawals or a combination of options). This flexibility enables providers to adapt their product to the specific requirements of each Member State, as conditions for the decumulation phase will generally be determined by national legislation.

5.1. According to the European Parliament, it is important to provide a choice in the out-payment phase

A public representative noted that it is important to provide a choice in the out-payment phase. This is a pension product, not a savings product. It can be argued that it has features of a savings product, but it has to have a minimum period of time when people can get an income supplement at an important time in their life, when they have no longer an employment income. The basic PEPP was devised with a different approach to the out-payment phase. The life-cycling side did not require annuities as a mandatory requirement, as in the original text; it stated 30% upfront in year one with a drawdown period thereafter that was part of a drawdown plan to be agreed. The capital-guarantee contained a 30% initial payment in year one, 35% annuities, and the rest as part of a plan. That can be reviewed but the possible to have a choice is an important argument for people.

The text of the European Parliament also allows that some investments are so small that demanding people take annuities out is ridiculous. There is a requirement for EIOPA to guide on the threshold required. Below a certain threshold, it does not apply in terms of the basic PEPP. The other significant change, made following arguments heard during the negotiation, is that people are often asked to sign up to something early in the plan, at the moment of the contract, rather than in the decumulation stage or closer to the endpoint. It was suggested that five years would be the time for signing off to the out-payment plan. That gives more consumer protection. It is an addition to the original text that gives people more choice, as the position they will be in at an age closer to the point of retirement is unknown. A distinction has been made between capital guarantee and life-cycling on out-payment, and that approach is better in the long-term.

5.2. Other views expressed on the type of out-payments

An industry representative felt that the latest draft from European Parliament is not perfect, although it seems like something that can be agreed on over time. The possibility of a 30% lump sum out-payment in the first year and options in the following years was welcomed as allowing consumers to exercise choices more flexibly. It is even more critical to inform consumers about the implications of choices on out-payments. As it stands in the text, it is essential that the information can be provided in a digital form. It targets a generation of millennials who retrieve information mostly digitally, and this is a key feature.

An industry representative advised that the position is clear, and those expressed in the Council and European Parliament texts, and the Commission proposal, are witnessed with a great deal of interest. They are slightly different, so the trialogue is wished good luck in being quick and successful. The PEPP is a pension product. A pension is revenue over time after retirement. The natural form of out-payment is annuity. It is the only system which encompasses longevity risk, and which ensures both the retiree and the collectivity that this supplementary revenue will be due throughout a lifetime, whereas, a lump sum happens at once either partially or totally. Once it is used up, there is nothing left, save collective solidarity. These pension products should only be those with an out-payment in the form of an annuity, with some exceptions to this principle. It might be useful to buy a flat or a house on retiring, which can be an exception. There must also be exceptions if one partner in a couple dies. In some cases, there must be flexibility that allows a partial exit in the form of lump sums, but the principle should be an annuity.

This creates a problem with the Council compromise as it stands today, because it exerts no prioritisation in these terms. The European Parliament's position is preferred as, even if it is not enough, it imposes a minimum out-payment in the form of an annuity and must be considered by the co-legislators. The only way to cover longevity risk and to protect savers until the end of their life is an annuity. The Commission proposed flexibility on out-payments, which was supported by the Council negotiating mandate. It is a pension product, so the default option should also cover against the risks of very old age. Only a lifelong annuity can do this, but the proposal wants to have the best of both worlds. As an understatement, starting an annuity right at retirement age, where it is all put into government bonds, might not give a great return.

What has been pushed for, albeit unsuccessfully, is already an option in the Riester-Rente. The customer comes out however they like, with capital, annuity, fixed annuity or programmed capital withdrawals, while paying a premium for a deferred annuity at the age of life expectancy. Old-age insurance was set at 70 years when life expectancy was 60. Now the threshold for old-age insurance has been lowered but life expectancy has risen from 80 to 85, whether for a man or a woman. The deferred life annuity premium should be bought at 80 or 85, as it is the only way to cover the risks of very old age. Taking a programmed capital withdrawal out over 10, 15 or 20 years is okay, but there are questions about

how people will survive if they outlive this. This proposal follows a consultation with an academic expert. It could cost roughly 15% of accumulated savings, provided a return is ensured. It is not much but it should be the minimum as, if not, the risks of very old age are not covered.

A regulator noted that this was a fundamental point of some disagreement with the Commission's proposal. There has been progress on the European Parliament text. One thing that needs further thought is the split between the PEPPs with a guaranteed default option and those without such an option. It would make sense for a lifecycle product to have the same possibility for the consumer to have that choice five years before the retirement phase. Another element that must be considered is that the public perspective should be to protect those who need that protection. Unfortunately, some countries' experience shows that, when there is a complete choice of using a retirement pot, the ones who need it more are those who take a lump sum. That is a public-policy element that does not need to be over-engineered, but having an element of protection makes sense.

It is in the hands of the industry to develop products that are much more innovative in terms of the retirement phase than existing ones. Being honest, in a low-interest-rate environment it is difficult to have a good proposition to sell a fixed annuity to a client. Innovation is necessary. Deferred annuities are important. Mixed products with drawdowns and annuitisation are needed, alongside other types of products that evolve, to give consumers the capacity to provide services when dependent because, unfortunately, that is what will happen to many people with a longer life expectancy. Innovation should come to this and it should not be over-engineered to curb innovation. The fundamentals should be there in terms of what a long-term pension product should be, especially for the default investment option.

1. A capital guarantee lifts the investment risk from the saver to the provider, giving savers a high degree of certainty over their investment. However, the safety of a guarantee has the downside of being expensive, and providers will generally invest via low risk/low return investment strategies. Furthermore, not all providers will be able to offer capital guarantees.
2. 'Life cycle investment strategy' can take the form of asset allocation using 'risk desensitisation grids' between funds. This strategy ensures that most savings are invested in equities for younger savers and include a de-risking mechanism to increase the proportion of bonds and monetary instruments as the planned retirement approaches achieved by the switching of funds. This is done quarterly or annually; the allocation being determined depending on investors' age.

Review of the Solvency II long-term package

1. Specifics of the long-term package

1.1. Essential aspects in the long-term package that are beneficial and should be preserved

Solvency II appears to work well as a regulatory framework, and provides insurance companies with important benefits. EIOPA is now producing yearly reports on the impact of the long-term guarantees measures, the most recent of which focused on disclosure and how to improve it; it is now assessing the risk management measures that are foreseen for certain long-term guarantees measures. The long-term guarantees measures have created a regulatory capital relief of €166 billion.

An industry representative stated that although Solvency II has been costly, it is now a central part of their organisation's decision-making processes.

An expert stated that Solvency II has the 'immense merit' of being a risk- and principle-based framework, as opposed to the blind quota that existed in the past. It incentivises the diversification of portfolios, and more recently allowed infrastructure to be considered as an asset class, which is very important. It also removed barriers to high-quality securitisation. The LTG measures show that matching and volatility adjustments applied to the discount rate for calculating the technical provision has had a positive effect. The LTG measures represent real progress.

A regulator stated that, in a risk-based and market value-based system, it is not easy to accurately portray a long-term insurance business; the LTG measures work in this context, and will have a positive dampening effect on pro-cyclicality. Although some companies have not yet fully taken Solvency II into account in their risk management, it has been a necessary step towards regulatory harmonisation and supervisory convergence in Europe.

1.2. Potential areas requiring adjustment in the Solvency regulation

An industry representative stated that their organisation believes that the volatility adjustment is the main area where practical experience falls short of the initial concept and political willingness. The volatility adjustment does not accurately reflect their business model, and is not as effective as it could, or should, be. Additionally, it could result in inadequate incentives: the reference portfolio includes unit-linked business, for example, which is not the right approach from a technical perspective. Finally, the reference portfolio could create herding behaviour: if all insurers invest in that portfolio, this will create a super-systemic risk.

A regulator replied that there are no indications of a herd behaviour or that the representative portfolio impairs the effectiveness of the VA. The regulator was not in favour of company individual portfolios, which might generate moral hazard and incentivise insurers to invest in bonds of low credit quality.

Another industry representative stated that they would want to change the treatment of equity in the investment strategy link with Solvency II. When Solvency II was introduced in France, €50 billion was moved from equity to less risky assets. Diversification would be good for consumers, and to achieve this, organisations like theirs should be allowed to hold more equity, but a small change in equity has a significant impact on Solvency II metrics. Additionally, Solvency II has a pro-cyclical effect: this is not hugely problematic at the moment, but this may change when the market moves somewhat.

A regulator replied that its organisation has analysed the investment of EU insurers and has not found indications for a negative impact of Solvency II on equity investments.

An expert added that the probability of default being considered over a single year implicitly assumes that insurers are short-term brokers or traders when calculating their value at risk. There is also the risk margin calculation, which is told to remove a significant amount from the own funds of insurers, and the evaluation of risk in the standard formula needs to be reviewed. On the

whole, the Solvency II capital requirement is probably too conservative.

Another regulator stated that they are concerned about a shift of risks from companies to customers, particularly in the areas of retirement provision and insurance. Insurers must be able to offer long-term insurance products with reasonable and meaningful guarantees.

1.3. Preserving the core concepts of Solvency II while making improvements

A regulator made it clear that their priorities are to make sure that undertakings are able to transfer their legacy book from before Solvency II, with very long interest rate guarantees, to the new supervisory regime; that the measures should mitigate incentives for pro-cyclical investment behaviour resulting from market-consistent valuation; and that undertakings must still be able to provide meaningful long-term guarantees in the new regime. Actual risks and illiquidity characteristics of these products need to be reflected in the LTG review, particularly where insurers cover long-term guarantees with long-term assets, or with 'hold to maturity' aspects.

An official stated that although it is important to adhere to the Solvency II model, this does not mean that the 2020 review should not be ambitious. Europe should aim to have the best model in the world and contribute to setting a standard internationally, but the rules should be the same for everyone.

An industry representative added that there should be as much co-ordination as possible regarding the in parallel ongoing further development of Solvency II, establishment of a global Insurance Capital Standard and endorsement of the new IFRS accounting framework enforcing. The worst possible scenario for the industry, its customers, shareholders and the wider public would be a 'same, same but different' scenario that incurs significant costs and could result in inconsistent management incentives.

An official stated that the long-term guarantee package is, to a large extent, linked to the question of equity. Technicalities are the most important thing, and it is also vital to discuss what the model aims to achieve. Increasing investment and fostering sustainable growth is the top priority of the European Commission; this is fully supported by the official's nation and most of his/her colleagues. The official noted that they are not satisfied with what has been achieved so far.

An industry representative stated that the framing of Solvency II has encouraged some insurers to move too much risk onto customers. The European Commission also needs to address the issue of risk being transferred from insurance companies to policy-holders, which goes against the spirit of Solvency II. To provide a good return for customers, it is necessary to move into slightly riskier asset areas, notably equity, with long-term detention. This allows insurers to build products that are attractive for everybody.

A public official stated that the European Parliament would be open to a discussion about changing some aspects of the rules; the ECON Committee is in the process of preparing a letter to be sent to the European Commission on this topic, and the European Parliament is likely to consider volatility adjustment as one of the issues it needs to deal with. However, legislators need to remember that Solvency II exists to contribute to financial market stability and protect policy-holders, and any approach needs to take these two boundaries into account.

Another regulator stated that they have seen a lot of push-back against internal models, because the credibility of these models has been severely damaged in the banking sector. The regulator's organisation is working hard to enhance credibility and trust in internal models. In their view, Solvency II has created many benefits for how insurers manage their portfolios and risks, especially via Pillar 2.

2. Beyond the long-term package – an overall review of Solvency II after two years

2.1. Solvency II in the context IFRS 9 and 17

An industry representative stated that new accounting standards are coming into effect - IFRS 9 and IFRS 17- which are extremely important. In the experience of their organisation, IFRS 9 leads to significant volatility. It is important that insurers should not be incentivised to invest in even less risky assets. IFRS 17 is a major standard and an extremely complex one; this can also drive up reporting volatility. As such, it is necessary to be cautious about the new regulation, and make sure that it does not have a significant impact on how insurers operate.

A public representative noted that the ECON Committee has requested an evaluation of IFRS 17's long-term effect on investment, and the discussion about LTG measures should take this into account. There also needs to be a consideration of whether insurance companies need to take climate and biodiversity risks into account and take into account stranded assets.

2.2. Making sure that Solvency II delivers on its full potential

An official stated that there will be many technical discussions about how to improve volatility adjustment; the first question is how much change can be effected, and what the real impact of the volatility adjustment on the internal model will be. The second is about the role of national threats versus European ones: triggers have been introduced into the adjusters, consistent with threats in Europe remaining largely national. These triggers would not have worked for many countries during the 2008 financial crisis, and do not appear to have worked during recent episodes in some countries. There are other questions that can have significant impacts on how volatility is considered, such as whether the volatility adjustment should be dynamic for the standard formula; the official noted that this will not be easy to answer.

Volatility adjustment and matching adjustment have been limited to fixed income and excluded equity in the past; the official's main concern in this area relates to investments in equity. The long-term guarantee package is useful for life insurance, but there are many non-life portfolios that should be more invested in equity, so the current package does not address all of the existing questions. There have been some proposals about creating an equity volatility adjustment, but this will be technically difficult, and defining an equivalent for spreads in the area of equity is not obvious. The pro-cyclicality of such a mechanism needs to be debated. Another official stated in this respect that in addition certain markets in Europe invest more in equities than others do, and equity risk is therefore more important in those markets.

Other ideas that have been proposed might be more disruptive and are even more debatable: in particular opening up the valuation framework for discussion begins to touch on the core principles of Solvency II. An official's overall view is that work should take place on other aspects of the issue: in particular, the ongoing level 2 review, which can greatly contribute to facilitate equity investments by insurance companies.

An industry representative stated that their organisation approves of the Solvency II framework on the

whole; what is envisioned is a 'rightsizing' of Solvency II, rather than a revolution in the approach. Pro-cyclicality and long-term investment are the two most important issues, and changing the volatility adjustment to better reflect a company's underlying risks would help to address both. Risk mitigants would need to be embedded in such an amendment, to prevent companies from loading up on the highest credit spread assets. It is also important to avoid taking a piecemeal approach to these changes, and changing volatility adjustment in the right way would also enable companies to offer better products.

A regulator stated that the issue of proportionality should be talked about more. Supervisors need to be clear about the cases in which they can act proportionately and those in which they cannot. It is also worth considering whether every report that is produced adds value. Another regulator agreed that proportionality is important, particularly in the area of reporting. A public official stated that the issue of proportionality needs to be dealt with seriously. Proportionality is not necessarily related to the size of a company: a small company can have large risks, and vice versa.

2.3. The current process to review of Solvency II

The EIOPA is currently working on a call for information from the European Commission, focused on the identification of illiquid liabilities, what their duration is, and what assets are matched to them. This organisation is also assessing macro-prudential elements in Solvency II, both those that already exist and those that may need to be added. In this context, a regulator's organisation is not in favour of implementing changes to the long-term guarantees measures already by the end of 2018, because EIOPA is currently engaged in an intensive review of these measures, and one should wait for these reviews to be complete before taking action.

A holistic impact assessment of all changes is very important, but time constraints need to be taken into account: EIOPA needs to deliver its LTG opinion in early April 2020, with a consultation in autumn 2019. Regarding asset liability management, the matching between the assets and the liabilities is an important aspect of Solvency II, and being well-matched is better than reducing the equity risk charge. The regulator's organisation would also like to enhance the existing disclosure requirements on the LTG measures, based on feedback that has been received from the market, from stakeholders and from analysts, and to consider macro elements in Solvency II.

An official hoped that an EPP rapporteur would be appointed soon to deal with the ESA review; given the number of topics that Europe is currently dealing with, including Brexit, it would be a significant mistake for this topic not to be finalised during the current mandate.

2.4. Additional regulatory issues regarding the Insurance sector in the EU

An official stated that another important area is the protection of policy-holders regarding cross-border activities, and dealing with companies that default. Freedom of provision of services is a key element of the internal market, and should be preserved, improved and strengthened. However, at present, insurance companies rely on supervision carried out by other Member States, and this can work only if it is not possible to engage in 'supervisory shopping' in Europe. Europe needs supervision that converges in its standards, its quality, and its knowledge of activities in other countries; this could form part of EIOPA's regulation, or an amendment to the Solvency II regime, but it should be a priority for the review.

The official also expressed the view that EIOPA should have a much bigger role in dealing with internal models and some amendments need to be made to the freedom to provide services.

To complement this supervision, Europe should also aim to harmonise its tools for dealing with crises. The official's nation would make two proposals in this space: the first is about the guarantee mechanism. The same level of protection needs to be extended to all European citizens, which is not currently the case. Secondly, if a company collapses, the effect is not limited to its national market, and resolution activity will be more meaningful if it is done on the European level. This should form part of the review of Solvency II, and should be dealt with over the next few years, if not months.

FINTECH AND DIGITALISATION

Crypto-currencies: which policy approach?

1. Potential benefits and challenges associated with crypto-currencies and DLT

1.1. Prospects of crypto-currencies and their underlying DLT technology

An industry representative believed that, in a digital world and a digital financial context, there is a need for some kind of digital currency. Bitcoin has triggered in-depth analysis about what these currencies involve, but it is probable that it will not be the model for crypto-currencies in the future.

An official emphasized that crypto-currencies should be distinguished from the underlying technology (i.e. DLT (Distributed Ledger Technology) or blockchain). There is a broad agreement among the public authorities and the industry that the potential applications of the underlying DLT technology are worth exploring. The official also remarked that there is a focus on bitcoin at present, but there are more than 1,500 crypto-currencies in use. The first four are however considered to represent 70% of transactions.

Several panellists agreed that while the prospects of crypto-currencies are uncertain, the DLT technology underlying bitcoin could have very positive applications in the financial sector. An official mentioned that DLT can help to cut out intermediaries in financial transactions and reduce fees. An industry representative emphasized that DLT protocols are extremely useful, with many potential applications that could provide improved efficiency, transparency and traceability of operations. Where DLT can be the most beneficial is to help accelerate and improve the efficiency and reliability of complex processes involving many intermediaries and operations and the handling of large amounts of documents. That is the case for example of trade finance transactions for which tests have proved that the standard delay of 7 to 10 days can be reduced to 2.5 days with a DLT system. Other interesting areas of potential application include long-term credit and loans to large companies, cross-border payments and foreign exchange.

DLT however has limitations in terms of scalability and speed at present due to its decentralised nature and the need to manage identity and privacy. Central banks are assessing the possible use of DLT with permissioned blockchain to optimise some of their processes, such as collateral management or real-time gross payments, an industry representative mentioned. Concerning payments, there could be some efficiency gains compared with the current TARGET2 system, but these would not be huge and it is doubtful whether DLT technology will eventually allow sufficient scalability for this to be possible, because the execution of payments involves only a limited number of participants (a few thousand institutions related to a central bank). An official confirmed that there is no benefit at present in using DLT to replace existing financial market infrastructures (FMIs) but this may come in the future. Another official added that limited speed is another drawback of decentralised technologies, compared to the infrastructures currently used in the interbank space that allow the processing on a real time basis of hundreds of thousands of transactions. DLT has not reached that capacity yet and this might take decades. This is an important element because the financial world operates in real time. Another challenge is providing a sufficient level of trust to the different counterparties participating in a transaction, an industry representative stressed. This might require moving to a system that is not fully decentralised, with a few trusted agents specialising in specific fields.

The industry representative added that there are also interesting applications in the tokenisation of assets, which is indirectly related to crypto, such as initial coin offerings (ICOs). This type of funding is an alternative or complement to private equity and it may help to increase the investor pool. Unfortunately, ICOs are exposed to frauds and raise concerns in terms of investor protection and anti-money-laundering (AML) which will need mitigating with further regulation.

1.2. Issues raised by private crypto-currencies

Different issues and shortcomings associated with the use of current versions of crypto-currencies were discussed. An official noted that the General Manager of the BIS had summed up these issues well, describing bitcoin as 'a combination of a bubble, a Ponzi scheme and an environmental disaster'.

Firstly, bitcoin and other so-called crypto-currencies raise terminology issues, an official stated. They claim to be currencies, but from a central-bank point of view they are not because they do not satisfy the three functions of money: (1) their value fluctuates very significantly meaning that it is difficult to use them as a unit of account; (2) as a medium of exchange they are less effective than fiat currencies since their price fluctuates significantly, they generate relatively high transaction costs and there is no guarantee of reimbursement, and (3) their lack of intrinsic value and guaranteed convertibility into fiat currency and the fact that they are not based on any underlying economic fundamentals mean that they cannot be used as a trusted store of value. This is an important problem because in the eyes of the public a currency has attributes and protections associated with it, starting with the capacity to convert it at par into bank notes or central-bank money or the ability to be repaid if there is fraud. Nothing like that currently exists for crypto-currencies, so misleading messages need to be avoided.

Their benefits in the retail area are also doubtful, several speakers pointed out. An official emphasized that there is already a great deal of supply of payment solutions, both domestic and cross border, so it is difficult to see what additional benefits can be brought by crypto-currencies in that area. Commercial bank money is the most used asset for retail payments, but the existing payment systems perform the bulk of transactions with central-bank money, which is not the case for crypto-currencies. The official added that it is often claimed that crypto-currencies may help to bring down costs, but the balance between costs

and safety needs to be looked at for retail solutions. What has not been developed yet is a disruptive solution which brings down cost and provides the same level of security and safety that central banks have collectively delivered for the payment system.

Thirdly crypto-currencies are exposed to risks of fraud and can easily be used for criminal activities. An official mentioned that with a fully distributed and decentralised ledger, it is possible, when owning more than 50% of the coins or items issued, to manipulate the technology, even to the point of shutting it down. A study produced for the ECOFIN has also shown that bitcoins are widely, up to one third, exchanged for Russian roubles, with transactions in dollars, pounds or euros representing a much lower proportion. This indicates that not all bitcoin purposes are legitimate. An industry representative emphasized that anonymity is also a key feature of crypto-currencies. This preserves privacy and means that they can potentially be used as a substitute to physical cash, but also for criminal, money-laundering or terrorist financing activities. However, if we decide to move towards fully identified digital currencies, there is a risk that other anonymous currencies might develop, e.g. a dollar-based anonymous currency, so caution is needed in this area.

A fourth issue are the increasing amounts of energy that crypto-currencies are burning. An official mentioned that there are several analyses and estimates for bitcoin varying between 9 TWh and 70 TWh, which corresponds to the energy consumption of some small countries, so it is not sustainable. This comes from the decentralised nature of the network, which makes it energy-intensive and slow. An industry representative however observed that many experts believe that this technical limit may be solved eventually through an improvement of technology, because every block does not need to contain all the information.

2. The prospects of Central Bank backed crypto-currencies (CBCC)

2.1. Potential benefits and risks of CBCCs

Several panellists suggested that central bank backing with certain types of blockchain could offer opportunities to crypto-currencies in the future to become alternatives or complements to traditional currencies in certain circumstances. Central bank backed crytpto-currencies (CBCC) could facilitate access to finance in emerging countries for example, where financial inclusion is limited. An official described the specific legal situation in Sweden, where the central bank, the Riksbank, is considering the issuance of a central-bank digital currency, the e-krona. The reason behind this is that Sweden does not have a legal-tender obligation, meaning that shopkeepers are stopping to store cash, because it is expensive, and accept only digital cash. That worries the Swedish Riksbank because it might lead to a situation where people have to rely mainly on digital cash backed by private banks. Another official emphasized however that central bank backing might take away one of the major appeals of crypto-currencies at least to some people, which is their decentralisation. Some central banks such as the Riksbank might start issuing a digital currency one day, but that might not be in the way that the supporters of crypto-currencies want it to be.

Another concern that some speakers raised is that CBCCs could facilitate bank runs, because they could make it easier to move cash from commercial banks into digital assets backed by the central bank. An official noted that the Bank of England had issued a working paper in May, which suggests ways in which CBCCs can be designed to avoid bank runs. The main idea is that the CBCC would not be exchangeable with commercial-bank deposits in all circumstances. Limiting the convertibility of CBCCs might mitigate the risk of a bank run and make CBCCs safer but might also take away one of their major benefits. When thinking about these issues, it is important however to separate the implications of a system built from scratch from those of a system building on the current position, the official observed. Starting from the current position means that conditions regarding convertibility may be necessary and most central banks are likely to require non-convertibility for the provision of central-bank digital currencies.

2.2. Implications of central bank accounts

An official suggested that providing everyone with the possibility of opening a central-bank account could be an alternative to a central-bank digital currency. Several panellists however believed that this possibility should be approached with caution due to its implications for the banking sector and the financial system at large. Some panellists pointed out that there may be no difference between allowing access to the central bank account, the central bank issuing digital currency, and CBCCs.

An industry representative emphasized that it is necessary to consider the overall impacts of central-bank accounts. They have advantages in terms of monetary policy, since negative rates can be applied if necessary for example, but have far-reaching implications that need bearing in mind. An account in a 'super-safe institution with deep pockets' such as a central bank would indeed offer people a level of safety that can be found nowhere else in the financial system. This means that the central bank would naturally attract a large amount of deposits and savings, unless commercial banks were able to offer high interest rates, thus depriving the latter banks from resources and reducing their lending capacity. If banks can no longer lend enough to the economy, an alternative could perhaps be to set up a new public institution related to the central bank in charge of screening loan applications and managing risks. This would however lead to the creation of a 'super-monster' in charge of a large part of the financial system including monetary policy, financial stability, supervision and the entire range of banking activities, which is difficult to imagine in the existing open-market economy. Another official agreed that with central-bank accounts, the role of the central bank in the financing of the economy might change dramatically. Also, there is an implicit division of labour between banking institutions and the central bank, in terms of serving retail needs that might be jeopardised.

A public representative believed that access to central-bank accounts and central bank backed digital currencies are two different questions and that one can be developed without the other. In additional a model where a large amount of the money used would come directly from the central banks rather than being created via private banks could be an interesting model to further evaluate. This would have a transformative impact on banking models, but it would also raise interesting questions about the responsibility of central banks. The speaker was not convinced by the arguments that this would make central banks too large, because to some extent their balance sheets have already significantly increased. The speaker added that it is possible to run a bank without a great deal of deposit-taking and to run a central bank with significant deposit-taking.

An industry representative stated that a bank, by definition, is an institution that takes deposits in order to grant loans. So, if there are no more deposits, it is no longer a bank. A public institution close to the government can be created for screening loan demands, if many deposits move out of commercial banks, but that would be an entire change of model. The capacity for commercial banks to create money can be curtailed or made safer in many ways, but a bank needs to take deposits to be considered as such.

3. Possible policy approach regarding crypto-currencies

3.1. Main questions to be addressed regarding the regulation of crypto-currencies

An official suggested that the starting point when thinking about policy actions in the area of crypto-currencies should be the interface between the digital and the 'real' world, since that is where most risks might materialise. This includes consumer and investor protection issues as well as money-laundering risks. Some of these issues might emerge also solely in the digital world, for instance in the context of ICOs. When looking at the legal background, many digital assets seem similar to real world assets, so the present legal system should be capable of dealing with possible issues.

A public representative mentioned that the European Parliament report on crypto-currencies and blockchain had recommended addressing risks at the interface between the digital currency and the rest of the world, which includes mitigating risks associated e.g. with digital wallets and proposing Know Your Customer measures. A positive aspect about DLT technology is that it makes it somewhat easier to trace transactions than with cash.

Another official stated that in terms of the possible regulation of crypto-assets three questions need addressing. The first question is who to regulate. One issue with crypto-assets is that there is no identified issuer behind the asset. That is a fundamental and unprecedented characteristic. In terms of regulation of payments, those who provide services associated with the issuance of assets and their conversion into fiat currency or commercial-bank money, will therefore probably be the main target, although this is still a developing ecosystem. The second question is what type of risk to regulate. For the time being, the priority is criminal abuse. Money-laundering, investor and consumer protection risks and market integrity issues including the manipulation of the prices of conversion are important issues. Financial stability risks are less of a priority for the moment, given the limited state of development of cryto-currencies compared to the total amount of currency in circulation. The huge price fluctuations that can be observed might however create shocks in the future, with spill over effects and financial-stability consequences, therefore these risks need monitoring as well. The third question concerns implementation. In terms of geographical scope, the cross-border dimension of these activities requires close coordination between jurisdictions, a first step in Europe being the fifth anti-money-laundering (AML) directive that establishes a common stance for that type of risk. A second requirement is regulating technology in a way that is proportionate and does not stifle innovation. An industry representative agreed that a technology that is in its infancy cannot be regulated in detail, but on the other hand waiting for it to develop could eventually create problems. DLT should not be regulated too early, but there should be on-going cooperation between the public authorities and the private sector to develop joint learning in this field.

A third official was not sure that crypto-currencies are easy to regulate. The touchpoints with the standard financial system can be regulated, but crypto-currencies could develop into an alternative financial system, becoming units of account and means of payment that never touch the regular financial system. There are already cases where bitcoin must be owned in order to participate in ICOs, so this is a potential risk. In addition, the official did not consider that risks associated with crypto-currencies are specific, although they are quite challenging to mitigate. Consumer protection is mostly related to financial literacy, which is a general concern in the financial sector. AML is a major issue, but it is not specific to crypto-currencies either and there are major risks with ordinary cash.

3.2. Possible policy approach

An official believed that a safe environment provided by an appropriate supervisory and regulatory framework is needed to foster the development of technology and suggested two ways of addressing the regulation of crypto-currencies. The first is some form of labelling, which would be an optional application of a crypto-currency framework aiming to identify services that fulfil a set of predefined requirements. Then potential users and the market can decide. The other is based on the principle of proportionality. This has been used in Europe for payments, with requirements indexed on the degree of development of a given activity. Reduced requirements are possible, depending on the scale of the activity, as well as some exemptions.

An industry representative stressed that moral persuasion on the part of the authorities could be an effective way forward. The recommendation that the EBA made in 2014 to the national supervisory authorities to discourage banks in particular from buying, holding or selling crypto-currencies has been effective. If the banking system is not involved, it is difficult for a currency to develop, especially if not backed by a public authority.

An industry representative emphasized that DLT standards need to be developed with a European perspective from the outset, in order to avoid extensive harmonisation and interoperability work down the line. The EU blockchain initiative that was launched at the beginning of 2018 with the support of 23 countries ready to experiment and share knowledge, together with the private sector, is a positive example in this regard. The commitment of the FSB to issue guidance at the end of the year on DLT also gives hope that global thinking can move forward in this area. Answering a question from the audience about the need for common European standards (e.g. regarding bitcoin trading platforms) in order to avoid regulatory arbitrage, an official stated that a level playing field is needed based on common definitions of financial instruments and trading venues. A public representative emphasized the tension that needs tackling between national jurisdictions in the EU developing new activities and trying to attract new business (e.g. in the area of ICOs) on the one hand, and on the other hand the need to ensure that appropriate standards are met at the European level. The speaker recommended a cautious approach at the European level in order to ensure sufficient investor protection.

Harnessing the potential of fintech and digitalisation in the EU

1. How can fintech and digitalisation benefit markets and consumers, and what are the risks?

1.1. Examples of areas of development and specific projects that showcase the potential of fintech and digitalisation – artificial intelligence, blockchain, and the cloud

An industry representative stated that digitalisation will fundamentally change the ways that consumers and corporate clients interact, buy products, buy services, and leverage things. Over time, this will become more experience-focused and less of a transactional interaction. Barriers to accessing the digital space are falling away, although more still needs to change, and as such the quality and provision of products is going to increase exponentially. An industry representative stressed in this respect that although securities markets have been digitalised for some time, the same processes that were used during the days of floor trading have been more or less replicated in the digital world. Securities markets now need to rethink their value chains, because new technology can make these markets much more efficient, especially with distributed ledger or blockchain technology.

Another industry representative stated that their company has embarked on a major Distributed Ledger Technology (DLT) project, re-platforming its trade information warehouse, and it is noted that although some temporary new friction has inevitably been created, their company sees a great deal of promise in it. This is currently a private chain that is not particularly distributed, but as build phases continue, this is likely to be its end state. Their company is also looking closely at artificial intelligence, which is showing particular promise on the risk management side, and in the cloud space. Their company has been having an important ongoing conversation with its cloud vendor to resolve the issues that have arisen. The industry representative added that their company is interested in bitcoin ETFs, although no ETF product has yet been approved by the national supervisor.

A central bank official stated that the core of digitalisation is innovation, which their institution sees as very positive. This major innovation, which contains elements of creative destruction, is positive for consumers, because it offers more choice and more efficiency along the value chain and creates a much broader offer across Europe. Financial services are no longer bound to a certain place, and making information about markets much easier to access is good for those markets and for economists.

A panellist commented that blockchain technology will also be able to greatly benefit the public sector as it becomes more established and secure. One example is securities transactions, where regulators will be able to access real-time data and use it as a trial for detecting market abuse.

2. How does the EU's approach to fintech and digitalisation differ from other regions?

2.1. The major differences and points of similarity between the EU and the US

An industry representative stated that there is currently friction in the value chain; this friction is particularly noticeable in the EU, which is 28 markets containing 500 million people, as opposed to the US, which is a single market with 320 million people. This friction will reduce as a result of new technology, but it is not yet clear whether current industry players will introduce this technology, or whether other organisations will do so. One panellist commented that it is clear that Europe will need to rethink the Capital Markets Union, and new technologies might play a key part in encouraging integration and breaking down barriers.

Although the European Commission's FinTech action plan is good, Europe is lagging behind in this area, and needs to become more agile and faster in terms of decision-making. For instance, their institution had wanted to use a solution based on cloud technology, currently in use in the US and in the Nordic countries; however, it was not allowed to do so, because the regulators did not have a view on how to handle data in the cloud. This institution was therefore forced to 'de-cloud' that solution, incurring extra costs and friction; 12 months later, it received approval to put the solution into the cloud, and is now working on 're-clouding' that technology.

Another industry representative commented that one helpful aspect of the US's policy approach is that policy in capital markets is generally technology-neutral. This allows firms to try new and different tools as they emerge, which has served the US marketplace and investors well.

An official stated that the single market is one major advantage of the European Union. In the areas of blockchain and artificial intelligence, the financial industry needs to implement them and inform regulators of what impediments they have identified in the current legislation. Regulators will then need to remove those impediments while ensuring financial stability and investor protection. The official noted that they would be reluctant to use legislative action to 'push' a market, as this often has the opposite result to the one intended.

2.2. Regional variations in approach

2.2.1. Can, and should, the Nordic approach be replicated in other areas of the EU?

The speaker stated that the success of the Nordic countries is due to a combination of digital and cultural factors. The exchanges that their organisation runs have been digitalised for quite some time, and contain very well-developed online banking, online brokerage and online trading environments, among others. This, combined with the culture of equity investments, has created an ecosystem that is favourable for capital raising and good investments.

The Swedish ecosystem listed 100 new companies last year, the fifth consecutive year in which it listed a large number of small companies. This is the result of a combination of decisions over the past 20 years or more, the first of which was how Sweden deals with its pension system: investors and savers decide for themselves where a small part of their pension should be invested. Six years ago, investment saving accounts were introduced in Sweden, which represented a revolutionary development; they have now been copied as best practice in Norway and Denmark, and a couple of weeks ago, Finland decided to implement it as well. This makes it easier than ever before to save into ETFs, mutual funds and direct equity. The industry representative expects that a 'Nordic pole' will emerge, and the EU could do more to share best practice, such as by creating a handbook dealing with how to create a culture of investment.

A panellist observed that Sweden's methods of financing small companies are quite persuasive. Cultural factors, such as the treatment of tax and language issues and knowledge of technology, appear a significant part of it.

2.2.2. What specific developments are taking place in France and in Germany?

An official stated that in late 2017 France modified its securities law, enabling the transfer of property materialised through a blockchain. Doing so means defining a blockchain from a legislative perspective, which is not easy, and also ensuring that security measures are introduced to ensure that the transfer of property is genuinely materialised. Conversations about this are currently taking place with the European Commission and data privacy regulators, with the goal of remaining technology-neutral.

Another official added that all of Germany's existing players are innovating dramatically. Fintech companies may no longer be the main players in this space: the larger players are innovating much more, and have far more power, banking licenses, and means available to them. The challenge for regulators is now managing the financial technology being developed by a variety of players, including banks, fintechs, and large technology companies.

They added that regulators and supervisors are also innovating: real-time supervision carried out by sensors in banks' IT systems represents a major opportunity for supervisors.

3. An environment conducive to harnessing the potential of fintech and digitalisation

3.1. Regulatory challenges regarding digitalisation and fintech

An industry representative stated that regulation tends to be based on the entity, rather than the activity and risk level, which puts banks at a disadvantage. Their organisation either builds businesses internally, invests in them externally, or buys them; if it aims to build a business internally within the fintech space, it will probably incur a 'regulatory drag' of about 30% to 40%.

Responding to this point, an official stated that supervisors and regulators face problems as a result of the fragmentation of the value chain: banks split their core business into different parts and different tasks, and regulators need to be sure that the responsibilities of the bank managers are not cut off by these positive technological developments. That is why they insist that management take responsibility for the services that they have attributed to computers, algorithms and clouds in various parts of the world. However, supervisors do not want to act as an obstacle to increased efficiency in the banking industry, and need to find a way to meet their own responsibilities for the financial stability and resilience of institutions.

Another industry representative stated that a locational policy is not the best way to ensure privacy or data security. The EU and policy-makers around the world have been very good at dealing with some of these technologies, especially newer ones like distributed ledger technology and AI. Policy-makers have spent time educating themselves about how these technologies might impact the marketplace; however, more education is necessary.

Another central bank official stated that digitalisation poses large and interesting challenges for legislators and regulators. First, they need to be good at understanding what digitalisation means, including recruiting people who have this specialised knowledge. Regulators need to protect financial stability, investor protection and other important safeguards while simultaneously understanding the potential benefits that new technologies can create.

The panel agreed on the fact that getting the regulatory approach right is very important, and this matrix of technologies and regulatory approaches could be a significant driver of European integration in the future; there is a need to be very careful in this space.

3.2. The importance of technological neutrality

An industry representative stated that remaining technology-neutral requires regulators to take some positive action: the regulation produced 10 years ago was not written with blockchain technology or artificial intelligence in mind, and regulators will need to identify whether it contains some impediments to the sound development of such technologies.

An official added that this space is evolving, and the only thing that regulators know for sure is that they do not know what this area will look like in one to three years' time. As such, it is important to create an evolving piece of legislation; it is easier to do so when the industry asks for this kind of legislation. This has been the case with blockchain, crowd-funding and ICOs. It is what France intends to do with the PACTE bill that is currently going through the legislative process.

Another official agreed that the regulatory and supervisory approach needs to be technology-neutral, enabling the development of new technologies and products that do not fit into the framework of existing regulation. The task of regulators is to devise rules to mitigate the risks that exist.

A second industry representative agreed that they would like an environment of technological neutrality, which does not currently exist in some areas. Unless there is a level playing field in the area of data, companies like theirs are at a significant disadvantage, particularly where they are using machine learning and AI to help them make decisions faster and experiment more.

3.3. Leveraging sandboxes

An industry representative stated that the sandboxes that exist are not broad enough, even if they are developing in the right way. In particular it is difficult to have a sandbox within an organisation: often, creating a business or putting a proposition to a client is based on fixing a problem, and that problem is often made up of multiple technological areas and components. If the regulation and approach is different for each, this has a significant impact.

Another industry representative agreed that there is a regulatory drag on institutions that have a host of significant responsibilities from regulation. However, in this representative's view, regulators and supervisors have mostly struck the right balance. They have to ensure that regulations that have been in place for a long time, and with good reason, are adhered to. Supervisors should not suspend regulations relating to prudential practice 'willy-nilly'.

The role of digitalisation in further integrating EU retail financial services

Retail financial service markets in the EU have not integrated much in recent years, which is likely to change due to digitalisation. In this perspective, the panel considered areas of expected high impact and the challenge of that impact for the industry. The impacts on retail payments and on market infrastructures, such as derivative-market infrastructures or securities-market infrastructures, were not covered.

The panel had two parts: first, the issue at hand, services expecting the highest impact from digitalisation and why. It also considered current obstacles to further cross-border integration and notably the extent to which customer and data protection may create new challenges and complicate things. The second part dealt with policies and the future EU frameworks, which may be needed to reach new frontiers for digitalisation and avoid fragmentation.

1. The main impacts of digitalisation and its role in further integrating EU financial markets

1.1. Benefits and concerns associated with the development of digitalisation and related disruptive processes

An industry representative advised that there is a personal and institutional passion about what technology can bring to end-investors, market participants and society at large. Opportunities in this respect are the two main challenges for retail investors who do not save enough for retirement via Pillars II and III savings and often only hold cash. According to an Investor Pulse survey, two-thirds of retail investors' assets are held in cash, which is suboptimal to achieve a long-term beneficial outcome for investors. Technology can help here.

An industry representative noted that retail clients are increasingly adopting digital channels and mobile phones for investments. In a country like Germany, one third of clients buy a mutual fund online; in Sweden, it is already 60%. This rate increases every year, so is a good basis.

A public representative advised that this is not a business as usual situation. Digitalisation comes with a disruptive way of doing business and of dealing with day-to-day issues. It is a disruptive process, which requires recreating the way business was done up until now and reinventing internal mechanisms of functioning, as well as how customers and databases are dealt with. Improving existing business models will not be enough to do the job. Furthermore, such a disruptive process will not only change financial systems and economies, but also impact social and financial inclusion, and financial and digital literacy. Citizens must be prepared to deal with new technologies, because a bank, company or start-up has the means to adapt or create new rules. That is difficult for the normal citizen.

A public representative stated that the impact on citizens' day-to-day lives and how consumers will deal with new technologies must be considered. Technologies should be available to and benefit everyone. It will be more cost-efficient and more transparent. It solves many problems, but whether European citizens will have access to this technology and be able to understand or deal with it properly is key. There are dangers and customers need protection. Cybersecurity is another important issue. It is a complex environment and the European Commission is already working in this field. Discussions with industry are more efficient than ever.

An industry representative noted that things are not always smooth. It is often said that digitalisation will promote access to banking services, but that is not necessarily the case. It may not be everywhere or for everyone. Banks have a strong and long experience of fragile clients and a specific public mission of banking accessibility that has been undertaken for decades. A decision was made recently to tackle banking and digital exclusion together. It should not be forgotten that digitalisation also creates banking exclusion.

An industry representative advised that digitalisation has two business models: the first and most common is full, non-fee-paying, funded by resale; then there is fee-paying with personal data protection. European citizens and European policy must study whether these models can coexist, the choice given to customers and the macroeconomic consequences. Balanced models that allow for a wide provision of services are required.

1.2. Opportunities and threats for incumbents associated with fintech

A Central Bank official noted that European banking practice is small compared with other countries. Only Germany is among the top seven global fintech hubs, with a staff size of one-sixth and an investment one-tenth of California's. European fintechs must improve greatly in order to play a major role. However, at present the issue is primarily matching non-EU tech firms and EU incumbent banks, not fintechs and non-EU tech firms.

An industry representative noted that moving the discussion towards service providers and away from banks makes sense. Customers expect banking services to be available everywhere, at any time, with real-time answers, which is a tremendous challenge for banks. Digitalisation provides an opportunity to meet this new demand. Banks are investing billions of euros in upgrading systems and implementing digitalisation for KYC and online authentication, so fintech and traditional actors should not oppose this investment.

An industry representative advised them that fintechs bring to traditional banks the ability to develop answers to new challenges, on a small scale but rapidly. The bank's knowhow is on scaling up solutions that are imagined and drafted by service providers. Designing a service that seems to function for tens of thousands of customers and scaling it to tens of millions of customers is different. This is typically banks' knowhow, but other actors will have the same knowledge available. Banks have experience of many customers and of regulation and supervision. Fintechs should not be seen as a threat but as partners.

A Central Bank official questioned the strengths of the different institutions. The GAFAs can build new infrastructure from scratch without legacy IT. They have economies of scale and are attractive employers to fintech talent, with a data-driven business and a large database on customer behaviour. Alternatively, incumbent banks also have strengths, the most important being trust. They bother about data privacy, which can be an asset in this debate. In addition, they have a physical asset base in the form of complex products as well as an established relationship with key customer segments, which could be another advantage.

1.3. Robo-advice for retail investors shows high development potential

An industry representative advised that standard transactions are going digital, while the hybrid model

will be the most successful for more complex needs and the provision of advice. Monitoring 200 robo-advisors providing online investment advice globally shows 80% of flows with institutions that offer digital advice in a hybrid model, where there is access to a financial advisor via webchat, phone or in branch. Financial advisors are still needed, but it is a different way of transacting with end-investors. A segment will be fine doing it online alone, but many clients still need the trusted human to talk to.

An industry representative considered that two areas of investment technology generating the most passion are robo-advice and digital passporting. Discussions with major distribution partners about offering robo-advisor technology are ongoing, and that it facilitates ease of access for end-investors and improves investment outcomes is clear. Some call it the democratisation of private banking because robo-advice can combine financial wealth and retirement-planning tools: particularly proper, fully compliant advisory processes that guide the end investor to a portfolio usually offered to clients and which is well-diversified, focused on asset allocation and able to be implemented with cheap and efficient building blocks. This has the benefit of demonstrating to end-investors the need for longer-term investment horizons and perspectives, and guiding investors to portfolios that match their needs, requirements and risk profiles, something which can be adjusted.

This can have two benefits: including one for investment performance. For the cash and securities holdings of retail investors in a country like Germany or Austria, just 1% higher performance on average would correspond to a 1% GDP effect, which is quite a benefit for society. Second, on costs, the average mutual fund bought by a retail investor in the EU three years ago would have costs of at least 2.5%, considering production and distribution. Market robo-advice offerings have all-in fees of between 1% and 1.5%, which is half the price level for an all-in investment offering to retail clients.

A panellist asked about the number of robo-advisors and the industry representative noted roughly 200. The panellist wondered whether that number is the entire universe and was advised that new robo-advisors are introduced to the market daily. The panellist also asked if they were followed by clients investing in them.

An industry representative compared Europe and the US. An estimated aggregate of robo-advisor assets would be slightly more than 200 billion sitting with these models, of which around 4-5 billion is in the EU. The rest is in the US. The biggest dynamics in Europe are in Germany and the UK. Germany has 40 models in the market, and the UK follows close behind. Austria has one small provider. Europe is lagging behind the US significantly, and cross-border provision of the service is currently concentrated in large countries.

A panellist noted that 200 robo-advisors with 200 billion under management does not mean much under management on average. The industry representative agreed as it is still in the early stages.

1.4. Giving the same access to client data may facilitate the cross-border provision of financial services

An industry representative considered pass-porting in the provision of cross-border services, where the end-investor faces situations such as switching a provider. There are new fact checks every time, namely Know Your Customer (KYC) and profiling checks, which make it difficult for a private investor to have an overview of the entire financial situation. It is not a motivation to be open to new offerings. A project that could bring real benefits to end-investors and make their lives easier would be to give the same access to client data. It would also benefit insurers, asset managers and bank industries as well as regulators. This is positive provided that proper data protection is in place and clients are assured that they control their data.

2. The possible need for a faster and more proactive regulatory approach at the EU level to foster an appropriate development of digitalisation

2.1. Building on national initiatives, a more proactive and harmonized regulatory approach at the EU level should contribute to reducing the domestic and regional bias prevailing in retail digital services

A regulator advised that such services constitute an important area that grows in importance every day. Establishing cross-border digital services in the EU is a slow process. Progress is quicker on a domestic and regional basis, as in the Nordic countries. That is demonstrated by figures issued by the European Commission in its Digital Economy and Society Index, showing that over 90% of internet users use online-banking services in countries such as Sweden, Finland, the Netherlands, Estonia and Denmark. In other countries, however, the percentage reaches only 9%, so there are huge differences between EU countries. More digital capabilities from service providers are needed, as are digital skills in the consumer sector, which cannot be created overnight.

A regulator mentioned banks operating in neighbouring countries, which can be done when there is trust in service providers. There is perhaps more of a home bias for digital services, as well as cultural and language affinities. However, crowdfunding initiatives are perhaps promoting cross-border crowdfunding but are likely to remain small-scale.

Harmonisation in Application Programming Interfaces (APIs) should be a priority because they would reduce the cost of entering new markets. EU-wide electronic IDs in the private sector are also missing. While it will be obligatory in the public sector, it will not in the private sector, which requires service providers to integrate national solutions and makes providing services more cumbersome. Obstacles are technical as well as skills.

A public representative noted that the FinTech action plan and crowdfunding regulations on pass-porting will assist. The EU has no common market; there are 28, soon to be 27, realities and business models must adapt to each to work across Europe. Pass-porting will help new and existing businesses.

Answering a question on the cross-border development required for the avoidance of fragmentation of future fintech and digital retail financial services and whether action plans have been drawn up an industry representative noted that the cross-border angle is independent of innovation. It is a general statement. The closer the harmonisation of the rulebook, and for regulation and the interpretation of the EU rulebook in individual countries, the more cross border industry will flourish. A good example is the Undertakings for Collective Investment in Transferable Securities (UCITS) and the Markets in Financial Instruments Directive (MiFID), which is advanced in having a common approach. UCITS successfully provides funds across the EU and beyond. No provider has registered funds in every EU country, because markets still add individual, local flavours and ask for recordkeeping or standards not found in other markets. Closer harmonisation is better for cross-border trade and will help it catch up with larger markets like the US.

Dealing with initial coin offerings (ICOs) will be a national solution. This is not so good as having Europe-wide regulation, but as that takes time, it should start at the national level to provide safety, and then be combined. A Central Bank official agreed. If not, everything is hindered, which should be avoided, or it leaves room for large tech companies. Something must be in place to support customers. A Central Bank official considered passporting to be a good idea. It was proposed a few years ago, but Europe-wide usage was not supported. Approaching cybersecurity at the EU level is key, as a decentralised register is more accessible to those seeking to use it for unintended purposes. A regulator noted that if legislative proposals are not Europe-wide, they will be drafted locally and be more difficult to change.

However, a regulator considered it possible to agree with the FinTech action plan, while disliking its focus on monitoring, assessing, following and encouraging. It is a slow process. The European Securities and Markets Authority (ESMA) drafted the crowdfunding proposal to the Commission a few years ago which was also a slow process. Now crypto-assets are being considered and again, countries are drafting their own domestic legislation, as happened with crowdfunding. Perhaps the EU should be more proactive.

2.2. In the face of multiple possibly competing national initiatives, and powerful international technology providers, ESAs have an important role to play to increase EU negotiation power, build trust in order to enable and develop cross border operations

A regulator advised that the European Supervisory Authorities (ESAs) should play an important role in cross-border services. The more cross-border services there are, the more confidence in the work of the home authorities is needed. If a proper job is not done in the host countries, and if they do not have consumer legislation in place where they could react, the ESAs should have powers to intervene. They should also have a say in the authorisation process to avoid a situation where countries' authorisation processes are too lax because of competition between countries for new business. ESAs should be involved in the authorisation process. It is not problematic for banks in the eurozone because it is an intrusive authorisation process. There are grey areas where newcomers test the limits of how much can be done without a licence, although a licence gives greater credibility. That is an area that should be tackled.

An industry representative noted that examples from day to-day bank life are useful to demonstrate the need for European policies. Banks are fragile in negotiations with cloud-computing companies, which are mainly big US tech players, and struggle to impose the required technical, regulatory and security constraints. A reference framework is needed at the European level, with guidelines developed at the European level. A European scheme rather than national provisions is essential for the cloud and the same can be said about regulatory sandboxes. It is mandatory to ensure a fully level playing field between new entrants and existing actors.

An industry representative considered that investors are not granted the same level of protection through crowdfunding as regular investors. There is no reason for an exemption of provision of investment advice for these investors. More European regulation is needed to protect markets and actors against other actors who should submit to the same rules. Knowledge coming from across the Atlantic, which is no longer European, such as cloud technology, needs an answer at a European level.

2.3. Competitiveness and effective consumer protection require pragmatism and agility and faster regulatory processes, at the EU level

A public representative advised that there is a need to anticipate and try to adapt to technologies which will emerge in six months or one year's time, although it is impossible to regulate something that is not yet there. There are discussions for the future to regulate and create a framework, which is impossible. Last year, there was no discussion in the European Parliament about distributed ledger technology (DLT), which is mostly known as Blockchain relating to cryptocurrencies. However, DLTs are more than just cryptocurrencies. There is now more than one Parliament debate each week about Blockchain and how it will change people's lives.

A public representative advised that a Blockchain report dealt with DLTs to understand them better. Regulators need to understand the business first and try to regulate it. When considering new technologies and actors in the industry, the message was that business plans can only be created for six months, not even for one year, because what will happen in six months or one year from now is unknown. It is a fast-changing and dynamic environment. Regulators can only organise different debates to boost dialogue with the industry, try to be there to understand what is coming next and how to regulate it. However, European legislation cannot be changed. New technologies being invented must be faced. The process in Brussels is slow. It is crucial to anticipate and create rules to give freedom and allow companies to innovate, adapt and create new models that contain everything that is perceived as useful for them, to be more efficient.

A Central Bank official advised that there is agreement that digitalisation is there and should be there, as it will support cross-border activities. Supervisors must square the circle for necessities without regulation. The challenges are speed, personnel and methodology. Speed is especially difficult for supervisors because they tend to be perfectionists. This is not exactly what is needed now. National ministries have organised fintech advisory boards, where fintechs, banks and supervisors discuss these issues together. Yet the official noted that it is difficult to get technology experts on official pay.

An industry representative was concerned about complaints of being behind the US in digital development, followed by proposals to regulate the market to death in the name of consumer protection. A point raised in Sofia, on new cross-border distribution rules, was about empowering the national competent authorities (NCAs) to have 10 business days' pre-approval for marketing material. A robo-advisor does not communicate with clients by mail. Although it is digital and immediate, it is being regulated to 19th century levels. The decision is between moving forward or protecting consumers against anything that happens.

A Central Bank official agreed that Europe must speed up. Regulators must be open and leave some responsibility with the client, which requires work on financial literacy. No one should be excluded from services; however, a backstop for misuse is necessary.

2.4. The operational arrangements and regulatory frameworks of Sandboxes still raise concern

There is an issue of methodology and how to operationalise sandboxes, as discussed by the fintech advisory board. There is the question of whether deciding who is let into the sandboxes is for supervisors or for people who are advanced in discussing business plans. There is an advantage for those who know what a sandbox will look

like. It is possible to get into real life without fulfilling all the banking regulations but only for a limited time. It should be accessible for existing banks; otherwise, they must comply with the regulations and new ones do not.

3. Other issues regarding the regulation and supervision of fintech and digital financial services

3.1. Technological neutrality and level playing field issues

An industry representative considered that actors will still be needed, typically banks, to provide citizens with services everywhere in the EU, whatever their skills, whatever their access to the internet and whatever the complexity of their device. One can imagine a business model of banking services in the future that cover these needs. However, in the very-low-interest-rate environment that has existed for years, profitability in retail banking is a real challenge. And it will be more of a challenge if new actors capture some parts of the value chain without being submitted to the same regulations and supervision as banks. Respecting a level playing field is of the utmost importance.

Supervision is taking a technology-neutral stance. While the industry must assess the technology, a supervisor judges the banking service that is to be supervised according to banking rules, so not declaring one technology as winning over another. The question is whether regulators want to cover it in depth or take a similar neutral approach.

A public representative insisted that there are 700 MEPs, all with different approaches. Some are keener to understand and go more in-depth into the technologies to better understand them; some are not. The debate in the European Parliament is between those who would stay neutral and let the industry do its job and others that believe it must be understood and the future anticipated. New technologies and accelerated digitalisation will not only change the economy and financial system but also politics. Democracy in the digital era will also change.

An industry representative noted the right approach to digital innovation in financial services and cross-border provision is balancing the facilitation of innovation. A rulebook is in place for the provision of financial services, which should be the core standard. At the same time, it is beneficial in such a dynamic environment as the digital space to be in close dialogue with industry participants, to watch and to monitor, and be flexible to adapt where required. It requires the same rules for established players as for innovators.

A regulator advised that financial regulation should be technology-neutral, with a level playing field between incumbents and newcomers. In areas like crowdfunding initiatives, the regime is lighter for entrants. Increasing cross-border digital transactions requires regulation regarding API standardisation to develop platforms and foster open banking, the harmonisation of electronic IDs in the private sector and common practices on standards for innovative consumer-due-diligence solutions on the technical side.

3.2. A principle-based framework should foster innovation

A Central Bank official advised that the opinion is that a transaction-based regulatory approach is better. However, there is a question regarding how supervisors can get a grip on transactions. There are challenges since a supervisor can act only within a framework as decided by the regulator.

A public representative outlined regulators' experience in facing new challenges. The first fintech report came before the European Parliament 18 months ago and prompted a discussion about potential regulations. Strict regulations would kill innovation, which is desirable in Europe, as it needs to go at the same speed as the US or Asia. Innovation and creativity in Europe are essential and must be endorsed. The best approach would be a principle-based framework that encourages innovation, while respecting the basic rules.

3.3. Data access and sharing issues require an answer at the European level

A public representative advised that the fight between banks and new, smaller start-ups, intermediaries and financial services was also discussed. The debate was about whether client data should be on the bank's database or shared with intermediaries. It was a huge debate at that time.

An industry representative advised that there are data working groups outside Europe. Interaction and the exchange of information is often spoken about and is supposed to be in customers' best interests. Banks are fully in line with the current European regulation but a G20 group on data protection urges sharing with others not only direct information from customers but also data that has been processed and to which value has been added by banks. This goes too far, so support and an answer at the European level is needed.

3.4. Conditions for the provision of digital services to retail investors

A regulator advised that cyber risk is important because not all of the risks are understood. Cooperation and a free flow of information between authorities and companies should be supported, along with the test-resilience framework contained in the action plan. Service providers and applications must be reliable and safe for services to flourish and for consumers to be satisfied.

An industry representative concluded that digitalisation and increasing the quality of services provided to customers is desirable, but not at the expense of consumer protection and operational risk. Cyber-resilience goes throughout the value chain. Cyber risk is a threat for digitalisation and so ensuring cyber-resilience is a priority more so in today's climate of multiple cyberattacks. An industry representative agreed.

An industry representative considered data protection and cybersecurity key. End-investors will not adapt it without being assured that data usage is controlled. The end-investor must be in charge of what happens to their data and be in control of their own data points. They need to be assured that there is no risk of data theft. That is a key area to establish the foundations for everything to come.

Disclosure standards and cost transparency for investments are also important. Every investor must be able to easily find out about the risks and costs involved.

There can be no compromise on KYC procedures and suitability requirements, but a digital ID and passport will help in that it does not have to be redone every single time. A product can be purchased, or a provider switched and wherever checks are done, the same standards are applied to everyone.

Algorithms often drive investment decisions. Ensuring that investment professionals and proper standards for robo-advice are in place is key so that retail clients' money is invested in a way that follows common best practice. It is also about order-handling and transactions.

Digital and regulatory disruptions in EU retail payments

1. Areas of technological disruption in European payment systems

1.1. The payment environment across Europe is changing

An industry representative stated that, at least in Scandinavia, many disruptions have already taken place; in Sweden, only 1% of payments are made in cash, and the figures for Denmark are probably similar. Even small businesses that previously faced heavy costs if they received credit card payments are now getting access to cheaper payment systems.

Another industry representative agreed that digital business is already widespread in Nordic countries. However, markets are global, and the real differentiator is being able to give customers different payment options and choices across the globe. In most European countries, the technology exists to develop digital business, but in remote areas of Chile or the Philippines, for example, cash still needs to be used.

A central bank official explained that Europe has quite a varied landscape: some detailed data from 2016 indicates that in some countries more than one third of retail payments, in value terms, were made using cash. Statistics from the Eurosystem level indicate that the amount of banknotes in circulation has been steadily increasing by 7% to 8% per year, in the context of 1% inflation.

An industry representative stated that different European countries take different approaches: in Scandinavian countries, consumers can identify themselves using the EID, but in countries like Spain, it is very difficult to process payments online. Legislation should not create a single model, but rather opportunities for all consumers.

1.2. Is regulation helping or holding back the pace and quality of adjustment?

A central bank official stated that blockchain and crypto-currencies have not yet delivered any real efficiency or safety in the European environment. The first policy action of the Euro Retail Payment Board was to push for the introduction of instant payments, asking banks to be involved in these kinds of schemes. This led the ECB to develop TIPS as a solution for settlement as opposed to clearing and, as part of this, the ECB looked at different forms of technology. However, decentralised technology such as DLT is not yet efficient enough. Conversely, the energy required for instant payment and settlement through TIPS is negligible, and its cost is very low.

PDS2 is a very important framework for modernising the regulatory environment in which payments are taking place today. However, banks still resist providing a harmonised and standardised way of interacting with third-party providers and providing their customers with services, and more needs to be done in this field. It is very important to have a harmonised solution in Europe, so that payments do not take place outside the banking system or via non-European providers.

Another central bank official stated that PSD2 is an example of good regulation, as it introduces the concept of open banking with third-party providers. This increases competition and the diversity of services that can be provided; these services are provided in a regulated manner that gives users confidence in the reliability and trustworthiness of the system. The official commented that generally, introducing regulation inevitably means imposing constraints, and it is important when doing so to not favour one form of technology over another, as well as to avoid imposing excessive regulation or an excessive amount of caution.

Another example of good regulation is the Interchange Fee Regulation (IFR), which imposes a maximum on the interchange fee that can be charged. In the first two years after IFR came into effect, in a large European country interchange fees decreased by almost 40%; the merchant fee decreased by about 20%; and credit card use increased by 7% to 8%. This promotes the use of electronic payment methods and decreases costs for users and the economy as a whole.

A public representative stated that regulators and public policy-makers need to keep up with developments in technology, because technological developments are driven by consumer demand. Consumers demand faster, more efficient and better products, and the private sector responds to this demand, but the public sector is less flexible. For example, it is still a legislative requirement to obtain secure customer authentication for transactions over £30, but public representatives do not believe that this helps consumers; rather, it is a 'tick-box exercise' that makes people in the public sector feel better.

2. Europe is adjusting to benefit from digital disruptions

2.1. TIPS in going live

A central bank official stated that the TIPS project was agreed by the ECB's governing council in June 2017, and will go fully live on 30 November 2018; he emphasised that this represents a very quick development of a central bank project. The pilot phase for TIPS is open: all of the tests have been validated, and all banks can connect through the pilot scheme and make instant payments in less than one second across Europe. One benefit of TIPS is that it is a settlement system that is open to all TARGET2 participants, and as such there is no limit to its reachability. Opening an account will be free.

The official's institution believes that most banks will gradually connect to an instant payment service locally over the course of the next few months or in 2019. It will also be made possible for them to receive money in a TIPS account, to give them full reachability across Europe.

Another central bank official stated that instant payments will be a 'game-changer' in the context of the European retail market, but they will not be surprised or alarmed if these payments do not become common quickly. Northern European markets are much more familiar with these kinds of instruments, but they are not known in some other countries. With the introduction of TIPS, the market has made it clear that it wants one solution, and has even requested that the ECB's solution should be a multi-currency solution. As such, at the end of October, the Danish krone will move onto the ECB's platform, and two central bank currencies will be able to be settled using the TARGET2 services. For the new generation of payment services, including TIPS, which will be introduced in November, the ECB has been asked to be multi-currency, and there is a clear interest in extending the same service to other currencies.

One question raised was whether the growth of instant payments will actually increase the use of electronic payments, as opposed to cash. A central bank official replied that their guess is that instant payments

will create use cases for transactions that are currently settled using cash, such as fuel deliveries in rural areas or transferring small amounts of cash between family members. In countries like England and Denmark, the growth of instant payments has not significantly affected the card payment business, but millennial customers tend to pay using their phones, and will use whatever channel allows them to do so, whether this is SCT Inst or card.

An industry representative stated that fraud is their institution's biggest concern in the area of instant payments; although its fraud rates are very low, it still experiences some fraud.

There are clearly issues with instant payments, which are currently being discussed among the ECB, the EPC and banks in the advisory group. However, the central bank official noted that cash is also susceptible to fraud: it can be stolen, and it is very difficult to recover or trace if it is taken.

2.2. Incumbents and disruptors are working together for the benefit of customers

An industry representative noted that bankers are generally not technical experts, but they are open to new forms of technology and technological development. Symmetrically, most fintech companies employ very creative people with good ideas about how to develop new systems, but these people are generally not skilled in adhering to compliance or regulatory requirements, such as those relating to the protection of customer data.

Another industry representative stated that their company, working with some technology companies, has been testing the ability of artificial intelligence to speed up its Know Your Customer evaluation. If a transaction is flagged, their company has been able to use artificial intelligence and technology to make much information from public sources around the world available to the investigator, saving days or weeks of investigation time regarding that particular transaction, person, or company. Speeding up and perfecting Know Your Customer activities will take time, but should be achievable.

2.3. Further meaningful regulatory harmonisation in the EU is necessary

A public representative stated that the role of policy providers is to 'not get in the way'. Regulators and public policy-makers often create problems through poor legislation: in the area of data protection, for instance, there is a difference between the wording in PSD2 and in GDPR. In PSD2, there is a requirement for explicit consent, but in GDPR, the word used is 'consent', and regulators and policy-makers have not indicated which takes priority. As a breach of GDPR can result in massive fines, lawyers and CEOs might choose to err on the side of caution, and this caution stifles innovation. Big business wants maximum harmonisation because it is more efficient for them, but in the public representative's experience, legislation at a European level tends to be fairly heavy-handed. Rather, they would advocate national competent authorities having discretion.

An industry representative responded that maximum harmonisation does not mean creating regulation that fintechs or local players cannot manage to abide by; rather, it means creating an environment in which the same rules apply across Europe. And these rules should be accessible for both incumbents and disruptors.

Another industry representative stated that there should be a level playing field for incumbents and newcomers. Most long-standing companies respond to regulations and inconsistent standards by creating very large compliance departments that adopt the most restrictive standard imposed by any regulation, even if another, less restrictive regulation applies. This is easy for incumbents who can invest a lot of money, but is more complicated for fintechs and start-ups, and this holds back innovation. Regulators play a very important role in facilitating dialogue between all stakeholders, including incumbents and fintechs; the Euro Retail Payments Board is a good example of how all stakeholders can be brought around a single table to agree rules and build trust.

Regulators should develop rules that are flexible enough to keep pace with innovation, even though this might present some short-term challenges to incumbents. The more widespread electronic payments become, and the more technology enables merchants to take payments electronically, the better this will be for the industry overall. Incumbents can act as critical partners to fintechs, helping them to understand regulations and acting as a 'backbone'. It might also be beneficial for these innovative companies to begin in a sandbox environment, with regulators and incumbents working with these companies to determine which regulation is right for them without giving them a 'complete pass'.

Another central bank official stated that they approve of innovation; the European Central Bank and Eurosystem are working to support it as much as possible. The ECB has developed a fintech lab to help it understand the technology involved, and has undertaken projects alongside other central banks, including some analysis of how this technology can be used for RTGS payments via the 'Stella Project' that it has carried out with the Bank of Japan and published on its website. The ECB is also considering creating a page on its website to host innovation events at which visions and ideas can be shared; it has no current plans to introduce a sandbox for innovators, but would consider doing so if it believed that this would promote innovation.

An industry representative stated that their company has a strong digital division within its business, growing at a rate of more than 20% year on year, and is investing heavily in its compliance programme. However, there are still some gaps in the legislation; GDPR conflicts with PSD2 in some areas, and their organisation sometimes struggles to exchange information with law enforcement agencies, because sharing third-party information creates conflicts. There also exist conflicts within individual pieces of legislation, such as the Fourth Money Laundering Directive; this industry representative's colleagues find it hard to understand that although the Directive applies across Europe, its implementation is focused on countries' individual needs.

A central bank official agreed that the implementation of directives differing between countries is becoming an even more critical issue as instant payments are developing. These slight differences are difficult to deal with in situations where instant payments occur across different European countries and need to be settled in a matter of seconds. It is a general challenge for the European Union to improve how its directives are implemented on a national level.

2.4. 'Sandbox' pros and cons

An industry representative stated that benefits might arise from creating sandboxes or other tools that would allow fintechs to develop new systems, but it is also important to maintain high standards in order to prevent money laundering and stringent Know Your Customer requirements. Striking the right balance is vital; the banking industry is skilled at complying with these rules, and technology experts within fintechs are skilled at

developing more efficient systems, so these two skillsets need to be brought together. Although sandboxes can be useful, there needs to be a level playing field so that no market participants can circumvent their anti-money laundering requirements.

The public representative observed that regulators need to trust the industry and come up with better solutions. The concept of sandboxes allows for this kind of experimentation, but there are different types of sandboxes in different European countries.

Another public representative added that they are not sure that a huge European sandbox would work, because Europe does not directly regulate many industries. It might be possible to have a sandbox for credit rating agencies, but this representative does not believe that much activity would take place in it. He or she noted that the FCA has a sandbox in London for more innovative companies, and stated that as the United Kingdom's legal system is based on the common law, where companies can do what they like so long as they do not break any regulations, sandboxes are more effective in the UK than in more 'dirigiste' regimes such as France.

Data privacy: implications and challenges

1. Assessing the GDPR a few months after enforcement

1.1. Data Definitions

Data is omnipresent and cuts across all sorts of sectors and companies. Every citizen's life is affected by data, in one way or another. The panel first looked at the positives and negatives of a legal definition of data privacy in the ground breaking new GDPR. A regulator stated that GDPR gives control over personal data by creating a balance between a human's fundamental right to protect their data and improving legal certainty for companies doing business across Europe, but an industry representative believed the regulation is missing a piece of the puzzle around guidance. Data itself is such an intangible asset to define, and there are complications around it that have not been addressed. GDPR comprises legislation that is new and ground breaking in many ways, but the hardest part of the problem, is that there is a lack of clarity around the application of key concepts.

1.2. Opportunities and challenges for the incumbents – Banks, insurers, FANGs[1] and BATs[1]

An industry representative adopted a broader scope by noting how banks have always been custodians of personal data. Trust is their foundation. Many Europeans grew up with a small local bank, then the banks grew and scaled up. They replaced their branches with digital platforms and lost a sense of personalisation. Another change is coming in the competitive landscape where banks will have to face new competition from companies utilising data better and providing more relevant services. Such changes are being driven by technology and improvements in data analytics. Big tech firms are coming that specialise in digging out the gold from data and doing so in a super user friendly way. The incumbents have to compete not just against the FANGs, but also the BATs.

Into that mix is a third driver, which is regulations, but PSD2 as much as GDPR. The European Payment Services Directive pries open accounts and payment systems to third parties and, because their business models are built on the data they collect, they can offer for free services that the banks currently charge for. The banks must utilise their customers' data better and modernise their core interfaces to offer a personalised service to customers who are used to Netflix knowing more about their habits than they do.

An industry representative described GDPR as an IT problem focused on innovation. It was designed for Google, Facebook and the other big tech companies, which have a great deal of this data and have benefited from being able to extract the nuances from it. While a new entrant trying to enter the consumer business or financial services is not able to gain easily the same understanding of data, an undoubted positive from GDPR is the huge opportunities it brings to the European technology market.

In June, California produced some new laws that are very similar to what Europe is trying to do, but Silicon Valley does nothing for free. However, the way that technology companies learn to deal with data privacy gives them a competitive advantage compared to the rest of the market. In aggregate, old economy actors are struggling with this legislation when new entrants and the FANGs have a technology estate that has developed flexibly, so it is easier for them to conform. This should provide motivation for old-economy companies to renew and improve the way they manage data within their systems.

A participant emphasised how seriously the insurance industry takes data protection and digital responsibility, seeing them as points of differentiation. It is even looking beyond legal requirements and asking if there should be an ethical code on top. GDPR has raised the bar for everyone and means other companies can compete against financial services, but it should also be seen an opportunity for financial services. Companies can show their customers what they are doing and thus gain their trust. The man on the street wants to see he is being treated fairly and know his data is being used appropriately. This ultimately it comes down to transparency and fairness.

Insurance companies have been processing data for hundreds of years. The basis of their operations is that, to assess, price and manage risk, data must be processed. Over time, the amount of data has increased and ways to analyse it have become more sophisticated. This speaker therefore cautioned against the suggestion that insurers are late to the table, late in harnessing data; it has always been an integral part of their business model.

Yet, financial services more generally are behind other areas in the way they manage data within their organisations. Coping with GDPR is really about revamping legacy systems to meet these new requirements. There is still a huge opportunity for the financial industry, because GDPR forces them to revamp legacy technology and systems. The hope is that financial services will embrace this opportunity and put responsibilities in the right places, although this industry speaker believed more guidance is needed for them to succeed.

1.3. Has the GDPR levelled the playing field? Are there any unforeseen consequences?

Some statistics from the UK about access requests show the public has not responded to the Freedom of Information Act in the way many predicted, perhaps because there is no payoff from GDPR for the end consumer. It grants them protection, but an industry representative questioned whether it has been implemented in the right way.

An official saw GDPR as a remarkable opportunity for the EU market, but a number of challenges must be tackled for it to realise its full potential. It offers legal security and user protection across the EU that goes beyond PSD2 coverage. A second opportunity comes from integrity, which could play a differentiating role, as consumer confidence is key in the new data economy, particularly so in the financial sector, which deals with private data about savings and earnings. A third opportunity is for new entrants, as data portability is a major asset.

Important questions about cost exist. This regulation, in its crystallisation of fines and associated penalties, has made people realise that data is not the new oil; it can be both a liability and an asset. There is a cost to compliance, at above €100 million for the average global corporate. Around 25% of this is being invested in trying to solve data problems. Most established old economy companies have parts missing from their technology estate, which makes it difficult for them to meet the GDPR standard. Finding other ways to do this is a big issue for them. There is also an ongoing conflict around records management and how long to retain data for.

An industry representative described the GDPR guidelines as too broad for what is actually happening in the trenches. Firms such as Facebook and Google have had years to learn how to price data, which is how they are able to offer so many services for free. Financial services firms are late in joining that conversation. With this liability looming over them, they may be too late.

Another industry speaker stated that there are always unforeseen consequences to implementing new legislation. If the barrier to entry is raised by putting a significant incremental cost on the marketplace, the smaller players and competition will fall away and the bigger players will consolidate into a smaller group. This reinforces the fear of 'too big to fail', which applies today beyond financial services to tech companies too. Anyone who has tried to negotiate with Google or Amazon knows that the final contracts always favour the larger entity. The industry speaker hoped GDPR will not cause the industry to deal only with the 'too big to fail' players, but still defend innovative SMEs. Increased guidance should help in this respect. It will thus be a huge opportunity for them too.

One industry representative believed there is benefit from guidance containing more examples of how aspects of GDPR apply to SMEs and tech companies in general, and another industry participant emphasised that, in the short term, guidance from the European Data Protection Board (EDPB) will be useful to avoid a fragmented landscape.

Such dialogues with the regulator need to happen soon, because fragmentation issues are starting to emerge and need to be stopped before they run out of control. Another industry representative thought complying with GDPR is manageable, though not cheap. He has received good guidance from the authorities and is able to discern the differences that exist between the regulations.

2. Regulatory harmonisation and implementation

2.1. The European Data Protection Board, the supervisory authorities and dialogue between them

The EDPB is not new to working together, as the successor to the Article 29 Working Party. It is an independent EU body with decision making and legal powers, capable of adopting binding decisions that can be challenged before the European Court of Justice. It also issues opinions and writes letters. Its website has been in operation since 25 May, alongside Twitter and LinkedIn pages. There are explanations of the one stop shop mechanism and meeting agendas are posted on these sites. The EDPB's power goes beyond that of the former working party; together with the ESAs it aims to ensure a harmonised application of GDPR throughout the EU, as well as consistent protection for all EU data subjects. Allocated with new tasks and assigned new powers, a regulator believed the EDPB could count on the strong expertise of its robust membership network of connected supervisory authorities.

The EDPB has to ensure a high and consistent level of data protection for individuals, wherever they are based within the EU. Their one stop shop mechanism makes it easier for individuals to enforce their rights and for companies to comply. A regulator recognised that the strength of the EDPB is in its capacity to speak with one voice, while at the same time taking the independence of each ESA into account. Hence it strengthens cooperation between individual authorities.

An official described some of the challenges ahead, specifically financial stability and access to data for supervisors and regulators. The Commission identified this topic in its FinTech action plan, but some pragmatic implementable solutions are needed to enhance the security integrity of the European financial sector. An industry representative perceived another challenge, as much for heavily regulated banks as small fintech and regtech startups, in the amount of dialogue they are required to have with the regulators.

A regulator saw GDPR as an evolution, not a revolution. Companies on both sides of the Atlantic and of all sizes are well prepared for it, and the EDPB includes guidance as part of its obligations. The trust of customers, of insurance companies, banks or others from across the financial sector, is as big an issue as capital. This regulator stated that data protection authorities are not fining machines; they look for consent and talk to companies as well as complainants.

Dialogue with the United States is important, and the EDPB has a permanent dialogue with different companies and the government sector. Everyone will have to deal with the ethical use of personal data, because every CEO is also an individual who wants their personal data to be protected.

2.2. Interpretation of the regulation by national competent authorities

A public representative explained how data enforcement is national, but regulation exists under European law. This should remove any national discretion, but the harmonisation of GDPR by national competent authorities is a significant question. In France, President Macron has launched an exercise on regulation in data affairs. An industry participant saw that the aspiration of the regulation is to apply EU wide and not require national implementation, but the reality is GDPR contains flexibility clauses and a margin for manoeuvre, which pose a significant challenge. Not only are some companies operating across Member States, but beyond the EU as well.

One specific example from insurance concerns processing sensitive personal information. An insurer needs to be able to process health data at the time of underwriting and when assessing a claim, but there is a debate about whether consent is an appropriate legal basis. GDPR is strict in that any consent needs to be freely given and cannot be conditional upon fulfilment of a contract. Certain Member States, but not all, have asked for a clear derogation and will legislate to allow insurance companies to process health data in order to fulfil their contracts. The situation between states is therefore fragmented. Some of the specific advice on consent goes beyond the already high hurdle of the regulation. Separately, from a reinsurance perspective, it is neither practical nor realistic

for insurers to tell their clients about every single third party to which they may transfer information. It is also not within the spirit of the GDPR's notion of transparency and of information to consumers being concise and accessible. A balance is needed between giving people enough information to make informed decisions and supplying too much to make them better informed.

A regulator explained how in general the EDPB will act through consensus, but GDPR foresees a dispute resolution mechanism. Article 70 listed numerous tasks to help companies and national supervisory authorities prepare for this regulation. Fining is a new issue for many and some authorities have not had the opportunity to deal with complaints in the way now prescribed. There has been a huge preparatory effort, this regulator thought.

2.3. Global consistency and regulations from other jurisdictions

A negative likely outcome raised by an industry speaker is that, if there is no global consensus on the implementation of a regulation, its ultimate structure will be fragmented. These inconsistencies lead to a high degree of cost and the potential for arbitrage. GDPR is European, but there is no consistent US equivalent yet and other geographies are developing or have developed similar regulations. Knee jerk reactions might send values suddenly up or down. This speaker cited the Cambridge Analytica scandal earlier this year, and the high level of political interest it received.

A Data Protection Directive was issued in 1995. Data protection issues have been around at least 20 years, but the US is getting more serious about it now. A white paper was recently drafted by Senator Warner entitled The Potential Policy Proposals for Regulation of Social Media and Technology Firms. This includes a US version of GDPR, which any company described as a 'tech firm' is expected to follow. It lists decisions that can be made by a bot versus a human, with the intention to isolate corporate behavioural analysis.

Data privacy is an issue that not only Europe is grappling with. It is a theme for regulators around the world, and there is now a risk of sectoral overlay. An industry speaker warned that if, in addition to GDPR, ESAs come up with their own guidelines on how companies use big data, it may un level the playing field that GDPR has sought to create. People can be confused by conflicting legislation, such as MiFID asking companies to collect all their clients' data and GDPR telling them to give it up. An official believed a dialogue between data regulators and financial regulators is needed to resolve this conflict.

When asking for a great deal of data there is a risk that competing issues will arise, which is why functional regulators are more pragmatic about what they ask for. Any potential MiFID III will have to take GDPR into account. If done properly, it will help improve the data requirements of financial institutions. The G20 commitment to trade repositories means all transactions on derivatives have to be reported, which entails a huge amount of data. This raises questions of storage and the need to develop big data instruments. An official hoped GDPR will prove a valuable tool to help financial institutions better use the data they have. Financial regulators reinforced the protection of financial entities in reaction to the crisis 10 years ago; data regulators may now need to improve their supervision of data protection activities.

An official saw how GDPR could enhance the service for users and that that is part of its political mandate, but care must be taken around financial stability and 'too big to fail', married to aspects of digital conduct. An industry representative summarised the issue as one of guidance and alignment in reinforcing it. It requires dialogue on a global basis, particularly with the US. Equivalence decisions for other jurisdictions was tabled as a topic for a future Eurofi panel.

2.4. Can we outsource GDPR liability?

An industry speaker raised a problem with the liability issue. There are no precedents for fines in this area and whenever there is potential for a huge liability people try to outsource that liability. In the financial industry, software buyers are trying to outsource their uncapped liability to the tech providers. This puts tech providers in a very difficult position as software buyers will often insist that these terms are non-negotiable and that they must be accepted by all suppliers. Surely this is not the reason GDPR was made, yet this is how contracts are being formed. Guidance around relationships between vendors and suppliers would assist here. It would give tech providers an official standpoint to refer to when faced with these situations in contract negotiations. It is important to understand that one sided contracts could stifle innovation and ultimately drive the whole financial services industry in the direction of only interacting with companies that are too big to fail, which has created problems in the past.

Another industry speaker saw a related situation in that, for reasons of administrative law, insuring fines is possible in certain Member States. The legal cost associated with any GDPR action is insurable and elements of overall compliance with the GDPR should also be insurable. The fines themselves are a different situation, but the landscape varies across Member States.

3. Trust, transparency and digital conduct

An industry speaker stated that the big advantage for the banks is that people trust them far more than they do social media networks or big tech firms. This is frequently measured in surveys. It gives the banks a buffer and is something on which they need to capitalise. Speaking pessimistically, some feel that GDPR only brings the other up to this standard and improves trust in the competition. This could cut both ways if GDPR means consumers get cleverer at valuing their own data. It could give back a meaningful sense of control over ways of utilising data that are useful to consumers, with which the banks may be able to compete.

Regulators in financial services have often debated whether data or technology neutral products should be offered to people. If there is a demand for such products, they will exist, but companies cannot be forced to offer them. The risks associated with them will differ according to the products.

It is in the overlay of digital conduct and the responsibilities of organisations that the trust question will be operationalised. The industry is seeing an accelerating growth of concern about privacy, protection and human rights issues, so the regulators must engage in this dialogue soon. The US is the undisputed data powerhouse of the world and also where the FANGs are based, so strong alignment is needed on issues around digital conduct.

An industry participant questioned whether companies need to consider the ethical use of data as part of their sustainability frameworks, and if they need to talk to consumers to understand their expectations. One cannot assume that all consumers across the generations have the same attitude to data.

1. FANG: Facebook, Amazon, Netflix and Google – BAT: Baidu, Alibaba and Tencent.

Cyber-resilience: priorities at global and EU levels

1. Key components of an effective cyber-resilience approach

An official stated that there are three main phases on the 'road to cyber resilience'. First is problem identification and the recognition of the importance of the issue by the private sector. This issue cannot be only tackled by IT departments; it must be addressed regularly at CEO level. The second phase involves thinking about the solutions and designing the tools which will increase the cyber resilience of different entities within the financial ecosystem: i.e. identifying best practices, defining guidance and standards, developing and structuring information and cyber intelligence-sharing mechanisms between different stakeholders. The final phase is the implementation of these tools. The official considered that most parts of the financial system have completed the first phase and are designing solutions to improve cyber-resilience. Some are already transitioning to the implementation phase.

A regulator believed that an appropriate cyber resilience vision is for firms to be threat aware and to be able to defend themselves effectively and respond proportionately to cyber-attacks. Firms must assume that disruption will happen from cyber-attacks and ensure they are able to recover and respond effectively. This is not simply thinking about reinstating a system, but also about how critical services can continue to be offered. The interconnected nature of the financial sector globally also necessitates the building of a cyber-resilience capability both between the industry and public authorities, and across jurisdictions. Cyber-resilience is not a tick-box exercise. In addition, as said previously, it must be driven top-down from Board or CEO level and must be part of the overall business strategy, because these risks need to be addressed at all levels: people, processes, and technology. In terms of people, market participants must ensure there is a cyber resilience secure culture; in terms of processes, market participants must ensure they can recover and respond; and in terms of technology, they must keep step with the latest developments.

An industry representative emphasised the importance of considering cyber resilience from the point of view of threat. First, the threat is undoubtedly increasing in intensity, frequency and sophistication, and it will continue to increase. Defensive strategies must focus on detection, response and anticipation (and also on related information-sharing and collaboration), and not only on prevention. Secondly, the threat is truly global, but the regulatory ecosystem is fragmented across jurisdictions. Further effort is required to harmonise the regulatory environment, with a principle and risk based approach likely to facilitate agility and reward collaboration. A stronger focus is also needed on practical approaches such as the TIBER-EU Framework[1], rather than more "paper based" ones. Thirdly, cyber attackers will always look for the weakest link or entry point to achieve their goals. From that perspective, it is important that the rules, requirements and supervision applied to organisations are based on their activity, rather than their size or status and that they are implemented across the whole value chain in a context where more new players will be entering the sector notably following the implementation of Payment Services Directive (PSD2). Some new players may indeed hold millions of records containing highly sensitive information, which previously were held in more secure environments. Following a comment that PSD2, if implemented as planned with an authorisation of access to data should help to secure a process that is currently not secure, the industry speaker also underlined that the firms that access data should be regulated and supervised with the same level of requirements as the firms owning the data for the process to be sufficiently safe.

2. Ongoing approaches to cyber resilience at the global and EU levels

2.1. Cyber-resilience initiatives at the global level

An official agreed with the previous speaker that cyber-attacks have no country border and therefore require a global approach but considered that global initiatives are usually more successful when they build on strong national or regional pillars. CPMI has published two important reports on cyber over the last couple of years. First, in 2016 the Guidance on cyber resilience for Financial Market Infrastructures (FMIs) with IOSCO. Secondly, earlier in 2018 a strategy to address the risk of fraud in wholesale payments stemming from so called endpoints[2], which is essentially the CPMI's collective response to the Bangladesh central bank incident in 2016. This incident was a pivotal moment because it exposed vulnerabilities in what the industry otherwise thought was a highly secure structure, and it was a call to further action for all market participants. These two reports map out a two pronged global strategy for managing cyber risk in payment clearing and settlement arrangements. The first one focuses on protecting the core of the financial industry, the FMIs themselves, whereas the second one is about protecting the periphery. The underlying theme of these two reports is that cyber-risks are evolving, which means that everybody must move and learn together with close engagement from the authorities and the industry.

A regulator stressed that cybersecurity is also a responsibility shared at the international level by industry participants, authorities, and central banks. CPMI IOSCO in particular has held workshops with industry participants and authorities from across the world to share information about how firms are applying these principles in FMIs and how the industry can progress further. There is also the G7 Cyber Expert Group, which works with the industry to look specifically at third party vulnerabilities, third party resilience and cross border exercises. Similarly, the Financial Stability Board is preparing a lexicon and undertaking industry workshops.

2.2. The Eurosystem cyber-resilience strategy

An official outlined the Eurosystem's three pillar strategy: reinforcing the resilience of FMIs, evaluating financial sector resilience and improving industry engagement and dialogue with the authorities. This cyber-resilience strategy has been approved by the Governing Council of the ECB, indicating the strength of its political backing and is being developed in Member States in line with the Eurosystem's three pillars. The immediate priority is to move from designing tools to real implementation by applying the guidance and tests defined and putting relevant groups and information sharing networks to work.

The first pillar is FMI readiness and ensuring the cyber-maturity of individual FMIs. This is an area where a substantial amount of work has been done recently, especially for systemically important payment systems such as TARGET2 and devising tools to measure their cyber-maturity. Two important pieces of work have been undertaken in this perspective within the Eurosystem: TIBER-EU mentioned previously and the Cyber Resilience Oversight Expectations (CROE). The objective of CROE,

which is under consultation, is to make actionable the global high-level standards developed by CPMI and IOSCO by providing practical guidance on implementation. It covers the entire cycle of cyber resilience, including governance, identification, protection, detection, response and recovery. Regarding the second pillar, financial sector resilience, the official suggested that the industry must look beyond FMIs and try to map and understand the interconnections between the different stakeholders in the financial system. Overseers are also undertaking business continuity exercises to understand the entirety of the ecosystem. In terms of strategic dialogue, the third pillar, the Euro Cyber Resilience Board (ECRB) has been created, aiming to facilitate high level strategic dialogue on cyber resilience. The ECRB includes the ECB, several Eurosystem central banks, the main FMIs, other European regulators and interested public bodies. Another important area to consider within the Eurosystem is the operation of FMIs and platforms such as TARGET2 and TARGET2 Securities (T2S) which are currently being enhanced and technically integrated. Investments are also being made in this context to improve the cyber-resilience of these platforms.

2.3. Cooperation between the industry and the authorities in defining requirements

An industry representative concurred that the Bangladesh Bank heist was a wake up call for the industry. SWIFT for example decided to build a Customer Security Programme (CSP) aiming to improve its community's cyber readiness. The CSP involves amongst other things a security controls framework, which is comprised of 27 controls, which all relate to prevention, detection, response and sharing, and all aim to improve endpoint security, much as the CPMI-IOSCO guidelines. Coordination between the industry and regulators in defining requirements and making sure they are achievable is essential, because different requirements will increase complexity and the burden for financial industry participants. It is in everybody's interests to make it as easy and fast as possible to implement these requirements and to develop them over time, because they will need to evolve.

A regulator agreed that regulators should seek to cooperate with industry participants. Many of the international and national standards are broadly consistent, but it is important for these rules to remain principle based and risk based and not be excessively prescriptive. Otherwise this will create opportunities for cyber-criminals.

An official stressed that the SWIFT Customer Security Programme and the CPMI strategy are complementary, noting however that there are other providers in the market e.g. in terms of messaging services and that it is important to cover all bases. Additionally, the 'industry' should include central banks in their role as operators. Another official confirmed that Eurosystem institutions are applying endpoint security rules to their own system, as operators.

An industry representative summarized that there is a common need for a joint space where industry players, regulators and supervisory authorities can develop collaboration, in order to harmonise rules and guidelines and remove barriers.

3. The importance of information sharing and education

3.1. Information sharing objectives and challenges

An industry representative emphasized that information sharing between regulators and the industry is very important. When cyber attacks occur, banks already share a great deal of information with SWIFT, which then reviews what has happened and publishes back to the community the indicators of compromise anonymously in order to assist banks and other players in anticipating future attacks. It would be very good if regulators could strongly support information sharing within the whole industry, beyond the SWIFT community. There are however barriers that limit information-sharing related to liability exposure, competitive information, privacy and data issues and questions around whether firms can share data on suspected cyber fraud or only on confirmed cases. Regulators and supervisors can help to address these issues and enhance the information sharing process, which is about trust and confidence.

A regulator agreed with the importance of a broad sharing of knowledge and threat information between industry members and the authorities. In the UK for example cyber coordination groups are designed to enhance information sharing between different sectors. Initially there was some information sharing taking place regarding critical national infrastructures but much less in other regulated sectors, and hence the FCA established these groups. The regulator agreed that information sharing is based on trust and that there is an issue here around what information is shared and between whom. Many firms express a desire to share information but then decide not to when prototype platforms are developed. This has been apparent in some of the international committees.

An official noted that cyber-resilience specialists express frustration at the fact that information-sharing networks often do not work at their full capacity because people hesitate to share information when a threat has affected institutions. Public bodies have a role in ensuring this information is properly anonymised and shared. This will be a very slow process, however, since it is based on trust. The incentives to cooperate will appear gradually as entities receive feedback that is actionable and useful in facing threats. One important aspect of this is to focus on sharing small amounts of information very soon after an incident has taken place, which is more useful than sharing large amounts of information some time after an incident. Another issue is that there are probably too many different groups working on cyber issues and information-sharing networks, which can be explained by the fact that the sector is a very complex puzzle. The official felt that these groups could be streamlined or harmonised somewhat and that existing groups should be made to work together more.

Another official emphasized some challenges associated with the management of information-sharing groups. Many people want to join these groups because they are a means of circulating information. The industry has several different fora. There is the ECRB also, which is not an industry wide body. It is clear that as many market participants as possible should be involved, but as soon as a circle is enlarged and expands beyond a country, it is difficult to maintain trust. The official noted some further challenges associated with information-sharing, which were observed during a cyber-resilience test conducted recently by the central bank community with the key FMIs in Europe. This exercise involved a key payment system, large retail institutions, CCPs, CSDs and central banks (as operators and overseers). One of the key findings from this was that the sharing of information is challenging, even when participants know each other well and believe in collaboration. A first need is to increase the speed at which information about threats can be shared. This requires harmonising the type of technical information

that is being shared and possibly also revisiting the MOU (Memorandum of Understanding) arrangements that exist across authorities and institutions in order to better organise information-sharing. Secondly, these exercises demonstrated that information sharing is also needed after cyber events. When a problem has been detected and resolved, it is necessary to communicate actively across different ecosystems to ensure that firms restart in a trusted, safe and coordinated manner.

An industry representative stressed that collaboration is growing, country by country, and to a certain extent across countries but there is perhaps space for more EU wide and global collaboration. The barriers to cross border collaboration should be eliminated because it is sometimes not possible to share vital information due to privacy or confidentiality rules. These rules must be weighed against the risks they create.

3.2. Education and developing "cyber talent"

An industry representative felt that regulators and market participants could collaborate more on education and building awareness about cyber-risk in all parts of the financial sector. Many market participants have internal training programmes which help to create awareness and vigilance and increase employee involvement. However, regulators should ensure that such programmes are expanded across the whole financial sector and are not limited to participants in the financial industry. The public also needs to become more aware of these issues. Regulators can play a role in supporting central banks, banking associations and other institutions in educating the public about the dangers of cyber attacks.

Another issue is the availability of talent in the field of cyber-resilience. Having the appropriate experts is difficult for industry players and possibly even more difficult for the public authorities. The industry and governments could work together to share the existing pool of talent on specific tasks and educate new specialists, an industry representative suggested. There must be a step change in this area because the industry needs to move faster, and ideally as fast as the "bad guys". This requires the creation of more knowledge and talent in particular.

A regulator agreed that there is "a war for talent" in the field of cyber resilience. It is very positive that in some areas there are new professional bodies which are training people to enhance their expertise in the area. In terms of education of the wider public, including customers and industry players, all market participants have a role to play. In the UK, there is the National Cyber Security Centre and the industry plays a huge role in communicating with their customers. There are adverts on the television about how consumers could be defrauded by cyber attacks for example.

4. The systemic dimension of cyber-resilience

Responding to a question from the audience about the risk of a broader attack against the whole of the financial sector (rather than individual entities) and of a total loss of data integrity, an industry representative underlined that regulators are considering worst case scenarios and assessing how firms will be able to respond to them and recover. Regulators are looking at issues that affect financial stability, financial resilience and also broader impacts across the economy. The speaker however felt that not every part of the financial sector or of a sub-set of it (e.g. the SWIFT community) would be attacked at the same time. What is important is considering where the data may be safe at the moment of an attack in a given network, how the data can be recovered from those entities and how participants can be sure that it is reliable. If a worst case scenario occurs, participants will want to know whom they can trust and where they can get the data they rely on to continue their business. In this perspective it is necessary to perform tests to ensure that networks can recover in a very short period of time, because in the end the objective is to restart the business as soon as possible.

An official highlighted that two of three pillars of the Eurosystem strategy focus on the ecosystem as a whole and not merely on individual entities. It is essential to integrate this picture of the whole ecosystem and the interconnectedness between the different parts into any cyber-resilience analysis.

Another industry representative stressed that broad worst case scenarios are always considered with regard to cyber resilience. These include fraud but also the disruption and destruction of systems, along with integrity issues and require a combination of approaches related to cyber, anti money laundering, fraud and many other disciplines. This convergence of issues must be considered and be looked at in a sufficiently holistic way.

Conclusion

The Chair concluded that the industry as a whole must perform a cultural paradigm shift as an ecosystem, moving from a defensive strategy to one that is much more about the capacity to recover after an incident. This means thinking about cyber resilience after an incident has happened and not only before; it also means thinking dynamically and not statically. The financial industry will have to constantly regenerate its system. This problem is about ecosystem protection, not merely protecting critical service providers.

1. The objective of the TIBER-EU Framework (Threat Intelligence based Ethical Red Teaming) is to stage simulated cyber-attacks as closely as possible to the tactics, techniques and procedures of real life attackers. The TIBER-EU Framework relies on external teams of ethical hackers or 'red teams' who subject a financial market infrastructure to an attack based on detailed intelligence information gathered beforehand. Importantly, this takes place without the prior knowledge of most of the entity's staff, who do not know that a test is taking place.

2. An endpoint in the wholesale payment ecosystem is defined to be a point in place and time at which payment instruction information is exchanged between two parties in the ecosystem, such as between a payment system and a messaging network, between a messaging network and a participant in the network, or between a payment system and a participant in the system (BIS).


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SPEECHES

Full transcript

Hartwig Löger

Federal Minister of Finance, Austria

Dear Ministers, State Secretaries and honoured guests, it is a great pleasure to have the chance to join this wonderful dinner in the famous event of the Eurofi forum. I know it is not easy after a very long day of discussions in panels and presentations about the main topics of finance markets all over the world, especially in the focus of Europe, to also hear a speech at a very late time when we look at our watches, so I have prepared short speeches and long parties; but I heard from Didier that you will start tomorrow morning at 7.45, so on my right side I have the long speech and on my left side I have the short version. It now depends on you. If you raise your left hand it will mean a vote for the short version. If you raise your right hand it will be a vote for the long version. Please vote now.

Okay, it is clear I go to my left. In this forum what you could not see – and what only I could see from here – is that some of you raised both hands. I know you, and I will invite you after the short speech to come with me outside and hear the long version.

First of all, also from my side, a very warm welcome. We are very proud to have the chance to host Eurofi. I have heard we have more than 800 members in this forum, and I have heard that is a record. I hope this is also in combination for an invitation to Vienna, because, as you could hopefully see, Vienna is a wonderful city, and a current statement was published that at the moment Vienna is the most liveable city in the world. You made the right decision to come here and we hope you will take a lot back with you.

To perhaps build a bridge to Eurofi and some aspects that I will try to mention this evening, I want to take a sentence from Gustav Mahler. Perhaps not all of you know him; he was a famous composer and conductor. On one occasion Gustav Mahler talked about Vienna; he said when the world comes to an end he will try to come to Vienna, because Vienna is the city where everything happens 50 years later. Gustav Mahler was an Austrian, so it was a clear decision.

I think this is the framework to declare the background of what you have discussed over the last two days. I think it is not the right decision, because at the moment we do not have the time to step back and try to hold the current situation for 50 years. It will not work, because we have to take a look at the future. We have to go on, and we have to develop. We have to develop business, we have to develop the finance market, and we have to develop the European Union. I think that is the background which is the most important for the talks. Yesterday I also had the chance to join a panel with David in a discussion regarding how we can go on in long-term investments, and also how to foster our growth on the European level to have a mid-term and long-term sustainable situation. The current situation we have now is quite high, and I hope every one of you is feeling it. We have a high level of growth, Austria being slightly higher than the European level, but that is not so important.

The most important thing is that right now we have to focus. It was also mentioned in the World Bank meeting that took place in Washington in April: when the sun is shining and growth is coming up – as it is now – it is the right time to repair the roofs and not wait for the rain to come back tomorrow or the day after tomorrow. This is also the most important effect: this Eurofi programme very strongly focused on growth and Economic and Monetary Union in a European focus. We also have to realise that there are some aspects that we are also discussing in ECOFIN regarding regulatory frameworks. We are also out of bilateral talks I had today, besides Eurofi. We always have to keep in mind that we are also in a global competition, and of course when we talk about regulatory issues and topics we try to build the basis for customer protection. We want to be safe in any form, whether it is banking, financing or insurance.

Overall, we also have to keep in mind that there is a need for improvement. I think we must also keep in touch with our colleagues in Brussels so that we really develop a framework which is safe on one side, which is unifying this European Union to a common Europe to be ready for the global competition on one side, but also ready – and this was also remarked by the Eurofi forum – for the technical competition that we are not waiting for. We have already been in that for years, and some of us are feeling it more. Some of us will potentially feel it later on, and those who will not feel it may not survive in that form. A part from that, I think it is very important to focus on these new challenges, such as digitalisation and other new models of business.

I will now also stress the topics we will have tomorrow, starting with Eurogroup and the ECOFIN meeting. There are of course some parallel topics there. I think the framework for the presidency we have in this half of 2018 on the Austrian presidency is quite clear: we want to strengthen the growth potential on a European level overall. It is also the basis for social peace on a European level. We also have to promote competitiveness and productivity. We really have to make it clear that there is a need for a reduction of legacy assets and more better functioning existing instruments. I think it is important to not always find and introduce more forms of regulatory mechanisms; we also need to concentrate on what will happen.

There was a clear decision from the leaders at the June 2018 summit on what we have to focus on in the next month. This is the main work we have now in our

presidency. It is built up of more than 45 files that we have to discuss, just in the topics of finance. I would say this is almost an overload and it is not possible to guarantee that, even from the Austrian presidency, we will succeed in all these files. What we are really working on is to concentrate on the main ones. On the one hand this is deepening EMU in the way it is progressing to the Banking Union on one side, and also important files on the Capital Markets Union. We see the major benefits for everyone, so we can and will increase convergence and find structural reforms in these topics.

There is always a discussion when we talk about the Banking Union. We know the discussion about risk sharing and risk reduction. In my opinion I made a mistake to come onto the discussion with you. Of course there is a discussion; hand in hand means that, in the opinion of most Member States, risk reduction is the most important before we step into the discussion about risk sharing. In my opinion I think – and I also mentioned it in the ECOFIN last month – we have to be ready when we have clear measures. One of the most important files we are discussing is the risk reduction measure package, and that we come on step by step with that, knowing that there is already a need to start political negotiations in the way that we can finalise the Banking Union in EDIS and prepare for risk sharing.

At the end there is no discussion if we have French, German, Spanish, Italian or Austrian banks. We have to be clear at the end of this process that we must have European banks, and that we have to declare in which form we can strengthen this European Banking Union. We also need to know about the competition on a global basis with the US market. We know that there are quite different forms in strengthening the private sector, and I think this is what we have to keep in mind.

In the frame of this presidency we also have to realise that there are some stresses to which we have insights. We know that up until now nobody has a clear view in which form we will solve the issue of Brexit. I think when we look at our watches we are near the middle of September. In the time until the end of October there is a need to clear up in which form this withdrawal can take. This means we can count the days until we expect a solution out of this. A question from my side is, 'Which form will this withdrawal take?' There is no real winner out of this discussion, whether the hard or soft form. We have to be prepared to be strong enough to stay in a strong European Union for the future beside the need of a partnership with the United Kingdom. On the other hand there is a clear message and a clear position, not only from ECOFIN but also from the European Union leaders, that cherry-picking, especially on the financial market issues, is not possible in that form. I think that during the upcoming days and weeks it will be hard work to find out the right way.

Aside from that, we are also awaiting the Parliamentary elections in May 2019. Of course, this is also coming up in the way that, when we are discussing the 2019 EU Budget and starting discussions about MFF, these elections are strongly influencing them. It is very hard work to get out of that.

I said it would be a short speech, so I will try to come to the conclusion. I think all of us feel it when we say that the European Union is a great success. We have more than 500 million people. We have developed a framework for peace, prosperity and freedom. However, as we said, it is not granted. We have to work hard on it every day to make it clear what we are working for. We are working for sustainability for all the factors I have mentioned. I think, even when we are discussing in detail some of the topics I mentioned, we always have to realise what is the overarching framework. I use the words from Jean-Claude Juncker: all for one and one for all. We have to realise every single day.

Thank you once more to all of you for supporting Eurofi in the process of many discussions. I am sure that you will enjoy this evening and your stay in Vienna and, hopefully, we will see you again. From my side I will also thank Didier, Marc, David and Jean-Marie, for the fact that you decided to come to Vienna. We will never forget it, and hopefully neither will you. Thank you very much for listening, and have a nice evening. Thank you very much. ■

Ewald Nowotny

Governor, Oesterreichische Nationalbank

Opening remarks

Ladies and gentlemen, dear David, dear Didier, welcome to Austria, which, this fall, holds the rotating Presidency of the EU. Also, on behalf of the Austrian Central Bank (Oesterreichische Nationalbank), welcome to what is going to be a great conference. I just want to add that we are very honoured that so many prominent guests have arrived here in Vienna, and I look forward to quite intensive and fruitful discussions.

This financial forum, which is organised in parallel with the informal Economic and Financial Affairs Council (ECOFIN) on a regular basis, offers a unique opportunity to learn from each other and to develop new ideas to the benefit of the public. We are aware that we share a common responsibility for economic prosperity and financial stability, despite the different roles of markets and regulators. Sometimes, of course, we have to work together.

This common spirit is also reflected in the motto of the Austrian Presidency – 'A Europe that Protects' – and is aimed at achieving, as the Finance Minister who will also

speak at this conference recently pointed out, a stable and strong euro area. The focus of the Presidency's economic policies will, therefore, be on completing the Banking Union and the setting up of a Capital Markets Union. This is not really a new message but it is still something where we know a lot has to be done. Fortunately, the organisers of this Eurofi event have made sure that these priorities will be discussed extensively throughout this conference, and we have just heard some of these issues from Didier.

The first set of discussions on Macroeconomic and Systemic Challenges touch upon topics such as the lessons learned from the crisis for financial stability, the state of EMU and EU-wide banking resolution, as well as investment gaps in the EU and in central, eastern and south-eastern Europe. I will come back to this in a minute.

The second part goes under the heading of New Opportunities from Technology and Sustainable Finance. This will discuss the challenges associated with fintechs, but also with cybercrime, cryptocurrencies and bank profitability. It will also focus on sustainable finance, meaning the contribution of the financial sector to dealing with climate change. Let me just mention that the Austrian Central Bank is a member of the newly founded Central Banks and Supervisors Network for Greening the Financial System, which will also hold an outreach meeting here in the margins of this conference. This network raises awareness not only of the financial risks posed by climate change and related policies but also of the huge opportunities that a transition towards a low-carbon economy offers to finance.

The third set of discussions, entitled Enhancing the Financing of the EU Economy, focuses, among other things, on current discussions in the Capital Markets Union and the Banking Union.

Finally, the last part, under the heading of Integration Challenges, takes a broader view on the progress made so far in deepening the EMU, including risk-reduction measures in the EU banking sector and, of course, dealing with the challenges of Brexit.

Without going further into detail, I would like to thank the organisers for putting together such a broad and topical programme, which will clearly be an inspiring programme for all of us.

Let me now come back to the first session: whether financial systems are safer 10 years after the Lehman collapse. I will take part in this discussion panel, so I only want to make some short remarks at this stage. We all know that, 10 years ago, the financial system was on the brink of falling apart. Today, we can truly say that all the efforts that have been undertaken globally have, first, of course, avoided the worst happening, but also, in the end, were quite successful.

Nevertheless – and this is what we will have to discuss extensively at this meeting – risks and challenges do remain. First, global debt is even higher than it was during the pre-crisis period. At 225% of world gross domestic product (GDP), public and private debt exceeds the previous record set in 2009. While this is not necessarily alarming in aggregate terms, the continuous debt increase has made emerging markets in particular vulnerable to, for instance, rising interest rates, and we see this almost daily in the news.

Second – and this is something that was mentioned by Didier just now – global imbalances remain large, both in emerging economies and in advanced economies, despite, to a certain extent, a narrowing since the crisis. The US and Germany are the world's leaders in terms of current-account deficits and surpluses respectively. Worryingly, the data plays to populist anger and protectionist measures that will only hurt domestic and global growth. Here, I think the situation requires a symmetric solution involving both net-debtor and creditor countries. In this regard, coordinated fiscal and structural policies based on the multilateral trade regime could do the job with the help of flexible exchange rates. However, a symmetric correction of current-account disequilibria is also an issue for the EMU, and this is something that has been highlighted by the very interesting Eurofi paper prepared by Didier Cahen and Jacques de Larosière.

The basic problem is, of course, that we are aware that there are situations in the context of a monetary union where we need what we call an internal depreciation, and we have had very dramatic examples of this. Where we do not have the same measures is what might be called an internal appreciation; therefore, we do have, of course, an asymmetry, which, by the way, for those countries with very high current-account surpluses and a very high dependency on exports, means that they are engaging in quite substantial risks. To be so dependent on the export side, especially in times such as these, is quite a strong risk for the national economy, so I think there should be some kind of 'enlightened' self-interest to deal with this issue.

The third point is the aspect of monetary policy normalisation of the Eurosystem. We are – and Peter Praet will have a more detailed explanation for all of this – ending the bond-buying programme. It is, however, also a question of increasing interest rates from a very low level. The question is whether this poses risks to financial stability. I can inform you that, for the informal ECOFIN, the Austrian Government has asked some expert groups to deal with this issue and, in a nutshell, the answer is that this does not pose a major risk to stability if you do it in a cautious and measured way. Of course, one also has to look at the situation of specific countries – and this is a further discussion that we must have – but assuming that the economic recovery is robust, a well-communicated and predictable exit might even stabilise the banking system by improving net-interest margins. In contrast, low market interest rates for a long time could have negative implications for financial stability and the health of insurance companies, pension funds and banks.

Finally, despite significant progress, remaining imperfections of the EMU architecture still hamper the resilience of the euro-area economy. Of course, we know that a currency union can never be perfect, and we know that even the American currency union is not perfect in that sense. Nevertheless, looking also at the US, I think the euro still has a lot of room for improvement, both in terms of risk-sharing and in risk-reduction. Here, in this aspect, I think a European deposit-insurance system would be a significant improvement, as would be the already-agreed fiscal backstop for the Single Resolution Fund, which is provided by the reinforced European Stability Mechanism.

The European Commission has made a number of proposals but, of course, reaching an agreement on all of these institutional innovations will not be easy. These innovations require a minimum of mutual trust, as no fiscal rule can exclude some future moral hazard altogether. Even though I can understand the policymakers' reluctance to give up sovereignty in budgetary matters, one also has to accept the fact that this sovereignty is already limited by financial markets even outside the EMU. At the end of the day, markets may put the euro area's resilience to shocks to the test. There is, however, no doubt that we are better prepared for the next crisis than we were for the last.

With this, I want to give the floor to Claudio Borio who, if I may say so, regularly challenges the comfortable consensus among central bankers; for instance, with regard to the role of monetary policy in averting financial risks. I am sure that we can look forward to thought-provoking insights. Thank you very much and, Claudio, the floor is yours. ■

Andrew Bailey

Chief Executive, Financial Conduct Authority

A case for balancing autonomy and co-operation in the interests of financial markets

It is a great pleasure to be speaking at Eurofi and to comment on the topic of multilateralism and global coordination which is so fundamentally important right now.

I strongly believe that competition and innovation in financial markets, supported by robust regulatory and supervisory standards provide better outcomes for users of financial services, particularly so in wholesale markets. An essential pre-requisite of these outcomes in my view is open financial markets which also support trade in goods and services.

As authorities from around the world we work together to develop and implement standards which are strong but flexible enough to enable competition and innovation. It would have been easy to turn our backs on open markets in the wake of the searing experience of the financial crisis, but to the great credit of everyone involved that did not happen.

Unfortunately, there is regular commentary that this approach is now being challenged. This would be a mistake.

It has always been the case that one jurisdiction cannot constrain the autonomy of another's domestic regulation (and here I treat the Single Market as one jurisdiction). But it would be a big, and in my view unfortunate, leap to therefore say that we cannot envisage open financial markets which support free trade - and to suggest that we cannot underpin open markets with a common commitment to international standards where they exist. Such a commitment to international standards is an essential part of achieving equivalent outcomes and thereby managing risks which go across borders. But also where international standards do not exist, freedom for jurisdictions to set their own standards domestically can certainly co-exist with international co-operation in a way that enables agreed equivalence of outcomes.

¨ Where international standards do not exist, freedom for jurisdictions to set their own standards domestically can certainly co-exist with international co-operation in a way that enables agreed equivalence of outcomes. ¨

First, on benchmark interest-rate reform. There is no constraint on domestic choices on the alternative and risk-free rate to be chosen for each currency. Different choices have been made for different currencies. But that does not remove the need for, or prevent, strong co-operation to co-ordinate the outcomes based on those choices.

Second, on financial innovation and regulatory 'sandboxes': there is no constraint on any domestic choice on the model for sandboxes or what is accepted into them. These are all rightly domestic choices shaped by domestic circumstances and demand. But that should not prevent co-operation to in order to enable cross-border activity where appropriate. To do otherwise would make no sense. That is why we in the FCA set up a Global Financial Innovation Network which will help pool regulatory expertise to support firms in trialling innovative cross-border services and products. And it is why The International Organisation of Securities Commissions (IOSCO) launched a FinTech Network to explore the effective use of regulation in financial technology and automation.

Closer to home, going forward next year, there will be areas where UK authorities will need to closely coordinate with the EU, the US and others whilst each managing our autonomy - and respecting the autonomy of others. To offer just one particular example: The Markets in Financial Instruments Directive (MiFID) II has been calibrated based on UK and EU27 markets combined and it may not make sense to break that down and have different UK and EU transparency rules for the same products.

When I speak to other regulators, I get a clear sense of a common interest to preserve the benefits of collaboration, sharing of information, and to ensuring effective supervision. But there is evidently a debate on this as we think about the post-Brexit situation.

One perspective is the desire to keep access to the Single Market open to third countries, including the UK, on the basis of open markets, equivalent standards and the right of establishment.

¨ I strongly welcome Commissioner Chris Giancarlo of The U.S. Commodity Futures Trading Commission's (CFTC) proposals for closer cross-border cooperation and a greater use of deference – reliance on comparable overseas rules – where they deliver broadly equivalent outcomes. ¨

Another is that financial activity involving EU parties should be carried out as far as possible in the EU. But this seems to go against the principle of open markets and free trade and is unnecessary in view of all the post-crisis work on co-operation and broad alignment of standards.

Moreover, other countries are moving in the direction to remove unnecessary location policies and national treatments. To this end, I strongly welcome Commissioner Chris Giancarlo of The U.S. Commodity Futures Trading Commission's (CFTC) proposals for closer cross-border cooperation and a greater use of deference – reliance on comparable overseas rules – where they deliver broadly equivalent outcomes.

¨ In Europe, as we will have identical frameworks, there will be a strong case for the UK and the EU to find each other equivalent on 'day 1'. ¨

In my view, the real strength of deeper capital markets is access to a global pool of capital to support the growth of companies and economies. Consistent outcomes of regulation are what matters, reinforced by strong regulatory co-operation and co-ordination - which is essential to preserve the strength of the global financial system. In Europe, as we will have identical frameworks, there will be a strong case for the UK and the EU to find each other equivalent on 'day 1'. And we should now work together to put in place the arrangements to achieve this in practice. By committing to this course, together we can also take a decisive step to head off the risk of transitional cliff edges.

I have previously argued that there are four key elements of such strong regulatory co-ordination: comparability of rules (but not exact mirroring), supervisory co-ordination, exchange of information, and a mechanism to deal with differences.

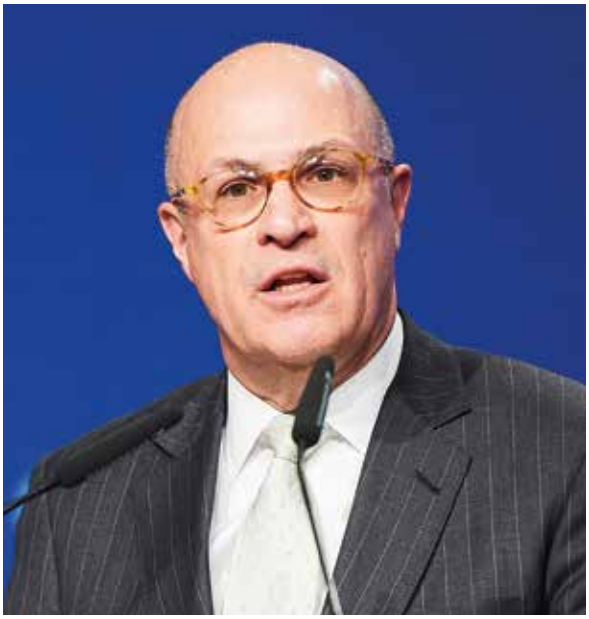
I see an emphasis on outcomes-based equivalence as fundamentally important to support the balance between autonomy and co-operation and avoid outcomes that will damage the economic well-being and successful financial markets. There has been a lot of debate around the use of the word 'mutual' in the context of the Brexit debate. 'Mutual' does not involve constraining domestic autonomy: rather, it involves approaches which should deliver broadly equivalent outcomes while respecting the autonomy of jurisdictions. This should facilitate the benefits of open markets, the thing we should all value and work hard to preserve. ■

J. Christopher Giancarlo

Chairman, U.S. Commodity Futures Trading Commission

Remarks

Good evening. It is my great pleasure to be here again at Eurofi. I wish to thank David Wright, Didier Cahen and Marc Truchet for organizing once again a great conference. Thanks also to our Austrian colleagues for their gracious hospitality. I am most pleased to be with you and address the leaders of the European financial regulatory community. It is also my immense pleasure to be here in Vienna. This is a city that has been described as more than a city; Vienna is "a way of life." Here that way of life produced Carl Menger, Friedrich von Wieser, the great Friedrich von Hayek, and Ludwig von Mises. It was they who made clear that human rights and advancement are inseparable from economic liberty and free enterprise. Vienna has been described as



having a "supranational, cosmopolitan consciousness." When someone speaks in Vienna, they address the world. This is certainly true here this evening.

Since becoming CFTC Chairman, I have made it my highest priority to build strong bonds with my counterparts in Europe and other parts of the world. Effective cross-border relations are central to the mission of the CFTC because of the global nature of the futures and derivatives markets which the CFTC regulates. I have striven to interact with my foreign counterparts with respect, humility and goodwill. We policymakers and regulators have a shared interest and responsibility to ensure our markets are vibrant, efficient and value-enhancing. Our common interest and mission mean we should be working together and not apart.

A year ago, at Eurofi in Tallinn and in a contemporaneous article in Les Echos de Paris, I expressed my view that regulatory and supervisory deference is the best way to ensure harmony between regulatory regimes. I depicted a vision for CFTC-EU regulatory coordination that would focus on ensuring consistently high-quality regulatory outcomes across our respective markets while respecting the differences in laws and regulations that are necessary to support the unique characteristics of our local markets.

While I believe that my call for deference was not a radical idea, but just common sense, I have felt my message has not fully achieved the positive effect intended. While I am proud of undeniable concrete achievements – most notably the accomplishment with Vice President Dombrovskis last fall of equivalence for US trading venues and exemptions for EU trading venues – I remain concerned with proposals and pronouncements here in the EU about financial regulation and supervision of third country firms that seem to reject deference as the governing principle for cross-border regulation.

We are all aware of the history of cross-border regulation between the CFTC and EU. Many here in Europe understandably criticized past CFTC actions for over-extending CFTC rules to European markets and firms. They were right to expect greater regulatory deference from a fellow framing nation of the 2009 G-20 Pittsburgh Accords. But I fear that history has now made us too cynical. We have forgotten how to reach for what is possible in favor of acting to protect what we have today. We have created hooks and raised barriers when we should be seeking openness and encouraging competition.

Earlier this week in Europe, I presented new views on how best to apply swaps reform regulation to firms and transactions across borders. I announced that I will publish shortly a comprehensive and detailed white paper analyzing the shortcomings of the CFTC's current approach and recommending improvements that better allow cross-border derivatives markets to thrive while meeting the goals of the G20. I gave several concrete examples that foreshadow the extensiveness and level of detail of my recommendations. My white paper will not be about theory, but hard reality.

This white paper will serve as a roadmap for a series of rulemakings that I intend to put forward to the full CFTC Commission in the future and, with their input, thereafter for public notice and comment and eventually adoption. Most importantly, I am giving substance to what I mean by deference. Deference is not just a slogan. It is a regulatory approach that can be applied to concrete regulatory challenges –regulation of swaps trading venues, regulation of central clearinghouses, and regulation of swap dealers. These ideas are specific and clear in showing how regulatory and supervisory deference can be applied to the regulation of the cross-border markets. As CFTC Chairman, I look forward to taking steps put these ideas into effect.

Addressing the world from this great city of Vienna, I call on you – the policymakers and regulators of Europe – to join me in adopting a similar approach to the cross-border application of swaps reform regulation. We have a rare and precious opportunity to trust one another; to put into place contemporaneously laws, rules and regulations that enshrine regulatory and supervisory deference in how we treat third country firms and transactions.

Regulatory deference has been the common practice of the European Union. The EU pioneered the use of equivalence and recognition to make it possible for outside firms to serve European markets. On such a basis, the EU and the CFTC showed how well we can work together in applying a joint framework of equivalence and substituted compliance and exemptions. We did it in 2016 when we reached agreement on the regulation and supervision of CCPs, and we did so again in 2017 when we reached agreement on the regulation of trading venues and uncleared margin requirements.

Now is the time to expand the use of equivalence and recognition. The EU should commit to an equivalence determinations process that focuses on achieving comparable regulatory outcomes and not rule-by-rule exactitude. Thus, EU can provide necessary legal and regulatory certainty to third country firms. And the EU should rely as much as possible on third country regulators and supervisors. I want the CFTC to do the same.

But here I must express some concern.

Current EU legislative proposals on CCP supervision are going in a different direction. These proposals, when understood alongside comments from some European officials, raise doubt about continuance of the policy of deference. I fully respect the EU policymaking process and the goal of enhancing EU regulatory capabilities. I have even greater professional and personal respect for EU public officials. Thus, it concerns me that decisions may be made in the next few months that will end up having a deleterious effect on transatlantic financial trade.

I come here today to put forward to you – European policymakers and regulators – a plain choice. I will embark the CFTC on the course of greater regulatory deference, including concrete proposals to further open up the CFTC regulatory regime to European firms and markets. My proposal seeks to recognize the power and authority of EU authorities to regulate and supervise the European market with limited involvement from the CFTC. It welcomes an EU approach that will do the same to US firms and markets. This is one approach.

The other approach is to reject what I put forward and to continue down the path of expanding direct European regulation and supervision over third country firms. The choice of approach is yours to make. I sincerely hope that we all recognize the unique opportunity before us to achieve true regulatory coordination between the US and Europe. It is time to seize that opportunity by putting in place the relevant laws, standards and policies to reciprocate our path of deference with a European recommitment to that most beneficial approach.

Or reject this approach and turn down that very different path of overlapping and confounding cross-border regulation with its high regulatory cost and constraints on economic growth. This would be the legacy of policymakers making such a choice. To be clear, the course I set for the CFTC will be robustly debated in the United States. The prospect of my course being fully implemented will be greatly enhanced if the European Union, as well as our other non-U.S. counterparts, pursue a common approach and harmed if they do not. I look to you to make the right choice and to express your choice with clear statements and clear legislative and regulatory actions.

I started by mentioning the great influence Vienna has on the world of economics. Friedrich Hayek argued that free market economics is the foundation of the highest form of human freedom. And, ultimately, that is what I am urging with these recommendations: the freedom of private enterprise that fires the imagination, liberates trade and commerce, unleashes markets lifts our fellow citizens into greater prosperity.

Vienna also has been called "the city of dreams." Let's realize the dreams of cross-border regulatory coordination and make it a reality.

Here at Eurofi this week, working together, we can implement a vision of regulation that will take us well into the 21st Century.

Thank you. ■

Mário Centeno

Minister of Finance, Portugal & President of the Eurogroup

The future of the euro area

Ladies and gentlemen,

It is an honour to be here with you today in this beautiful city of Vienna. I am grateful to Eurofi for the kind invitation.

Over the past ten years, we implemented significant reforms at both national and European level and the economy is growing in a more sustainable way. Against this backdrop, one can ask if the Economic and Monetary Union is already sufficiently equipped to withstand future shocks.

In today's increasingly complex and unpredictable environment, aren't there more important problems to solve?

• I believe we need to continue to reform the Eurozone because our EMU remains incomplete:

• A number of structural elements to improve its ability to withstand external shocks and crises is still missing

• An effort to improve its financial and fiscal architecture is still needed;

• We also need reforms to increase integration of financial, product and labour markets.

Without these, the economic and monetary union can only yield suboptimal results. We need a different Euro Area, an improved institutional landscape. A smoothly functioning environment that allows businesses and people across Europe to fully reap the benefits of our shared currency. The Economic and Monetary Union is working better today, but we cannot afford to take these achievements for granted when we are just halfway. We cannot afford to procrastinate until the next crisis catches us off guard. The question we are asking ourselves is no longer if we should reform the eurozone, but rather how we can do it together and in the best way possible.

We have been exposing our recovery to unnecessary tests. Despite the current expansion, risks and uncertainties are mounting. Escalating trade and political tensions and Brexit are some of the clouds on the horizon. They should prompt us to carry on the reforms we have started with a sense of purpose and urgency. Following the leaders' mandate from December last year, the Eurogroup has been focusing on the completion of the banking union and the revamping of the European Stability Mechanism. We have also looked at a fiscal capacity for the Euro Area. Let me briefly walk you through this work.

Banking Union

Starting with the banking union, the euro area remains vulnerable to financial fragmentation.

To become truly resilient and increase its productivity, it needs stable cross-border investments that would ensure funds are efficiently allocated throughout the economy. For this, it needs a fully integrated and more resilient financial sector.

The banking union, launched back in 2012, was key to the successful response to the crisis. Its results are evident — and you are in a privileged position to see that. Banks across the euro area have significantly strengthened their balance sheets by increasing their capital and reducing stocks of non-performing loans. But that is not enough.

SRF Backstop

The discussion on reducing the financial sector's risks and sharing those risks among euro area members is complex and politically sensitive. The Ecofin Council in May agreed on the 'Banking Package' – a number of legislative proposals to reduce risks in the banking sector. The package paves the way for another important decision: the European Stability Mechanism to become the provider of a common backstop to the Single Resolution Fund.

The backstop would be extremely useful to shield our economies in the context of a systemic financial crisis, by ensuring banks can be put under resolution even if SRF funds are fully used. The Eurogroup has been tasked with working out the final details by December, in particular the conditions for implementation before the end of the transitional period and the governance model. We already agreed that the backstop will be introduced no later than in 2024. The question is whether we can make it earlier.

EDIS

Completing the banking union also requires us to put in place a European Deposit Insurance Scheme, known as 'EDIS'. This is a key step to complete the monetary union: the safety of deposits should, to some extent, not depend on the bank or member state where they are held. An EDIS could complement national deposit guarantee schemes, thus enhancing the robustness of our banks in case of a future financial crisis. We need to acknowledge and address the many concerns surrounding EDIS.

To the extent that it would provide confidence to depositors and reduce the risk of bank runs, the implementation of an insurance scheme would have a positive effect on the system. Its benefits would materialize prior to, and in the absence of, a single euro being spent. Under the proposals being discussed, the contributions banks would pay into the scheme would be calibrated according to the risks they carry. In other words, risky banks would pay more, as a result of their higher probability of failure. This way EDIS would create incentives for banks to reduce their risks and improve the quality of their balance sheets. The Eurogroup has got a mandate from the European Council to begin working on a roadmap to launch political negotiations. We should make some progress by the end of the year.

European Stability Mechanism

Preparing the euro area for future challenges also requires us to improve crisis management procedures. The European Stability Mechanism has eight years' experience in successfully providing support to adjustment programmes. The Eurogroup will build on that. Leaders asked the Eurogroup to strengthen the ESM's role on the design and monitoring of financial assistance programmes. Let me now briefly touch on other relevant work streams.

Capital Markets Union

A well-functioning banking system is indispensable, but it is not enough by itself. The Eurogroup needs to continue working on the second component of what will become the financial union — the capital markets union. The capital markets union is necessary for two main reasons. First, it would enhance the allocative efficiency of our single market, igniting investment and innovation. Second, it should help to reduce the current over-reliance

on bank lending. This task will require action on many different fronts, from the removal of cross-border barriers to financial flows through taxation to improved insolvency frameworks.

Fiscal capacity

Finally, I will say a few words on creating a fiscal capacity for the euro area. The euro area, compared to other large monetary and economic areas is lagging behind when it comes to the mechanisms and the levels of risk sharing. Greater risk sharing would help to dissipate the impact of economic shocks. Risk sharing can be achieved through private and public channels. Often, it is a combination of the two.

In the US, around 70 percent of national and local asymmetric shocks are absorbed via financial markets – that is the private channel. In Europe, only 25 percent of the asymmetric shocks are dissipated through this channel. Consequently, fiscal buffers, which remain at national level, must absorb the bulk of the impact of downturns in Europe. This feature severely hampers the resilience of our monetary union and makes it more prone to crisis. A fiscal capacity for the euro area can be designed with a number of complementary objectives in mind. It could support the euro area's competitiveness, promote convergence and provide a stabilisation function, notably by protecting investment in crisis times. We need to achieve this by taking seriously the incentive structure – which includes moral hazard considerations –and with a view to improve economic efficiency – two principles that are shared by us all.

Closing remarks

Let me now conclude. Euro area reform is a crucial project for us and for the generations to come. It is our common responsibility to take it forward. I am glad to see the interest of the financial sector in this project. Building the Economic and Monetary Union is no small task, and it will require time and patience. In short, we should not rush into hasty decisions, while being fully conscious of the cost of inaction.

Thank you. ■

Valdis Dombrovskis

Vice-President for the Euro and Social Dialogue, also in charge of Financial Stability, Financial Services and Capital Markets Union, European Commission

Standing on our own feet: the case for completing the Economic and Monetary Union

Ladies and Gentlemen,

Grüß Gott!

Es ist mir eine Ehre, hier in der wunderschönen Stadt Wien für das Eurofi Financial Forum 2018 zu sein. Diese Stadt hat eine wichtige Rolle in der Geschichte Europas

gespielt, als Treffpunkt, Handelszentrum und Machtzentrum. Und das tut sie auch heute noch.

Die günstige Lage an der Donau, die sieben EU-Länder im Westen und im Osten verbindet, hat dazu sicherlich beigetragen. Aber Wien sitzt nicht am Ufer der Donau herum, und wartet dass neue Gelegenheiten den Fluss heruntergeschwommen kommen.

Earlier today, I visited WeXcelerate, one of the world's largest start-up accelerators, where entrepreneurs are working in new areas such as Fintech. These innovators are shaping the future, instead of merely reacting to it. This is exactly the kind of proactive attitude that we need to build the future of Europe. So my hope is that the Austrian presidency of the EU will channel this dynamic spirit into their work for the next four months.

This is important, because today, Europe is confronted by new challenges to our economic model: we see international diplomacy being undermined; we see the WTO and the multilateral rules-based order being weakened; and we see a trend towards authoritarianism in some places.

In this new situation, Europe should speak up for its values, for an integrated international economic system, and for multilateralism. To do so, Europe must stand on its own feet, and protect its economic interests globally. And to stand on your own feet, you need a strong and resilient economic and financial system, as well as a credible and attractive global currency.

This brings me to the euro, which will soon celebrate its 20 year anniversary. And it has come a long way since 1999. For the 340 million Europeans who use it every day, the euro has brought price stability and made it easier to do business and to travel. Today, it enjoys strong support from Europeans - 74 percent think having the euro is a good thing for the EU. And it is the world's second reserve currency, with 60 countries linking their currencies to it in one way or another.

But despite important institutional reforms to strengthen its resilience, the architecture of the Economic and Monetary Union remains incomplete. So last December, the Commission put forward a Roadmap to deepen the Economic and Monetary Union, followed by several concrete proposals. By putting in place these

missing pieces, we could support our future prosperity, help guard against another financial crisis, and strengthen the international role of the euro. Our summer economic forecast showed 2.1% growth forecast for 2018, but growing downside risks to the economy. So, we do not have much time to carry out the reforms we need. The right time is now, before next year's European elections.

Today I would like to highlight three priorities:

First, we need Member States to keep reforming to become more resilient and more competitive. Second, we need more integrated and shock-resistant financial markets. And third, we need to keep strengthening our crisis-management tools.

Let me begin with structural reforms in Member States. Such reforms are fundamental to modernise our economies, strengthen resilience, and foster economic convergence. In response to the vulnerabilities revealed during the crisis, many EU countries that embarked on ambitious reform paths were able to catch up remarkably. Today, countries like Ireland, Spain, the Baltics, or Portugal are all growing and adding jobs quickly. And the EU has supported such reforms along the way, including through the European Semester, which flags immediate reform needs and builds up peer pressure.

Reforms imply costs and often administrative and political challenges. This is why since last year, we have a programme offering technical support to design and implement growth-enhancing reforms in all Member States. It has been very successful, supporting almost 350 reform projects in 25 EU countries. Demand for support has exceeded all expectations. For the next Multiannual Financial Framework, the EU's 7 year-budget, we have proposed a Reform Support Programme. It is a comprehensive toolbox to foster reforms in all EU countries. Discussions on this proposal have started, and we hope to make rapid progress towards its adoption.

Alongside Member State efforts, deeper and more interconnected financial markets are also key for economic resilience. So, this is my second point today. More integrated financial markets would create a cushion to absorb sudden shocks and allow risk to be shared by private actors across EU borders. In turn, this would reduce the need for taxpayer-funded bank bailouts in the future.

This is a lesson from the crisis. It was the threat of national bank failures spilling over to Government finances that plunged the euro area into a second recession in 2012. So, the same year, EU leaders agreed to create the Banking Union. Today, EU banks are better capitalised, more coherently supervised, and much less likely to ask for a taxpayer bailout in a crisis. But the Banking Union itself is still incomplete. To secure the credibility of the current system, we need to put in place two missing elements: the first is a backstop to the Single Resolution Fund, which was agreed by Member States already in 2013. And here we are finally making progress.

Euro area heads of state recently agreed that the backstop will be provided by the European Stability Mechanism. The Commission insists that this backstop should be credible and readily available to use. Now we need to work towards an agreement in principle at the December European Council.

The second missing element is a European Deposit Insurance Scheme. The Commission tabled its proposal in 2015, and last October we presented additional ideas to help reach a compromise. Euro area heads of State and Government have now agreed to advance work on a clear calendar that will allow us to launch political discussions.

In parallel, we have made progress in reducing risks in the banking sector. We are working closely with the European Parliament and Member States to finalise the banking package, which puts internationally agreed standards into EU law. And we are working together to reduce Non-Performing Loans in the EU banking sector. Here we have also made good progress. The EU's average NPL ratio stood at 3.7% as per the first quarter of this year. This means a reduction of 3 percentage points since the end of 2014. However, this rate still varies considerably among Member States. We recently put forward a package of proposals to support further reduction, which is advancing well with co-legislators.

As a necessary complement to the Banking Union, we also need a genuine single market for capital. This is why we launched the Capital Markets Union. It is our flagship project for building deeper and more interconnected EU capital markets. In addition, it aims to foster well-developed local and regional markets, and ensure a strong position for Europe in the ongoing Fintech revolution. This Commission has already put on the table a range of proposals to build the different elements of the Capital Markets Union. But so far, 10 out of 13 proposals are still under discussion by EU co-legislators.

I welcome the recent declarations by France and Germany, and also from eight other Member States on the need for decisive progress. But I also count on the EU Council and the European Parliament to follow up on these declarations with real action in the coming weeks and months. This is necessary for having the foundations of the Capital Markets Union in place before the European Parliament elections.

Even economies in good shape can suddenly run into problems. This brings me to my third point today, about strengthening the crisis-management tools of the Economic and Monetary Union. While national budgets should stay the main instrument for economic adjustment, we should remember that shocks can sometimes drastically reduce the fiscal space to act. The last crisis showed this very clearly, even for euro Member States with sound public policies. That is why we also proposed a European Investment Stabilisation Function as part of our proposal for the next Multiannual Financial Framework. This Function is designed to intervene early by providing subsidised loans to support public investment. Investment is often the first item that is cut in a crisis.

By providing fiscal support before a shock spirals into a crisis, the aim is to facilitate a rapid recovery and avoid deeper recessions. Use of the Function would be subject to strict criteria of sound macroeconomic and fiscal policies. We believe this proposal is a good basis for discussion in the ongoing EMU deepening debate.

Ladies and Gentlemen,

All these reforms will help us to make Europe's economy and our currency more resilient, and to stand strongly on our own feet in today's challenging global environment. Today more than ever, Europe must be and will be the champion of an open and integrated international system, based on multilateralism. This is true whether you look at the global trading system, or at financial regulation and equivalence. This is part of the EU's DNA. And for Europe to successfully preserve and promote these values, a strong economy, an integrated financial system, and a credible currency is what it takes.

Thank you very much. ■

John Berrigan

Deputy Director-General, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Multilateralism and global coordination

Ladies and gentlemen, I am very pleased to have the opportunity to speak on the topic of multilateralism and global coordination. Given the similarities in philosophy between Andrew, Chris and me, I fear you are going to hear many similar messages today, but I will try to make them as different as possible. When David referred to my 'subtle mind' earlier, this was just a polite way of saying I am a generalist – as we say in Ireland, a gifted amateur. As the generalist of the trio, my remarks will be correspondingly general. I am warning you in advance.

If we assess where we are 10 years after the financial crisis and where we are going, I would make three broad observations. First, as we focus today on completing our well established agenda of reforms to increase the resilience of our economy and ensure our long term prosperity, we cannot and should not forget the lessons of the crisis. The overall lesson was that our financial system is inherently international and that financial stability cannot be achieved uniquely within national borders. International finance needs international regulatory cooperation. A stable global financial system is a global public good from which everybody benefits, so a common approach makes it safer and underpins the level playing field we need for free trade, competition and growth. Without it, we run the risk of regulatory arbitrage, renewed instability and generalised economic problems.

In 2008, this recognition propelled our jurisdictions – and I will come back to the issue of jurisdictions later – to work together in the G20 to further a common international financial governance agenda. We at the European Commission – and you heard this from the Vice President earlier – want to continue working to upgrade global standards in a way that works for everyone. It is why we support continued international cooperation in the G20 in the Financial Stability Board and the Basel Committee.

As we have successfully done in the past, we have to agree on the main principles of the most important financial regulatory frameworks in order to ensure that level playing field and to minimise the risk that financial institutions engage in arbitrage by shopping for the most favourable jurisdictions. The recent agreement on the finalisation of Basel III, hard fought as it was, is the most recent success of that cooperation. We must continue to move forward and move ahead together, which leads me to my second observation.

Despite our achievements, challenges remain that require coordinated action at international level. We should not think that, because we have the bulk of our agenda in place, somehow the need for cooperation is reduced. International finance will increasingly encounter challenges – I would just cite fintech and cybersecurity among them – and opportunities that cannot be addressed or solved by smaller scale and local actions, but demand coordination at the international level. Financial regulation needs to keep up with such evolution in the market.

This brings me to my third observation, that regulatory cooperation in the financial services sector has to be seen within the broader geopolitical context. Tensions in other domains – and, again, the Vice President referred to them earlier -, could easily spill over into our domain, so we must address more forcefully the causes of discontent in those areas. That goes well beyond the discussion that we are having and you will have on these issues later today, but we must address these sources of discontent if we want to maintain the consensus for an open rule based world. We have a duty to address these legitimate concerns about fairness and equality that globalisation increasingly raises.

In our field, it is essential that all major jurisdictions implement all the key elements of the Basel agreement. This is to maintain a level playing field for banks at the global level and to prevent any tensions that might emerge in our field. As in other domains, we also see good bilateral relations in addition to multilateral relations as complementary, and in no way contradictory, to multilateral agreements. In that respect, we value the regular dialogues we have with our trading partners and, I guess, the regular dialogues we can look forward to with future third country trading partners.

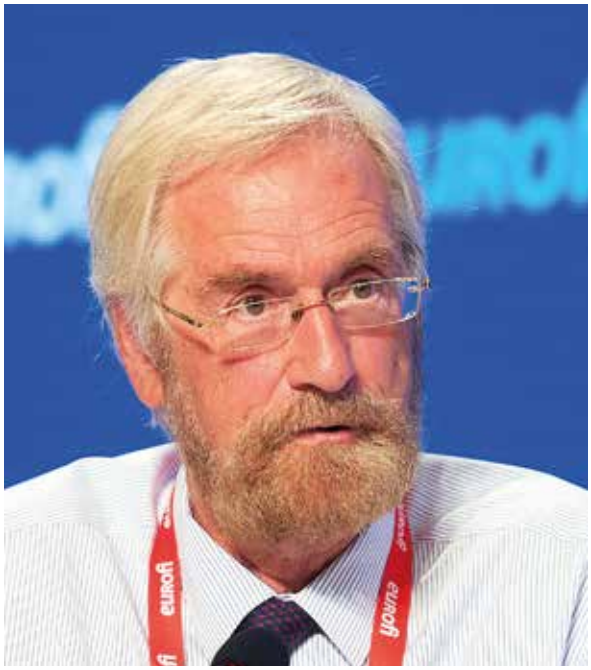
One penultimate point that I wanted to come back to is the issue of separate jurisdictions. While we are very committed to global cooperation, we have to recognise that we do not live in a fully global world. So, the Commission strongly supports global cooperation and multilateralism, but does not ignore that the global financial system comprises different legal and regulatory jurisdictions. Within any global coordination framework, each jurisdiction has the right – indeed the obligation – to safeguard its financial stability. Does this somehow weaken our commitment to global coordination? Of course it does not. In fact, it is quite the opposite; it just means we have to work that little bit harder to find solutions that are mutually acceptable to each jurisdiction.

Lastly, I want to join Andrew in welcoming the speech that Chris made earlier this week in London.

As a general response, we welcome the direction in the speech towards greater deference. As you know, we are historically a fan of deference. We already give the US more deference than the US gives us in clearing, so good on you!, We will study the speech very carefully and look forward to the elaboration of Chris's ideas in the forthcoming white paper. ■

Peter Praet

Member of the Executive Board,
European Central Bank



Creating an enabling environment for pan-European banks in the Banking Union

In recent years, the European Union has achieved major progress towards financial integration. We now have a single supervisor and a single resolution authority, and banks are subject to the same European rulebook. The Banking Union contributes to providing effective mechanisms for cross-border risk-sharing and broadening the sources of funding within a country, thereby promoting macroeconomic stability and growth.

However, we still observe a number of obstacles that hinder the fungibility of capital and liquidity of banking groups. Very often, these obstacles relate to regulatory fragmentation and ring-fencing of national markets. Further harmonisation would help to address many of the issues, while appropriate prudential safeguards can be put in place to address possible financial stability concerns by national authorities.

First, a number of national options and discretions are hindering the practical application of cross-border liquidity waivers within the Union. While such waivers are explicitly allowed by the CRR, and already contain prudential safeguards, so far the ECB has received almost no application for their use from the banks it supervises. An important reason for this lack of applications is the existence of national large exposure limits on intragroup exposures in several European countries. These limits prevent institutions in these countries from transferring liquidity within the group in a flexible manner and thus represent practical obstacles to the use of liquidity waivers. Effectively, they are hindering the free flow of liquidity in the Banking Union and should be harmonised further.

Second, the proposal to have cross-border capital waivers within the EU was not taken forward in the on-going review of the CRR, which is a missed opportunity.Such waivers would be consistent with the establishment of the SSM and the Banking Union and help to support the free flow of capital across the Union. On the one hand, it is understandable that some national authorities are concerned about the possible financial stability implications of the proposal. On the other hand, such concerns could be addressed by making the waivers subject to additional prudential safeguards, and by putting in place appropriate transition arrangements that account for the planned further progress on the Banking Union.

Third, the major progress we have made in our Banking Union needs to be recognised also in the international regulatory framework. For example, the G-SIB framework currently penalises cross-border transactions within the Banking Union by attaching a higher systemic risk score to banks with more of such transactions. This goes against the very rationale of the Banking Union, as it reduces the incentives for cross-border transactions and risk diversification. The international regulatory framework should recognise the progress that has been made in the Banking Union and exclude intra Banking Union positions from the cross-jurisdictional indicators in the G-SIB methodology.

Fourth, there are also some resolution related aspects that warrant further consideration. In particular, the allocation of internal MREL has turned out to be an area of tension between national jurisdictions. Jurisdictions with a foreign bank subsidiary prefer to have a high pre-positioning of internal MREL to ensure an orderly resolution of its local subsidiary. However, this implies a certain degree of ring-fencing to the detriment of the foreign parent bank. The compromise reached by Member States in the Council only allows that internal MREL is waived if the resolution entity and the subsidiary are located in the same Member State, neglecting the fact that we have achieved so much in terms of joint supervision and resolution among euro area countries. To account for this progress, internal MREL waivers on a cross-border basis in the Banking Union should be allowed as this would contribute to continuous cross-border banking, e.g. by generating efficiency gains and promoting further integration. Therefore, it should also be possible to use guarantees to replace internal MREL and allow for more flexibility in the allocation of resources within the Banking Union. Of course, to install confidence it will be important to have adequate safeguards in place, including that there is no legal or practical impediments to the provision of support by the parent to the subsidiary, in particular when the resolution action is taken. ■

Sabine Lautenschläger

Member of the Executive Board and Vice-Chair of the Supervisory Board, European Central Bank

European banking supervision – towards a common culture

Since 2014, we have made huge steps towards establishing a truly European system of banking supervision and embracing a common supervisory culture.

Does this mean nothing more needs to be done? Not quite. For a fully-fledged common culture, you need to have three things:

- First, you need a truly unified legal basis. You simply cannot build a comprehensive common supervisory culture if you have to apply a different set of rules in each of the 19 countries. Just think how we need to treat fit and proper assessments differently from one country to the next.
- Second, you need harmonised administrative practices. And here, we have made good progress in the last four years – wherever the legislator granted us scope. We established practices for all the major areas of supervision, such as the SREP, the treatment of NPLs, stress tests, the ICAAP, the ILAAP, and so on.
- Third, you need time and cooperation. After all, staff from 19 countries and 26 authorities have to be persuaded to leave their cultural comfort zone and align how they think, assess and act.

I measure how far we have come by the frequency with which banks ask about changes in supervisory actions.

In other words: how often do banks complain about changes in the way they are being supervised? They complain a great deal, I can tell you.

And we keep pushing forward. Let me give you just a few examples:

- We strive to increase the number of cross-border on-site missions, with even more on-site supervisors working on banks outside their home country. The success of this initiative will largely depend on the number of on-site supervisors the national authorities are willing to send.
- We have established a rotation scheme for members of our Joint Supervisory Teams. This too will help to spread a common culture. At the same time, it helps to avoid supervisory capture.
- We foster exchange between supervisors from across the euro area. We bring them together in many different working groups to devise training manuals and supervisory guidance.

But the ECB cannot create a common supervisory culture by itself. The national authorities can and should contribute, too. I understand, of course, that it is difficult to let go of traditions that have been honed over decades. Culture is a sticky thing.

But national authorities should embrace the European idea. And they should seize the opportunity to contribute to a new, common supervisory culture. They should let more of their staff come to the ECB, for a while at least. Let them work in a European environment and carry this culture back to their home countries.

And the idea of a European supervisory culture should be reflected in how we deal with banks. For example, national reporting requirements should be dropped; instead, we should aim for a single European reporting framework.

To sum up: a common supervisory culture is emerging, but it still needs to be nurtured and nudged.

Thank you for your attention. ■

Richard Gnodde

Chief Executive Officer, Goldman Sachs International

Richard Gnodde shared his perspective on the opportunities and challenges facing Europe, where he noted the level of optimism in corporate Europe remains strong. This is largely driven by increasing economic growth; the ability of Europe to manage geo-political risks; and a supportive regulatory environment.

Macro environment showing resilience and strength

Gnodde noted that, after a period of sluggish growth following the crisis, CEOs remain optimistic about short-term prospects in both Europe and the US with expectations that future business conditions will remain favourable for economic growth. Business leaders are reassured by policymakers' commitment – in both the EU and the US – to creating a positive business environment.

Geopolitical uncertainty continues… but Europe remains strong

Europe continues to face a number of political challenges, including around migration, but from an investor perspective attention is focused on Italy. Gnodde remarked that the EU's political leadership has always been able to navigate crisis and uncertainty and he is confident that we will find a resolution here.

A business-friendly regulatory environment in Europe and the US

On the regulatory front, Gnodde remarked that there has been a significant drive over the last year towards completing key elements of the post-crisis regulatory agenda. The most recent focus has been on the implementation of MiFID II, which had largely been smooth down to a substantial effort from both the industry and regulators. Looking ahead, he stressed the importance of redoubling efforts to achieving a Capital Markets Union, particularly in a post-Brexit context, to ensure that the EU has deeper, more integrated capital markets in order to improve access to funding for all.

CEOs need certainty… but they are facing changes in their operating environment

Against this positive backdrop, Gnodde remarked that CEOs are navigating some complex and potentially far-reaching changes:

1) Trade tensions escalating

Gnodde expressed concerns about the potential for a slowdown in global trade given a change in trade policy from the US and the ongoing uncertainty with Brexit. However, he does not believe that there is a desire on either side of the Atlantic to end free trade. Importantly, there is awareness on both sides that a reasonable solution needs to be found.

2) Brexit

There is still much uncertainty around the shape of the future relationship between the EU and the UK. Gnodde stressed the private sector alone cannot deliver a smooth transition in the event of a 'no deal/no transition' Brexit. He also underlined that strengthening supervisory cooperation arrangements is essential no matter what the future relationship in financial services looks like.

New questions are inevitably brought to the fore by Brexit, such as how to maintain the benefits of financial integration; how best to grow capital market financing in Europe; and how to ensure that European clients continue to get competitively priced financial services. Gnodde said we should spend more time asking ourselves what kind of banking and capital markets we would like to have in Europe in the next 5 to 10 years and how we can work together to meet the needs of European citizens.

3) Technology

Gnodde said that technology brings enormous opportunities which can be harnessed – not just for start-ups but for established businesses. It is important that policymakers don't unnecessarily constrain business models or companies' ability to adapt so that firms are able to respond quickly in order to thrive in the current environment.

Conclusion

In conclusion, Gnodde noted that against this backdrop of unprecedented uncertainty, there is ground for optimism and he is encouraged by what lies ahead. However, challenges need to be tackled without delay; otherwise there is a risk of investment going elsewhere. Gnodde underlined that global challenges are presenting an opportunity for Europe to capitalise on its strengths, by lending support to multilateralism and global trade and reaping the benefits of economic openness. In doing, so Europe can forge an even greater role for itself in the world. ■

Bruce Thompson

Vice Chairman, Bank of America

Tackling the short-term operational and practical challenges of Brexit

Overall progress made in the preparation for Brexit

The three main issues that need addressing in the context of a hard Brexit are well identified. First is the ability of UK-based CCPs to clear for EU entities. There is also a significant question around contract continuity, particularly for lifecycle events related to

derivative contracts. Then finally there is the question of data-sharing between the UK and the EU. This is a major issue, because it is very hard for the private sector to deal with a situation where it cannot share data with a third country.

The financial industry learned from the crisis that it is incumbent upon it to be well-prepared to serve clients in such a context. Many constructive discussions are currently taking place with public authorities about the types of actions that would need to be carried out in the event of a hard Brexit. The issue however that gives pause is that, with the persistent uncertainty about the final Brexit scenario, the closer any decision comes to the 29 March the more likely a negative outcome is. The financial industry therefore needs to manage this situation in order to accommodate that uncertainty, but the short amount of time remaining is a major concern.

Current level of preparation of market participants and next steps

While there is a great deal of 'movement' happening and the feeling of progress, there are not that many changes that are actually being finalized, which in turn increases the level of risk. This is due to the multiplicity of actions that need performing and the current uncertainty about the final Brexit scenario.

The speaker's firm started its Brexit planning one year ago based on the assumption that there would be a hard Brexit, at a time when that was not the most widely-shared option. Their objective when starting this planning was to ensure that clients could be serviced seamlessly, wherever they are based i.e. in the EU, the UK or elsewhere in the world.

This led to planning some specific organisational changes to handle this situation, which are now being put in place. The first one is to create an EU-based bank through the merger of its UK bank into its bank based in Ireland, which requires an application process and court procedures that are underway both in the UK and in Ireland. This process should be completed by December 2018. The second change is to establish a new investment firm to conduct the activities that cannot be performed within the bank and an application process is also underway for that entity.

When considering the amount of work that is required for setting up what are in effect a new bank and a new investment firm, there is a cumulative effect that builds up, which further increases the level of risk. Besides the licensing process, a great deal of ancillary activities are indeed needed that are costly and lengthy to conduct and implement: i.e. setting up the systems and the operational capabilities of the entities; repapering clients in order to make sure that the firm is in a position to start transacting with them; connecting to the different financial market infrastructures, which is in itself a three-to-six month process; facilities work to renovate and expand offices in the EU. There is also a significant human resources dimension in this project that is often overlooked, with people that need relocating and responsibilities that need redefining. While it is relatively easy to define this on paper, implementing it in an effective way is a significant operational task, with many questions and practical issues that need addressing.

The industry needs to commit whatever resources are necessary to address the problems raised by a hard Brexit. While there are other key regulatory issues to address for banks such as the impact on their capital requirements, the main concern at this point is the systemic and cliff-edge risk that might be generated if something goes wrong in the Brexit context.

Level of preparation of end-customers

Discussions about Brexit preparations often only address the issues that financial institutions are facing, but rarely what clients need to do in this context or what their specific issues are. Financial institutions such as the speaker's institution are striving to set up new entities in the EU as quickly as possible and are discussing with their clients the implications of these changes for them. The objective is to repaper clients into new EU entities as soon as they are licensed and set up. Clients will probably start moving more quickly when the Brexit date comes closer, which is why moving as fast as possible to create EU-based entities to on-board them is essential, as well as monitoring the situation very closely. ■

Patrick Thomson

Chief Executive Officer, EMEA, J.P. Morgan Asset Management

Forthcoming challenges and prospects for the EU asset management sector

Challenges and opportunities facing the EU asset management sector

An industry representative underlined the significant growth of assets in the recent years at the global level and particularly in Asia due to the increase of central bank assets and sovereign wealth funds in particular. One of the major opportunities for Europe is to work out how to attract that pool of capital.

The speaker outlined two main challenges facing the EU asset management sector: the market and investment challenge and the regulatory challenge.

The investment challenge

Europe is reaching the end of an economic expansion that has lasted for over nine years. It is still in a quantitative easing (QE) environment with a tremendous amount of capital chasing returns. Emerging markets were experiencing a sell-off at the end of August at a time when the US economy was continuing to power ahead. In this context, it will be challenging for asset managers in Europe to ensure that clients remain sufficiently diversified. There has been a loss of volatility recently but more volatility can be expected in the future, possibly of a significant magnitude.

The regulatory challenge

The industry representative believed that the regulatory challenges facing the EU asset management sector are largely centred on Brexit at present. The speaker's firm, as many other asset managers, is planning for a hard Brexit and considers this to be the most prudent approach when faced with the uncertainty surrounding the Brexit negotiations. The representative's firm manages the assets of many pension funds, government investment agencies and individuals in Europe, and it needs to be prudent in the way that it executes that responsibility. Clarity is essential in that perspective, about regulation and the way co-operation between supervisors will work going forward. One specific matter for concern, given the on-going review of the European Supervisory Agencies (ESAs) is the way the delegation of portfolio management outside the EU will be allowed to work in the future.

Coherence of the EU policy framework

The speaker considered that the existing EU fund policy framework generally provides coherence, despite the number of different regulations that asset managers have to contend with. The UCITS Directive in particular, which has evolved over time through detailed consultations with the industry and other stakeholders, is seen as a very successful regulatory framework within the EU and also as a genuinely international standard that has been exported to other parts of the world, notably Asia and Latin America. UCITS is predicated on a coherent set of features that ensure trust and confidence in these products: a high level of investor protection; a clear and concise set of rules that are consistent and predictable; and stringent liquidity rules. This framework ensures investor protection, both within and outside the EU, and provides savers with investment choice at a relatively reasonable cost. It is also a useful tool for introducing more investment into the EU economy from outside, which is essential.

Furthermore, the industry representative supported the Pan European Pension Product (PEPP) proposal and believed that UCITS are relevant in the context of this product. Creating a standard pension product that helps workers save for their pension and that can be passported around the EU, allowing them to continue to save for their pension without incurring friction or costs when moving from one jurisdiction to another, seems very sensible.

It is important, however, that any new regulation proposed should be thoughtfully deployed. Concerns remain around the PRIIPs regulation (packaged retail investment and insurance products) in particular, some aspects of which may not always be in the best interest of fund investors. Generally speaking, the Commission should make sure that regulations are genuinely working for the end customer. Many in the industry have articulated the challenges raised by PRIIPs to the Commission, and it is hoped that they will be considered.

Priorities of the upcoming Commission in the asset management area

Sustainable investment

Building a framework, a taxonomy and a set of principles around sustainable investing can potentially provide Europe with a clear advantage, the speaker believed. Giving an Environmental, Social and Corporate Governance (ESG) direction to investments will generate value over time. That means in simple terms that well-run companies should outperform badly run companies. Europe has a clear leading position in the area of sustainable finance at present with many large European institutions already having a significant amount of experience and technical expertise in this field. Most of the sovereign wealth funds and institutional investors in Asia for example are assessing this topic very seriously and are looking to Europe for guidance and leadership on this.

The taxonomy will be difficult to agree on and work is still needed to define the appropriate measures and metrics, but this is worth the effort because, as UCITS has shown, once a leading position has been established in a particular part of the market, it is easier to maintain it. A clearly articulated taxonomy around what ESG actually means, will allow promoting European ESG principles and regulation as a leading gold standard in this area.

Customer choice should however be carefully managed. It is critical that the ESG policy should not be too prescriptive and should avoid targeting only certain industries or sectors, because that would undermine the entire principle of sustainable investing.

Predictability of the EU fund regulatory framework in the Brexit context

Predictability is a key factor of success for attracting long-term investors, the industry representative emphasized. Europe is at present an attractive investment destination because of the predictability of its regulatory regime, compared with the current situation in the US for example where there are some concerns such as investment restrictions being envisaged on certain industries. The speaker's firm, an asset manager, acts on behalf of its clients and wants to ensure, particularly with regards to Brexit, that there is minimal disruption for them and that clients in different jurisdictions can continue to be served in an efficient and cost-effective way.

The possibility of maintaining current arrangements regarding the delegation of portfolio management services outside the EU is essential in this perspective, because this is a key component of the global model that the asset management industry is built on. Having authorities questioning this principle, as is the case at present, undermines the predictability of the EU fund framework. The industry representative strongly encouraged policy-makers to bear this in mind and to take concrete steps to clarify rules and how supervisory co-operation will work in the future in relation to delegation. ■

Jacques de Larosière

Honorary Chairman, Eurofi

Remarks on the future of the European Monetary Union

The problem of the Union's imbalances is wider and more complex than a pure European issue. What is happening in the Union in macroeconomic terms can be described as follows:

1. After the sovereign crisis of 2010 and thereafter, peripheral countries were forced by the markets to adjust. And they did:

- Their budget deficits have regained "acceptable levels" in the vicinity of 1 to 2% of GDP (and primary surpluses are typically above 1%). Therefore, debt levels are stabilizing;
- Their current accounts have reached equilibrium and even, in some cases, significant surpluses (against 2digit deficit figures a few years ago);
- This has been achieved by the containment of domestic demand in the face of high unemployment.

2. But, as this adjustment was taking place, "northern" current surpluses were reaching unsustainable levels (NL 10%/GDP - Germany 8,7%/GDP in 2017)

This was not the result of peripheral profligacy. The surpluses were exacerbated by the "specialization factor" common in Monetary Unions: the most productive players get more and more successful as they benefit from the relatively weak average exchange rate of the Union at large. In a way, the adjustment realized by the South has been offset by the growing imbalances (surpluses) of the North. In a "normal" Union, the excess savings of the North would irrigate the South and this would tend to even out the cyclical imbalances between different parts of the Union.

3. But this financial offsetting mechanism is not happening in Europe because of:

- A lingering lack of confidence;
- Which has crept into the regulatory setting: each country wants to "protect" its banks against potential contagion and the financial system is compartmentalized through systematic national "ring-fencing".

Therefore the need for a true banking Union which in many aspects does not exist.

4. Furthermore, current imbalances in the Union are becoming an international problem:

Around 10% of GDP surpluses in major exporting countries is just not compatible with the functioning of any international Monetary system.

It would mean the existence of a persistent regional engine of savings that would eventually distort world trade.

Such surpluses are thus considered as "fundamental" imbalances in IMF parlance and, therefore, must be corrected.

5. How to correct them?

The "old way" cannot work. You can ask a major deficit country to adjust. But you cannot ask a balanced country to continue to tighten its belts in order to mitigate the lasting and high surpluses of some other partners.

Why? Firstly, because it makes no sense: If the German national currency is undervalued – as has been calculated – by some 20%, it would not be wise to ask peripheral countries to nurture a 2% annual lesser inflation level than in Germany for 10 years in order to eliminate the discrepancy. It would mean continuing for years the shrinking of domestic demand in peripheral countries that need to grow. It would feed into political tensions and exacerbate populism … A Monetary Union should not lead to such a situation.

Secondly because the external world cannot tolerate for long the existence of a significantly depreciated currency that fosters a major trade surplus in the world. The present American reactions are there to keep us conscious of this danger.

6. There are many ways to solve the problem. Of course, one of them does not exist anymore, by construction, it is the change in depreciated exchange rates

But others are available:

- Surplus countries should to some extent rebalance their policy mix and support domestic demand (by promoting infrastructure expenditures for example);
- They should allow some form of income rebalancing: "a little more to wages and dividends and a little less to savings". These are rather usual traits of changes in macroeconomic policies;
- Some collective forms of action in the Union should be promoted (a more significant European budget could support automatic stabilizers in case of asymmetric shocks);
- Barring that, one could imagine some automatic rules that would force large surplus countries as well as large deficit countries to adjust. Some ideas are contained in the memo. They have nothing to do with a "transfer Union"; they are intended to help achieving a more symmetric and fair adjustment.

These are not new ideas: the Macro Economic Imbalance Procedure has been approved and ratified by the EU Council but never implemented.

All of this is extremely urgent because the political changes are moving very fast.

If nothing is done, the worst can happen. ■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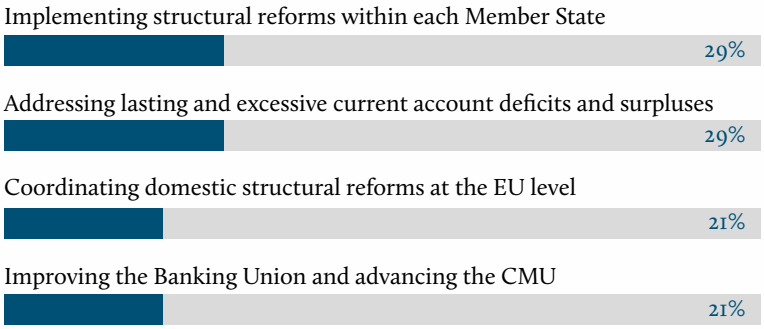

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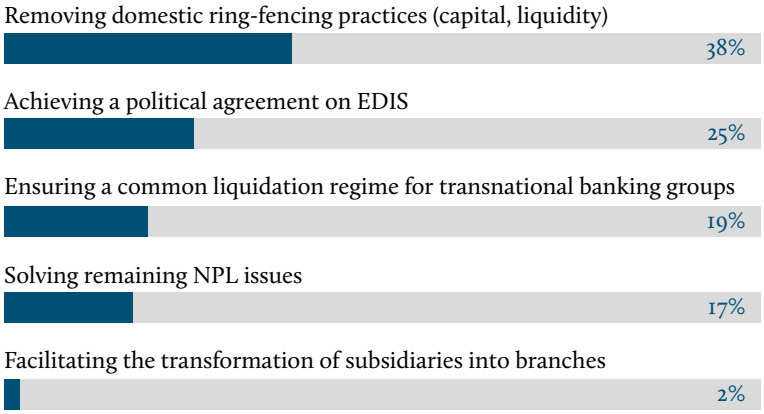

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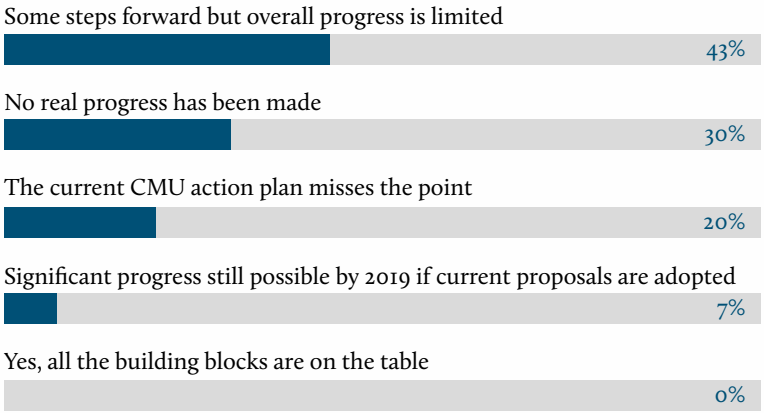

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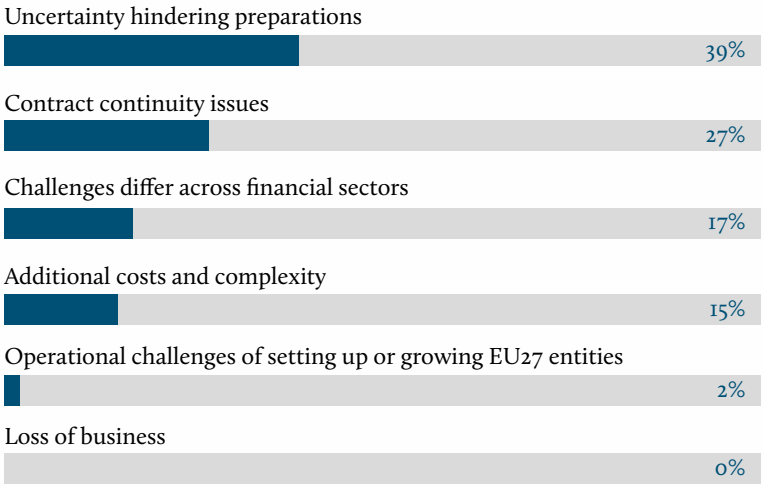

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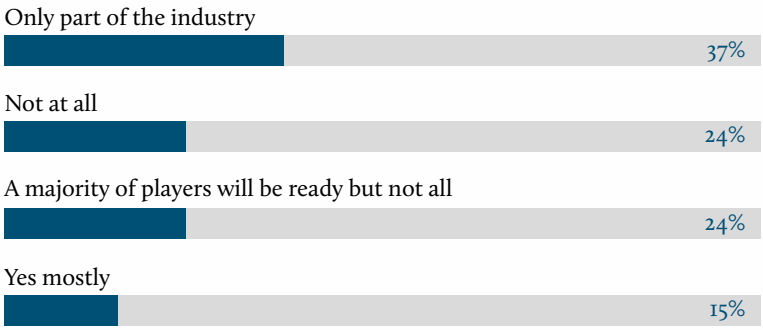

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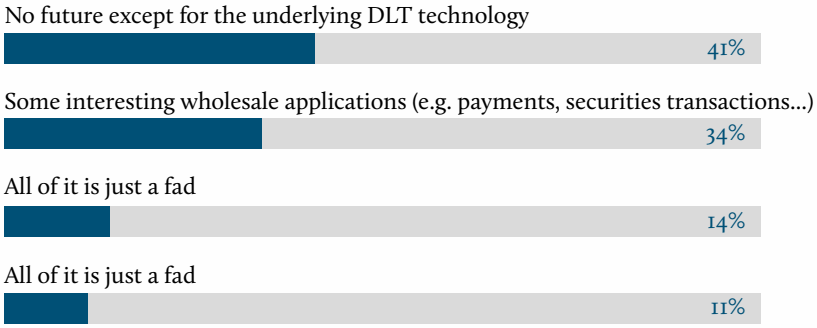

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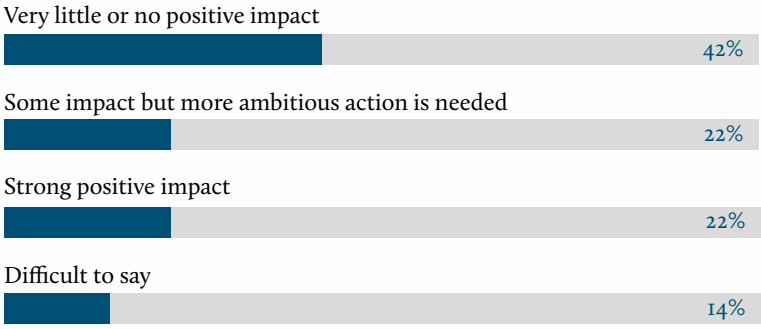
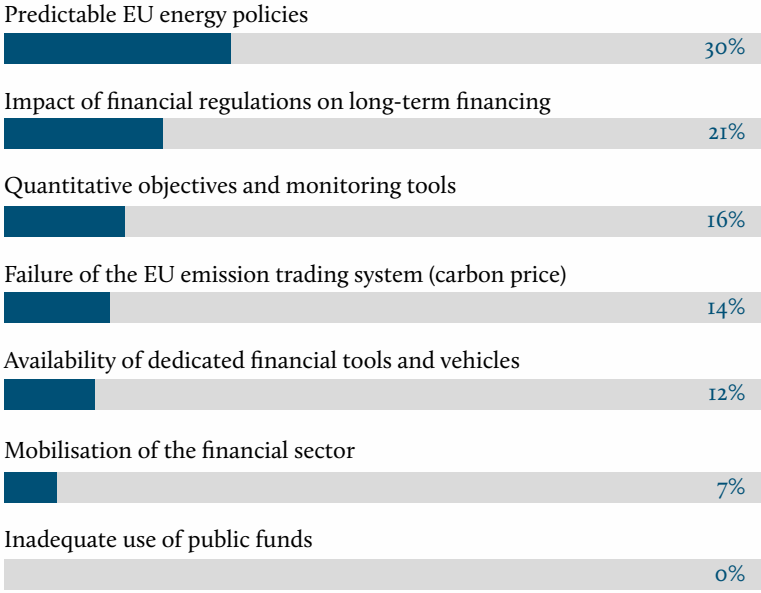
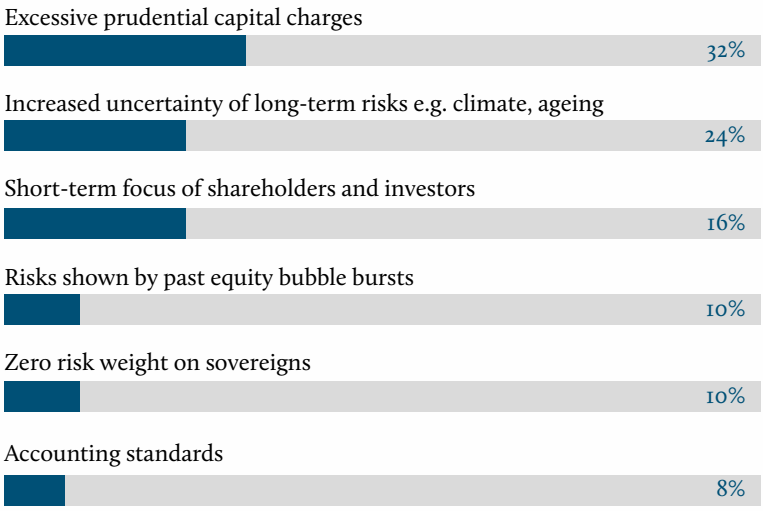


SUSTAINABLE FINANCE : Main obstacles to developing energy transition financing in the EU



LONG-TERM INVESTMENT : Impediments to long-term investment faced by EU pension funds and insurance cies?

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