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The **Eurofi** High Level Seminar **2017**

organised in association with the
Maltese EU Council Presidency

MALTA | 5, 6 & 7 APRIL

SUMMARY OF DISCUSSIONS

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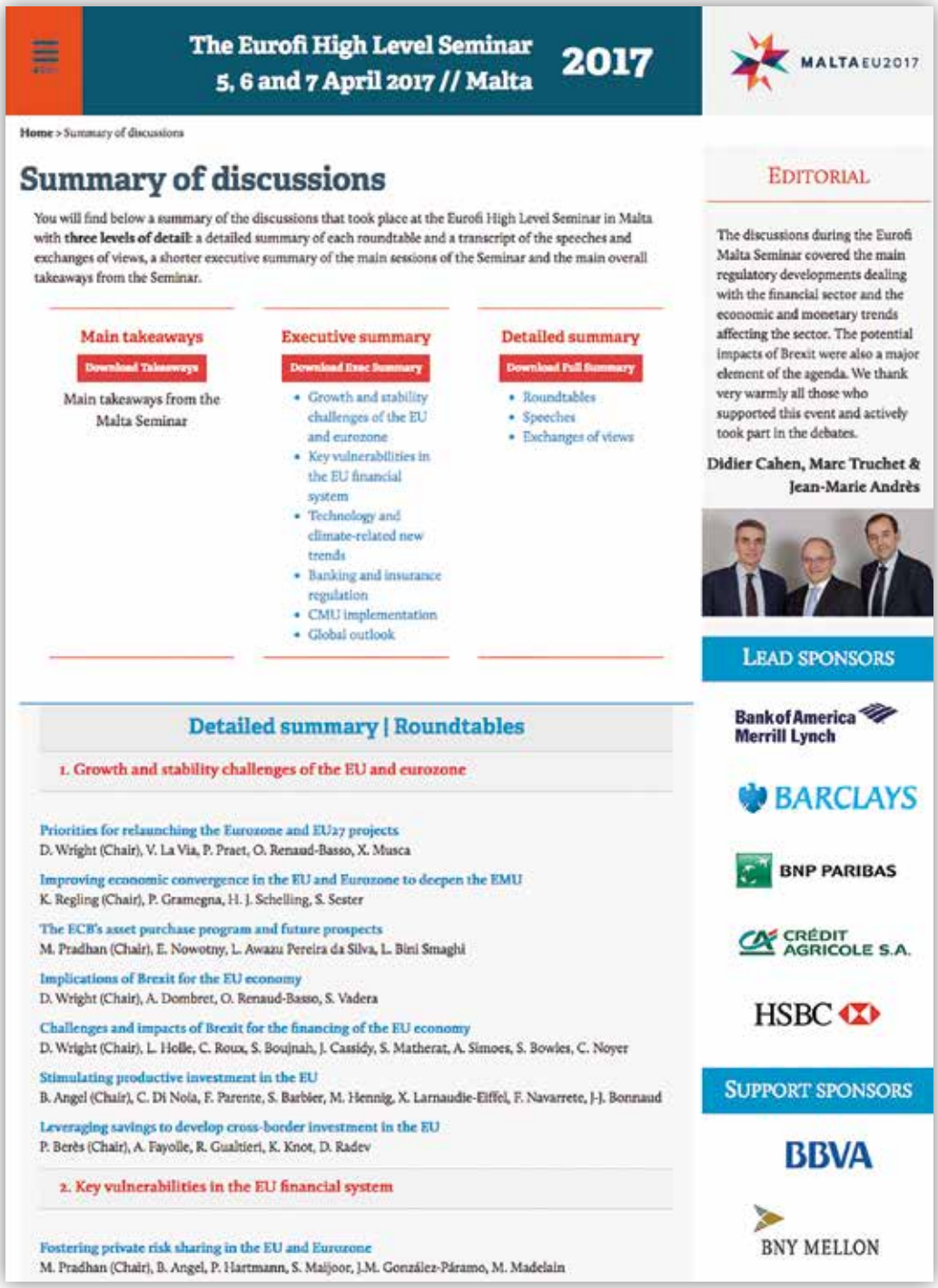

The Eurofi High Level Seminar 2017
5, 6 and 7 April 2017 // Malta

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Summary of discussions

You will find below a summary of the discussions that took place at the Eurofi High Level Seminar in Malta with **three levels of detail**: a detailed summary of each roundtable and a transcript of the speeches and exchanges of views, a shorter executive summary of the main sessions of the Seminar and the main overall takeaways from the Seminar.

Main takeaways

Download Takeaways

Main takeaways from the Malta Seminar

Executive summary

Download Exec Summary

- Growth and stability challenges of the EU and eurozone
- Key vulnerabilities in the EU financial system
- Technology and climate-related new trends
- Banking and insurance regulation
- CMU implementation
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Detailed summary

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- Roundtables
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Detailed summary | Roundtables

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Stimulating productive investment in the EU
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Leveraging savings to develop cross-border investment in the EU
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Editorial

The discussions during the Eurofi Malta Seminar covered the main regulatory developments dealing with the financial sector and the economic and monetary trends affecting the sector. The potential impacts of Brexit were also a major element of the agenda. We thank very warmly all those who supported this event and actively took part in the debates.

Didier Cahen, Marc Truchet & Jean-Marie Andrès

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The **Eurofi** High Level Seminar **2017**

Seminar organised in association with the **Maltese EU Council Presidency**

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SUMMARY OF DISCUSSIONS

Strengthening EU prospects in a period of major change

CONTENT

EDITORIAL

The Eurofi High Level Seminar 2017 was organised in Malta in association with the Maltese EU Council Presidency. More than 600 participants from the EU and international public authorities and the financial sector attended this three-day international event.

Over 170 speakers contributed to the 21 sessions of this Seminar, covering the main regulatory developments in the financial sector and the economic and monetary trends affecting the sector. The potential impacts of Brexit and new technology and climate-related trends were also major elements of the agenda, as well as the prospects of global regulatory coordination.

In the following pages you will find an executive summary of the roundtables that took place during this international Seminar, transcripts of the main speeches, summaries of the exchanges of views, and also an outline of the main take-aways of the Malta Seminar.

More detailed summaries of all the sessions of this Seminar can be found on our website www.eurofi.net.

We hope you will enjoy reading this report.

Jean-Marie **ANDRÈS**
Senior Fellow

Didier **CAHEN**
Secretary General

Marc **TRUCHET**
Senior Fellow

Malta 2017

MAIN TAKEAWAYS FROM THE SEMINAR

GROWTH AND STABILITY CHALLENGES IN THE EU AND EUROZONE

- Nine years after the crisis, there are positive signs of economic recovery in the EU, but the pace is moderate and cross-border capital flows remain limited compared to before the crisis. The Juncker Plan and the ECB monetary policy have had positive effects, but challenges remain that include the expected rise of interest rates and the lack of policy space to deal with possible future risks.

- **Improving the mobility and allocation of capital and private risk sharing within the EU are essential to restore growth and improve the resilience of the EU economy.** The Banking Union and the Capital Markets Union (CMU) should contribute to these objectives. A pre-requisite however is to restore trust between Member States, which involves **addressing legacy issues (e.g. NPLs) and improving economic convergence within the Union.** Measures have been taken to improve economic governance e.g. the Macroeconomic Imbalance procedure, but they have only been partly followed. Effective economic convergence in all parts of the Union would indeed favour the integration of EU banking and financial markets and encourage more cross border investment. It would moreover help to improve the competitiveness of each Member State, making the euro area more resilient, and would facilitate politically the implementation of additional public risk-sharing mechanisms such as a European budgetary stabilization fund.

- The euro in itself and monetary policy cannot solve domestic structural problems, the responsibility for which rests with each Member State. In addition, deepening the EMU is difficult so long as the existing rules aiming to ensure fiscal discipline have not been met by all Member States. Therefore complying with existing rules and objectives which should be enforced more vigorously, should be the priority.

BREXIT IMPLICATIONS

- It would benefit both the EU and the UK if an appropriate post-Brexit agreement could be found allowing, as much as possible, a preservation of existing financial market integration.

- An EU-UK free trade agreement based on mutual recognition and regulatory cooperation is advocated by many stakeholders, but ensuring that regulations remain consistent over time and that single market rules are not circumvented may be incompatible with the UK's political objective of 'taking back control', many considered. **Financial institutions should therefore prepare for a hard Brexit with possibly no deal or any proper transition period.** This requires initiating licensing processes and examining any implications of Brexit regarding the location and supervision of key financial activities especially those of systemic significance for the EU.

KEY VULNERABILITIES IN THE EU FINANCIAL SYSTEM

- A CCP failure is a very remote risk given the existing lines of defence, but it cannot be totally eliminated. **While appropriate risk management is crucial in the first place, the implementation of credible resolution arrangements is necessary** for providing legal certainty, ensuring that interests are well aligned and encouraging market participants to solve problems during the recovery phase. **Defining appropriate requirements regarding UK-based CCPs that have significant systemic relevance for the Eurozone,** given the volume of euro-denominated clearing that they process, is moreover essential in the context of Brexit.

- **Macro-prudential tools and supervision and wider stress tests could also help to improve the monitoring and mitigation of vulnerabilities from asset management activities.** However, these approaches need to be proportionate and should apply to an appropriate range of products and activities in order to provide investors and asset managers with the right incentives.

- **A major forthcoming challenge for reinforcing financial stability is measuring exposures across financial sectors, encompassing pension funds, insurance companies, mutual and hedge funds, etc.** on the basis of an appropriate description of what could create or transmit systemic vulnerabilities, and **taking into account the specificities of each sector and related micro prudential rules that may have a macro prudential impact.**

BANKING AND INSURANCE REGULATION

- The EU banking industry is confronted with rapidly evolving technology, new competitors, regulatory and taxation uncertainty and a challenging macroeconomic environment. **Resulting reduced ROE and high cost-income ratios may raise overcapacity issues, requiring further consolidation and changes in bank business models.** While assessing the risks related to these changes, regulators and supervisors should ensure that a level playing field is maintained notably between fintechs and incumbents, without impairing innovation and consumer protection.

- Bank regulation in Europe should ultimately aim at building an effective single banking market with an appropriate level of consolidation and competition. This requires notably **reinforcing trust between EU supervisors and also making sure that international banking standards take into account appropriately the specificities of Europe where banks are the main providers of financing for the economy.** More generally, implementing international bank and insurance frameworks which account transparently for the risk profile of each region/country in order to achieve comparable outcomes, was considered essential for maintaining a level playing field globally and improving confidence in the financial sector.

- **Given the specificity and complexity of the risks of each insurance company, using a risk-based framework and internal risk assessment models is essential.** A regular comparison by the authorities of the modelling parameters used would help to increase trust in such approaches.

- **An early adoption in the EU of NSFR and FRTB would be inappropriate before further assessing their impacts and knowing how these rules will be implemented in the US and at the global levels.** Although they target major causes of the 2008 financial crisis, these requirements fail to match the actual risk and the short-term nature of certain specific banking activities, e.g. synthetic financings, repo transactions, market-making, etc. according to the industry, which may threaten the growth of smaller EU financial markets in particular.

- **Proportionality in bank regulation fosters competition,** potentially enhancing the resilience of the financial system and facilitating the transmission of monetary policy, **but it may lead to deviations from an EU single rulebook for banks.** This raises level playing field and consistency issues that need to be further examined by the EU public authorities.

MAKING THE BANKING UNION A REALITY

- **The expected benefits of the Banking Union are being delivered too slowly,** many speakers considered. Although

many steps have been achieved (SSM, SRM, elimination of 100 national optional discretions...), its completion faces many structural impediments, which disadvantage euro area banks at the international level.

- Some remnants of the banking regulatory framework that implicitly support home bias and create impediments to cross-border business need to be urgently removed. Moreover, **the Eurozone is still not recognised as a single jurisdiction for the purpose of international bank regulation.** Indeed, cross-border banking groups operating across the Banking Union face local requirements for their subsidiaries despite their centralised capital and liquidity management and resolution strategy. Symptomatic is the treatment of additional capital charges for systemically important banks for which cross-border euro area exposures are still considered as international ones, hindering any cross border consolidation and benefits.

CMU IMPLEMENTATION

- **The implementation of the CMU needs to be accelerated,** as it is essential for improving the growth and resilience of the EU economy. Results so far are mixed in terms of the development of capital market activity and of the implementation of some actions originally prioritised e.g. securitisation.

- **Strengthening EU supervisory arrangements is vital for developing EU27 capital markets, which will be more widely distributed across Member States following Brexit.** This involves considering a further centralisation of certain supervisory activities, a reinforcement of the powers of the ESAs e.g. in equivalence assessments and a review of the supervision of critical market infrastructures, as well as continuing to strengthen supervisory convergence. Having an appropriate combination of EU level and domestic supervision is also necessary for retail activities in particular.

- **Further developing domestic and cross-border equity markets is crucial for financing the EU economy and fostering private risk-sharing.** EU level initiatives providing retail savers with a European long term saving vehicle such as the PEPP and developing a European approach to crowdfunding are essential for the support of the development of EU equity markets, as well as providing appropriate research (notably on SMEs) and transparency. However strengthening local market ecosystems with proportionate regulation and an exchange of best practices is also vital.

- **Solving conflicts of law regarding securities law and improving the consistency of withholding tax processes are key priorities for developing cross-border investment, alongside actions to improve and better align specific features of domestic insolvency regimes.** While these changes should take place according to a European perspective, they also need to be made at the Member State level, which requires both pragmatism and ambition.

NEW TECHNOLOGY AND CLIMATE-RELATED TRENDS

- Current Distributed Ledger Technology (DLT) pilot projects focus mainly on less automated niche markets and wider-scale applications of DLT are still fairly remote, due to many challenges in terms of standardisation, scalability, legal certainty and liability. **Further developing DLT and other new technologies in the capital market area requires a technology-neutral and pro-innovation regulatory approach and a constant monitoring of innovations.**

- **EU climate-related investment requires going beyond the current contribution of the Juncker plan.** In the context of the CMU, the High Level Expert Group launched by the EU Commission, will

propose policy priorities likely to improve the assessment of long-term risks by investors, the development of the green bond market and the focus of public financial resources on the mitigation of certain risks that the private investor is not able to accept.

GLOBAL OUTLOOK

- **Increasing risks of protectionism and domestic focus are creating uncertainty about the future of global regulatory coordination.** Concern was also expressed about future developments in the area of international trade and possible threats to WTO agreements.
- Reduced international regulatory cooperation may lead to a fragmentation of capital pools, potentially reducing market efficiency and the diversification of the funding of the EU economy.
- Global coordination is also essential for fostering an international level playing field, for mitigating the risks of highly interconnected activities such as derivatives and sharing the data needed for assessing market weaknesses.

EXECUTIVE SUMMARY

1. GROWTH AND STABILITY CHALLENGES IN THE EU AND EUROZONE

2. KEY VULNERABILITIES IN THE EU FINANCIAL SYSTEM

3. NEW TECHNOLOGY AND CLIMATE-RELATED TRENDS

4. BANKING AND INSURANCE REGULATION

5. CMU IMPLEMENTATION

6. GLOBAL OUTLOOK

Malta 2017

EXECUTIVE SUMMARY

Key outputs from the seminar


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1. GROWTH AND STABILITY CHALLENGES IN THE EU AND EUROZONE

Priorities for relaunching the Eurozone and EU 27 projects

1. Fostering economic convergence and deepening the EMU

1.1. EU fiscal rules must be respected

Europe's problems look relatively small as a percentage of GDP, but are difficult to address. It has to accelerate what it is doing and implement structural reforms much more decisively to achieve stronger and persistent long term growth. Consistent implementation of the Stability and Growth Pact remains crucial. There is a fundamental lack of trust in structural and banking reforms; this trust needs to be regained.

1.2. Structural reforms have to be implemented

Growth is improving in Europe, but is still modest; the recovery is uneven. Europe needs to rebuild trust among its citizens, and to improve its policy framework: improving the policy mix, relaunching investment, continuing to pursue structural reforms and promoting fiscal responsibility should lead to common fiscal capacity and the appointment of a eurozone finance minister.

1.3. Europe needs a high level symbolic initiative.

In the view of one speaker, Europe could be more ambitious than the Juncker plan, working in 'win win' areas like common security; addressing migration and the 'neighbourhood policies'; developing free trade agreements with countries; investment and completion of the internal market; and a large initiative on youth unemployment, which would require better use of structural funds.

1.4. A more complete EMU

A more complete EMU is the foundation for a stable and resilient euro area economy; this type of longer term project is required to maintain its dynamics and ensure the resilience of the euro area.

2. Delivering what has been promised

An industry representative stated that if Europe has lost the trust of its citizens, it is because it made promises and did not deliver. The Greek issue needs to be dealt with, and the problem of NPLs needs to be solved. Contradictory messages are being delivered regarding the Banking Union: European leaders say that they want cross border mergers and pan European banks, but at the same time there is much regulation defining prudential requirements related to cross-border banks in the euro area on a solo basis and not on the consolidated one (liquidity, pillar 2 requirements, internal MREL...). Moreover, the Eurozone will only demonstrate credibility if it resolves legacy issues and shows willingness to compromise on the remaining problems.

The EU has often said in the past that its political initiatives and 'grand mission' mask the fact that it is unable to resolve some of its remaining difficulties. People are clever, and understand that there are things that politicians and parliaments are not able to resolve, but they lose confidence in politicians if they are unable to deliver things they have pledged. However, as the economy is currently picking up in the eurozone, Europe is in a good position to address its remaining problems, to prepare itself for the 'grand initiatives'.

3. Making the Banking Union a reality

3.1. An effort from all sides and countries is required

The questions on the table are difficult to solve. The EU has done a great deal to provide solidarity, put together common instruments and provide financial support for countries; rebuilding trust will require the involvement of all parties and countries. Indeed one cannot live long with an asymmetry between supervision where one mutualises responsibility and resolution and where the consequences of potential bank failures are still predominantly national. The situation is unstable. Concrete examples >>>

>>> include a lack of fungibility of liquidity or capital. The fact that the euro area is not considered as a single jurisdiction may result in applying higher capital buffers to euro area GSIBs. This hinders banks in particular from becoming more European. Progress is therefore needed.

3.2. The urgency of agreeing an ambitious timetable for implementing and completing the Banking Union

Banks are key in the transmission mechanism of monetary policy. Europe currently has a collection of national banking systems exposed to their own country, with limited cross border private risk sharing. Even if a bank has no more sovereign exposure in its balance sheet, it is still exposed to its national economy, and therefore if the government of the country has a problem with public debt sustainability, so does its banking sector. There need to be cross border banks, operating within the context of the Banking Union.

To make progress, one speaker stated, there is a need to agree on the roadmap to complete the Banking Union and, ultimately, grant a European licence. Macro economically, doing so is feasible, even if it is politically difficult. Currently, national supervisory or resolution institutions overstretch their mandate. There are serious issues with the current position: the window is relatively small, and once the political situation in the two pillar countries of the union, France and Germany, is clarified, the project can then be relaunched in a credible way. Another speaker commented that once people see that things are happening, and agreements are made, confidence can then be very quickly regained in the economic and financial sphere.

A public authority representative added that two issues are forthcoming in relation to banking: one related to common deposit guarantee schemes (EDIS), and the other involving the permanent backstop to the Single Resolution Fund. These issues will be difficult to address, but compromises will need to be made.

4. Implementing the Capital Markets Union

4.1. Priorities to move forward

More progress is desired in the delivery of a CMU; the Italian Government recently issued a paper suggesting how to move forward. The basic concept is to look at CMU as a single undertaking, with a European approach to policymaking and a key principle for free markets to produce balanced outcomes; however, a system is also needed which can effectively address market failures. The key priorities are to effectively serve the needs of small and medium sized enterprises (SMEs), to enhance the cost effective availability of risk capital funds, to ensure that the rules of the game are effectively and uniformly enforced by the supervisory framework, and to complete both Banking and the Capital Markets Unions, along with finalising solutions to the legacy issues.

4.2. Brexit changing the overall picture

Brexit is changing the overall picture, and in the view of one speaker, if Europe wants to make progress on capital allocation, the euro area must be looked at as a single constituency. A public authority representative added that, in a way, Europe has a Banking Union, but without the benefits of such. CMU should also be a higher priority because of Brexit. That gives indeed the EU a higher priority to develop its financial markets internally and facilitate access to the market for all kinds of companies. There is progress on securitisation and prospectus, but it is slow. More focus and political attention should be given to the project. The representative looks forward to an ambitious mid term review process of the CMU agenda. The departure of the largest non-Banking Union Member State is an opportunity to explore the linkages between the Capital Markets Union and the Banking Union. All remaining 27 Member States have a vital interest in the success of both policy initiatives thus furthering financial integration. ●

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

1. The notion of convergence is at the heart of the Economic and Monetary Union

Convergence can mean different things to different people. In the Chair's view, countries can successfully function in the monetary union even with different income levels, as long as they avoid excessive macroeconomic imbalances. Preventing imbalances is more important for a well-functioning monetary union than nominal or real convergence.

There has never been a common currency like the euro, and there are many possible ways in which convergence can be introduced. Europe can, >>>

>>> and does, have economies with a different degree of development, income and with specific characteristics. It is therefore an illusion to believe that the European Union could have a macroeconomic policy that would be the same for all of its members and deliver exactly what every country needs.

As there is no economic government in the euro area, there is a need for a rules-based approach, with the Stability and Growth Pact, the Macroeconomic Imbalance Procedure and the European Semester. The European Union and the euro area have a remarkable economic governance toolbox at their disposal to enhance convergence and reduce imbalances; its full potential has not yet been employed.

A public authority representative added that the EU has some problems, but these are not problems that are exclusive to Europe: in Italy, for instance, there are very significant macroeconomic differences between the north and the south, but there are also significant disparities between different parts of the United States and of China. This is a problem faced by many countries and as long as Member States are responsible for their own economic policy, it is very difficult to achieve sufficient economic convergence.

2. The European economy is doing well overall; the European Union and the euro are success stories

The euro has repeatedly proven itself to be a robust currency, fostering a stable monetary climate. It has delivered material benefits: inflation has been kept under control, which has led to lower transaction costs. All economic players benefit from lower interest rates: households when they purchase a property, companies when they invest, but also governments and hence taxpayers. Spreads may temporarily react to political uncertainties, but remaining in the euro continues to be an efficient protection against such fluctuations. The euro is also simplifying day-to-day life for citizens and promoting capital market integration. Financial markets are more attractive to domestic and foreign investors, more liquid, and thus more efficient. This facilitates price comparison, benefits cross-border trade, and has given euro members a global voice on the international scene.

The main task for politicians now is to explain these benefits to EU citizens, such as with the campaign for the presidency of France. The single market is another good example of this, as illustrated by Brexit: the United Kingdom wanted to leave the EU, but remain in the single market.

Regarding the economic environment and income distribution, Europe is doing a lot better than is often perceived. Economic growth in the euro area is now back in line again with the US, and income distribution has not deteriorated much in Europe over the last 10 years, while it has deteriorated massively in the US, China, and in other parts of the world. Benefits from growth are therefore spread more equally in Europe than in America. There still remain some weak spots to be handled, including Greece, but Europe has now set up a Banking Union, and it is preparing the CMU. It has also built firewalls which are very important for the euro area and the European Union, like the ESM.

3. The euro in itself cannot solve the structural problems of the different countries. It is therefore essential that governments should 'do their homework'

3.1. Structural reforms are needed to boost potential growth and productivity growth in the euro area and to improve the business climate in some Member States

Responsibility for structural reforms rests with the EU's Member States. The causes of stagnation of investment in Europe are in great part structural, and structural reforms are therefore essential for stimulating investment growth in Europe. Member States need to take measures that improve the allocation of resources, increase productivity and competitiveness, improve market labour flexibility, support innovation and strengthen the business environment (operating margins of enterprises). Vigorous implementation of the Banking Union, including bail-in and bank resolution, is important, while judiciary systems should support the workout of problem loans. However, realisation of these measures is often fiercely resisted by vested interests.

3.2. Increasing incentives for Member States to stick to the rules and engage in reforms

In the view of one speaker, Europe needs to move towards mechanisms that provide strong incentives to comply with the rules and implement structural reforms, such as stricter conditionality for payments from the EU budget and structural funds, or a system of benchmarking of economic policies and outcomes to facilitate comparison among Member States and stimulate reform efforts. There is now a window of opportunity to begin structural reforms, both of Member States and of the EU. Improved economic governance may facilitate reforms, but cannot lessen the responsibility that Member States have.

3.3. Do we need transfers to promote economic convergence?

The Chair raised the question of whether transfers are necessary to promote convergence, noting that >>>

>>> with the EU budget, there is a lot of money flowing between countries; the Chair does not see a reason to add to this. Despite this, a small fiscal capacity, in the form of a stabilisation fund or an insurance scheme, could strengthen risk-sharing and tackle dramatic asymmetric shocks in the euro area without raising permanent transfers or debt mutualisation. In addition, risk-sharing through credit and financial markets can be promoted through completing the Banking Union and implementing the Capital Markets Union.

In one panel member's view, Europe is 'in the middle' between giving all responsibilities to the European Union and keeping all responsibilities with the Member States. Europe has done what it can in terms of monetary policy; the EU's Member States maintain a large amount of responsibility, and are responsible for fixing the problems within their economies. The Chair replied that it is important for Europe to employ its cohesion and structural funds: doing so helps to bring the Member States and the economic development of these states, closer together.

4. Deepening the Economic and Monetary Union needs a solid foundation built on mutual trust and confidence

4.1. It is difficult to make progress in deepening the EMU so long as existing rules have not yet been met by all Member States

On the European level, it is important to keep to the rules that have already been created; not all of these agreements have been fulfilled. For instance, the average level of debt to GDP in the euro area is around 90%, despite it having been agreed that the level should be 60%. During the Estonian presidency, this issue will be emphasised.

4.2. Complying with existing rules and procedures should be the short-term priority for improving the EMU

A representative of a public authority thought that there are already enough rules, but these rules need to be adhered to. Another public authority representative stated that for a number of Member States, the deepening of the EMU is very much dependent on how they can jointly demonstrate the ability to follow the rules based approach. A third public authority representative agreed that there should be no treaty change; it is more important to apply the treaties that already exist.

4.3. Increasing financial stability by implementing and enforcing the rules more vigorously

The Commission has to fulfil its task of policing how the debt reduction target is met and whether this is persistent; this would contribute significantly to strengthening financial stability within the EU. There has to be clear political will to follow the rules based approach and to implement the structural reforms. The present set up seems sufficient in principle, but implementation and enforcement of rules and procedures are not. Thus, first of all each and every actor has to stick to the agreed rules, and the European Commission has to implement and enforce these rules vigorously and even-handedly.

4.4. Delivering what has been decided

A public authority representative stated that the European Union should also prioritise finishing the work that it has started, including the Banking Union and CMU. Procedures such as those to limit tax base erosion and profit shifting (BEPS) have been started, but need to be finished.

4.5. The European Union should concentrate on 'big points'

The public authority representative continued by stating that the European Union should concentrate on 'big points', although it is also necessary for rules to be detailed. These big points include immigration and security, climate, and digitalisation.

4.6. A 'stepwise' process

The deepening of the EMU has to be a 'stepwise' process; a lot of managing of expectations will be involved. Europe must avoid trying to promote the deepening of the EMU on false pretences; there has to be a clear political will to follow a rule based approach and to implement the structural reforms that are inevitable in a more integrated EMU. One public authority representative stated that the points that should be focused on over the course of the next three and a half years should deal with unfinished business, creating growth and employment, dealing with the 'critical points', and beginning a programme of enhanced cooperation among the countries that want to be involved.

4.7. Risk sharing and risk reduction should go hand in hand

A representative of a public authority stated that there is the possibility of doing more together as European nations, but the speaker's country is only prepared to engage in this cooperation if this includes both risk sharing and risk reduction. If other countries are reducing their deficit and taking the necessary measures, then time limited solidarity mechanisms can be developed in parallel; however, most people do not support permanent transfers to countries in which no progress is taking place. >>>

>>> 4.8. The white paper on the future of Europe published by the EU Commission is a good opportunity to discuss proposals to enhance EU economic policy governance and deepen the EMU.

One of the main topics over the next half of 2017 will be the European Commission 's initiative on the five scenarios. Speakers gave their views on these scenarios; one stated that the first and second scenarios are not feasible, and the fifth – involving treaty change – is not credible, as Europe has been built step by step, and forcing very ambitious change is going to lead to a loss of support. They added that the EU 27 should stick together to achieve a Brexit deal that does not punish the UK or disrupt the rest of Europe.

4.9. Europe needs to address the Non-Performing Loans issue

Europe will need to work hard to address the issue of NPLs. Doing nothing will mean a return to the crisis. A number of risks and drawbacks are attached, including financial stability, lending to the real economy, and the macroeconomic conditions in the countries that are affected by high NPLs. There are clear rules to solve this issue (BRRD etc.) which have been successfully implemented notably in Austria. Questions also need to be answered about the consolidation of the banking systems within some Member States. ●

The ECB's asset purchase program and future prospects

1. The accommodative monetary policy of the Eurosystem: effects and side effects

The ECB has engaged in a very bold expansionary monetary policy, particularly since the beginning of 2015. It is currently providing €2,500 billion of central bank liquidity, about two-thirds of which is generated through the extended Asset Purchase Programme (APP). This is a very intensive operation but it has been successful.

The positive aspects of the 'ultra-accommodative' monetary policy of the ECB are much greater than the side effects. GDP is growing, and the danger of deflation no longer exists, so this is an area in which the ECB has been successful. Unemployment has started to decline. Since 2013, four million new jobs have been created in Europe. The recovery in investment continues to benefit from very favourable financing conditions. There are also worldwide, positive developments in the world economy. The signs of a stronger global recovery and increasing global trade suggest that foreign demand should add to the overall resilience of the euro area. Taking everything together, this has proved to be a success.

Of course, a long period of ultra-low interest rates implies risks: for instance, low interest rates may induce households and businesses to invest in riskier assets. As monetary policy makers, the ECB are concerned about these risks and monitor them closely.

Central banks saved the world from another Great Depression, and this has to be noted and commended. The positives are beginning to be realised now, although they have been somewhat slow to appear. The problem with QE is that, as was famously said, it works in practice but it does not work in theory. There are also collateral effects when too much of this 'strong medicine' is used for too long, in terms of the financial health of the industry.

The downside of the current situation is one of negative rates. Over time, this could increasingly hurt bank profitability and thus the credit channel. Europe entered a situation of negative rates in the hope of not getting into QE, and both negative rates and QE occurred. The question in the current environment arises from the uncertainty about when and how to exit. One challenge that the ECB faces is sequencing: whether getting out from negative rates or from QE should come first. It could be argued that, if negative rates can be escaped from first, the impact on long-term rates will be in the same direction, so more QE should take place; this could be a paradox arising from trying to exit by doing more. It is not clear to the industry how things will happen. The monetary policy should not be regarded only according to the interests of banks, because it is in the interests of the economy as a whole, and the current monetary policy has reduced the cost of risk to very low levels.

One particular side effect of QE has been its cross-border financial spill-over effects, particularly on emerging markets. These policies tend to increase local financial exuberance and to boost local credit markets. They transmit into emerging >>>

>>> markets through spill-overs, rising asset prices and the appreciation of exchange rates. That made life more complicated for local policymakers trying to manage their own financial and business cycles. There is perhaps a coordination policy problem here, and one of the solutions to mitigate excessive cross-border financial spill-overs might be to use macro-prudential policies. Much work has been done at the BIS but also at the IMF on macro-prudential policies and spill-overs. Overall, these policies have helped to mitigate the direct and indirect effects of the crisis, but achieving a smooth coordination will perhaps be the most difficult part.

2. Precautions need to be taken regarding the exit of the ECB's quantitative easing

Europe could learn from the US experience. The US had started exiting QE perhaps too hastily with the taper tantrum and had to improve its way of communicating to markets, but overall, the on-going exit process in the US seems to have been managed in a fairly good manner. Markets have been shaken to an extent, but that is unavoidable. There is a need to be careful about timing in this process: in Europe, there were issues that arose from trying to exit a little too early, or being a little too late in doing certain things. Another issue is the transmission mechanism of QE. In the US, QE has also facilitated the deleveraging of the private sector, more than the public sector. This deleveraging has taken six years, however, whereas in Europe there have only been two years of QE. The deleveraging process is still 'snowballing', so we have to be sufficiently patient. Additionally, the banking system is still greatly fragmented. There has been a serious impact from the recent regulatory changes, and the redenomination risk is still present. Fragmentation, in particular, remains an important element to take into account. Fragmentation is more benign now, compared to several years ago. It is natural to have some degree of differentiation in terms of sovereign-risk premium. This does not necessarily mean a loss of effectiveness in policy. However, withdrawing liquidity in a situation where liquidity is abundant but is not circulating well enough in the system could produce some quite negative reactions. There has also been some debate about the prolonged usage of APPs and QE, and withdrawal from either needs to be very carefully communicated.

The mandate of the ECB is price stability, and the question of debt levels is therefore only relevant insofar as it concerns for price stability. It is obvious that every exit from announced programs is a very difficult operation, and it is dangerous to be premature, but Europe does not want to be 'behind the curve'. A very clear policy decision for 2017 was made by the Governing Council in December 2016. The programme of asset-buying will go on until the end of this year, with reduced volumes. From 1 April, €60 billion will be bought per month, instead of €80 billion. Then, starting in the summer, there will need to be an examination of how the economic situation is evolving and how stable developments can be obtained.

One speaker did not perceive the redenomination risk. The markets do not question the existence of the euro. It was agreed that, in Europe, people are used to saying that there is no redenomination risk but, when going outside Europe, the question still arises. People in Europe 'have to preach'; people outside Europe are less confident, and are looking at election results very closely. Monetary policy should not compensate for this, but should take it into account. The markets are waiting for signals, because they have been told for years by Nobel prize winners that the euro area cannot work since its construction is not in line with that of optimal currency areas. In the Anglo-Saxon world, some people have been saying this since the creation of the euro, for different reasons. At one time, the markets were influenced by a redenomination risk, but this is not the case now. In any event, the signals from the markets are positive.

3. To encourage economic recovery and increase potential economic growth, structural reforms are indispensable

If there is one 'silver bullet' for these problems, it should be used, but the answer is a little more complicated. Central banks have done a great deal, and that needs to be appreciated. By making sure that the social fabric sticks together, they have helped to resist the current temptation of protectionism and populism. Central banks were not supposed to do everything. Monetary policy was never intended to be a substitute for structural reforms or for growth enhancing reforms, nor the only macro economic policy to be used. It became the 'only game in town' due to political-economy problems. Blame should not necessarily be attached to policymakers. Reforms are complicated, but are necessary and should make appropriate use of the time that monetary policy can buy to engineer structural reforms. However, structural reforms create winners and losers, and there is always a time inconsistency problem between benefits and costs. The role for monetary policy in a crisis is to do the utmost, but also to create the conditions for societies to engineer structural reforms. That requires more growth, which is being achieved in Europe, so things are moving in the right direction. Hopefully Europe will also reflect on what types of structural reform are needed. These will most likely have to do with the growth model >>>

>>> and sustainable environmental policies that will change technologies, as well as, particularly in advanced economies, more social inclusion and fairness. If monetary policy could be the first leg of this, hopefully this will be followed by a period of fair and profound structural reforms in Europe.

For the sake of future generations, potential economic growth in the euro area must be boosted. Unfortunately, this is not something monetary policy can deliver. It requires policies that provide the right incentives for investment. The sooner the structural reforms are implemented by Member States, the stronger and more sustainable the recovery will be.

The world is composed of, on the one hand, independent central banks and, on the other hand, of democratically elected governments. There needs to be mutual respect between these; the independence of central banks should be fully recognised but, on the other hand, central banks should also not try to be perceived as over influencing democratic governments. What can be provided is economic expertise, in fields that go beyond monetary policy. For a central bank to apply pressure to a democratically elected government would be inadequate. There has to be a dialogue, based on mutual respect. In some countries, unfortunately, there is a growing tendency to have a negative discussion on the independence of central banks. People need to be clear about the purpose of a central bank in a democratic society. The ECB has found the appropriate role; it pursues a dialogue with the political institutions, but as an independent player, and that is how it should be. Central banks should not rely on monetary policy as an instrument to push governments.

It was asked whether there is not some complacency in this perspective when affirming that there is no redenomination risk and no fragmentation, when TARGET2 balances are back to what they were in 2012. A question can be asked as to why the money is not circulating. The reply was that there is a certain element of fragmentation, but it is much smaller now. It must not be forgotten that Europe now has a banking union, so huge progress has been made. There have been studies by the Bundesbank and the ECB that show that this has nothing to do directly with fragmentation; it is more to do with certain technicalities of the APP. ●

Implications of Brexit for the EU economy

1. Potential impact and implications of Brexit for the EU

In the very short term, there has been no real economic backlash from Brexit. However, Brexit will ultimately have an impact on growth, a speaker believed; the current forecasts are of a loss in UK GDP growth of around 1%, and a quarter of that in the EU.

There may indeed be a significant impact of Brexit on the financing of the EU economy, the UK being the most important financial market in Europe, and second in the world and also given the high level of integration between the UK and EU financial activities. If Brexit hampers European banks and corporates in accessing London based financial services, this will affect funding conditions for Europe as a whole. Traditional banking services such as loans and deposits should be relatively easy to substitute for, but complex banking services such as derivatives clearing conducted in the City will be much more complicated to replace.

At the same time, Brexit presents an opportunity for Europe to create a much deeper capital market, particularly if the Capital Markets Union (CMU) can be accelerated. However, Brexit will also take up a great deal of time and negotiation, and will be the focus of a large amount of attention.

2. Priorities and possible outcome of the EU – UK negotiations

2.1. Priorities and appropriate conditions for the EU-UK negotiations in the financial area

All parties involved in Brexit should do their best to limit its negative impacts. There has been a good start to the negotiations; there is a shared view among the EU's 27 Member States about the objectives of the negotiation and also a shared understanding between the EU and UK that an alternative arrangement to the single market needs to be found, a speaker considered. This arrangement should allow preserving the unity and integrity of the EU27, with an indivisibility of the four freedoms, while also maintaining a very close relationship between the UK and the EU and a level playing field with a single rulebook. It is also essential that there should be no intention on the part of >>>

>>> the EU to "punish the UK" and the UK should not attempt any "cherry-picking" which would force the EU27 into a position they cannot accept.

The EU27 also needs to be able to ensure its own financial stability with some fundamental financial functions for Europe located in the UK. One speaker suggested that an agreement will need to be reached regarding supervision, providing the EU with an ability to supervise systemically significant providers and the UK with the reassurance that such risks can be managed. But the first step will be deciding how regulatory convergence and equivalence can be established.

2.2. Outcome that should be aimed for

One speaker considered that the goal that needs to be worked towards is a free trade agreement based on mutual recognition and regulatory cooperation. The City's ecosystem indeed currently provides the European economy with a depth of liquidity and attractive costs of capital (with 80% of EU27 capital market activity conducted through London) that would be jeopardized by any fragmentation. Such an agreement however does not need to cover all financial activities: capital markets are the most important topic and retail activities for example do not need to be included.

Achieving a free trade agreement in the defined timeframe is very challenging since such agreements take on average 7 years to negotiate. The current equivalence regime used in different EU legislations could form a basis, but this will need to be reviewed, enlarged and refined to be effective in the context of the UK. In addition an appropriate balance needs to be found between political, economic and market considerations, but at present the focus is more on politics, a speaker felt. The advantage though is that the EU and the UK will have a starting point of total regulatory convergence.

Without an agreement, there would be a need to 'safely disentangle' and 'rebuild' financial activities in EU27 with a sufficient depth of liquidity and risk capital, with adequate infrastructure, supervisory capability and governance, and this while retaining the ability to service clients, which would be very challenging.

The UK's decision to leave the EU will nevertheless inevitably bring fragmentation over time one speaker felt. An EEA type arrangement would have been necessary to maintain regulatory convergence over time, but since this is not possible, the UK wanting to take back its sovereignty, the UK and the EU may move in different directions in the future, despite a common starting point. For this reason it will then also probably be difficult for the EU to maintain a systemic infrastructure in a third country with potentially different regulations and supervision. Although an agreement might be reached regarding supervision, this will give rise to important issues of sovereignty in the future, the speaker believed, with political authorities wanting assurance that they can ensure financial stability in their jurisdiction, which is ultimately a national responsibility.

3. The need for a transition period and its feasibility

Two types of transition are necessary: a bridging and an implementation transition. The first is related to the fact that there may not be a new deal on the terms of the EU-UK relationship on the day of exit, and a bridging period will therefore be necessary in order to avoid disruptions for clients. Secondly, once the terms of exit are known, financial industry players will need to tackle many operational implementation issues (such as licences, regulatory approval, IT systems...), which will take a long time; it is therefore vital that these should be initiated early enough in the process.

One speaker stressed that it is difficult to define the transition period without knowing what the direction of the future EU UK relationship will be and that it is therefore very important that all parties should be prepared for the possibility of unsuccessful negotiations, even if this is not the desired outcome. Another speaker however considered that announcing the terms of a transition period very close to the date of Brexit would not be helpful and could make a 'cliff-edge' disruption more likely. ●

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

1. Uncertainty about the future EU-UK relationship

At present, the main issue that financial institutions, their employees and their clients are dealing with concerning Brexit, is uncertainty. The result of the on-going negotiations and the future relationship between the UK and the EU 27 are indeed difficult to anticipate. >>>

>>> One panel member emphasized that Brexit is a new situation and a signal of de-globalisation that business leaders need to adapt to. Two fundamental mistakes have been made in the UK: the first is wishful thinking, believing that Brexit would not occur and then, when it did, considering that its impacts would be easily mitigated and that there would be a smooth transition. The second is the belief that the present situation would never change: it is however the blunt reality that the City of London is going to cease to be part of the single market, which has been a key element of its success. Now the UK needs to decide which future it wants, but finding a consensus between those in the UK who want to 'take back control' and those in the EU who have a mandate to share control will be difficult, and there will be incremental costs associated with doing so. Another speaker responded that the UK side looks very unprepared because those who did not believe in the EU did not make the effort to understand how it works and are now doing so. 'Taking back control' will eventually mean doing things voluntarily that the UK was previously required to do, when in the EU.

In this uncertain context, clarity will need to be given to financial sector employees regarding their employment status in the future. One speaker predicted that London will remain an extremely important financial centre and therefore the best place to headquarter many financial institutions. There are however thousands of EU nationals working in the City and a large number also of British nationals working in other EU countries who have to be told clearly what will happen to them.

Customers have also expressed concerns about Brexit; it has frequently been said that separation between the EU and the UK will create de synergies and incremental costs. A significant area of concern for corporates is liquidity pooling and some are starting to change treasury locations or are working on back-up plans. One particular issue regarding cash management is that contracts are very long (10 to 15 years), therefore clients need to be informed about possible future changes. Other issues concern capital market liquidity, where stock exchanges or CCPs will be domiciled post-Brexit, and the incremental frictional costs of accessing those utilities in the marketplace.

2. Planning for a possible hard Brexit

In a recent survey, investors estimated a 40% likelihood of a 'train crash' Brexit, i.e. a Brexit without any agreement. Cliff edge risks are predominantly on the UK side, but nevertheless the EU needs to prepare for this kind of risk in parallel with its negotiations.

The best way for financial institutions to mitigate risks related to this situation is to prepare for a hard Brexit which involves first anticipating the worst case scenario resulting from the current negotiations, then developing an end state solution based on a 'logical' negotiation process, with the main goals being stability and certainty. Those that have not begun to prepare for the possibility of a hard Brexit should start immediately, a speaker emphasised. Another panellist however considered that most financial institutions have understood what is at stake and are getting prepared. If this is done properly there should be a smooth transition to the new state and no major impacts on the financing of the EU economy. Moreover Brexit should not be a reason for stopping projects.

One panel member explained that there are four particular areas that need to be looked at when planning for Brexit: licensing, client interaction, capital market activities and supervision.

The first area is licensing. A bank that wishes to deal with EU based clients and has not already gone through the full licensing process, will need to initiate this process early enough because it takes time and there will also be a need to build infrastructure in the EU and move people. For other players who already have a presence in continental Europe, the issue is to identify the activities that may need to be moved to the EU for regulatory purposes in particular and where these activities can be moved to, considering different factors such as real estate and tax. Many financial institutions are also examining the option of moving some activities to the US. One speaker from an institution that already has a significant presence in continental EU confirmed that impacts on that kind of institution are lower. There will be a need to move some activities but the lead time in their case is much shorter. In the end financial institutions will follow their clients although it is difficult to make final decisions about relocations until there is more clarity about the outcome of negotiations.

The second area to be addressed is client interaction: sales people who want to deal with EU clients will need to be based in the EU which might involve moving some front-office staff. The third is deciding where capital market transactions and notably derivatives ones will be booked and what this will imply. In the future the transactions of EU clients will need to be booked in the EU which requires having the appropriate IT capacity and re-documenting clients with on-boarding and KYC activities. Derivatives transactions will moreover need to be executed through so-called 'qualified CCPs' according to EMIR, otherwise capital requirements will escalate. If UK-based CCPs are no longer qualified >>>

>>> post-Brexit, this will involve complex transfers of activities and finding appropriate alternative CCPs in some cases. The fourth issue is supervision: many financial institutions operating in the EU will continue to have activities in the UK, and there will therefore need to be interaction between the UK supervisors and the European ones. If there is a loss of trust, and fragmentation of liquidity, this is going to be very expensive for the financial industry and may have a negative impact on the broader economy. A final issue is the location of risk management because some EU supervisors are requesting risk management to be located in the EU in addition to the front-office and the booking of transactions, a panellist explained.

One speaker emphasized the importance of avoiding market disruption in the period between the triggering of Article 50 and Britain leaving the EU, which means that, for instance, legal certainty in terms of existing contracts needs to be maintained.

3. Conditions for a continued interaction between EU and UK financial markets

3.1. Avoiding a circumvention of EU single market rules

An equivalence agreement between the EU and the UK is the way forward often proposed to ensure market access in the future, since the single market is no longer an option. However, several speakers stressed that the EU authorities should be clear about the conditions required. A panellist also emphasized that equivalence could only come after a difficult first phase of disentanglement.

Equivalence, which was designed to help 'at the margins' e.g. for avoiding double registrations, and not for managing all interactions with a major financial centre such as the UK. should not be a means of circumventing the rules of the single market. This involves clarifying that 'brass plating' will not be allowed and putting in place rules preventing UK financial institutions from playing EU jurisdictions against another. The ECB is developing consistent banking standards which will help this to be appropriately managed in the Eurozone, but improvements are needed in other sectors. There is a need in particular to spell out what is required from insurance and asset management entities that have their client base in EU27 in terms of workforce and competences based in the EU e.g. sales force, on boarding of clients, risk management, etc... Firms should not be officially managed by executives in the EU but in fact operated from the UK.

Potential equivalence will require common, high regulatory standards and strong supervisory cooperation, which may give rise to tensions with the principle of the UK 'taking back control' a speaker warned. There is also a need for a level regulatory playing field, and a framework that enables the EU 27 to manage financial stability risks that concern the Union.

3.2. Clarity about the transition period

A second element that needs to be defined is the possible transition period. A prudent management of the transition is in the interests of both sides and might be very useful in specific market areas. This transition will however need to be clearly defined, limited in time, and subject to effective enforcement mechanisms.

Any transition or implementation period should correspond to the amount of time necessary for each kind of activity to migrate in a safe manner, without operational risks, a market observer considered.

3.3. Supervision of UK based entities that are systemically important for the EU

Regarding financial stability, a speaker claimed that some essential activities need to be under the supervision of authorities that have a clear remit for the constituency those operations concern. The critical mass of activities that have systemic importance for the EU, including clearing, will therefore need to take place under the supervision of the ECB, the European Union's political authorities or the ESAs, because the British authorities cannot be asked to add to their remit the future of the Euro area. Regarding clearing, which is currently under the supervision of the National Competent Authorities, either the ECB or ESMA should be given this responsibility, or a new specifically created EU agency.

A market observer noted that it is likely that UK supervisors will take over many of the activities that are currently conducted by the EU Parliament and the Council at European level, which will help to depoliticise them. The way regulatory equivalence is managed in the UK with foreign countries is to make sure that there is an appropriate resolution regime in place and where third countries are lacking in terms of supervision, the UK proposes supervisory sharing. There is no reason why, for sensitive and global issues such as clearing, the same approach cannot be applied post Brexit, the speaker felt.

4. Developing EU27 capital markets

4.1. A significant development potential

In the longer term, the EU needs to work towards implementing the Capital Markets Union >>>

>>> (CMU), to develop a stronger, more efficient and more resilient capital market. The eurozone needs to rediscover the energy it has had in the past, and to realise that it has the potential to transform savings into debt and into equity, a speaker considered.

The EU27 indeed represent 86% of the GDP of the EU, and have many shared strengths: the highest concentration of large companies with a global strategy, of strong banks in good shape, and of a population with a relatively high standard of living, which generates a huge amount of savings.

4.2. The need to improve the EU supervisory structure

Even if the EU is cut off from London, there is no reason why CMU cannot continue, a market observer stated. But if the EU is serious about the CMU it will have to sort out supervision at the EU level, as well as being less political and opening the EU to other capital markets, Asia, and the rest of the world.

The EU needs to have a capital markets supervisor and this cannot be achieved just by empowering ESMA further, a speaker added. The capital markets sector is more complex than banking because market entities and the issues that they are facing are more diverse. In addition there is not an institution as strong as the ECB to take responsibility for capital market supervision. The level of discretion that such a supervisor could exert vis a vis the EU Commission will however need to be clarified, taking into account the Meroni doctrine (which sets down the criteria to be met in the context of delegation of powers from the EU Commission to other EU institutions). Supervisors will moreover need to be found who have the capacity to supervise all of these entities, some of which are very large. ●

Stimulating productive investment in the EU

1. Addressing current obstacles to investment

Due to the first flexibilisation of Solvency II in the field of infrastructure investment, insurers have found the possibility of investing more. However, there are still regulatory obstacles: insurers have no problem with the risk-based approach of Solvency II, but some of the calibrations of the standard approach must be revised.

Major insurance undertakings are already allowed to adjust the capital charge when they adopt an internal model. To allow for capital relief and possible recalibrations of capital charges, criteria need to be put in place alongside conditions to further focus the framework on certain assets, and ultimately lead the standard formula users to make additional efforts in order to better understand the risk behind these investments. For insurance companies it is ideal to be able to match very long liabilities with very long term assets, and it can be debated whether it should be justified consequently to use different calibrations for capital charges when the assets are matched. At the international level, some people are thinking in terms of activity based analysis; however, although this might improve the situation for the future, in the view of one speaker, the industry is currently 'handicapped' in its investment into equity. A public authority representative responded that their institution has looked at the equity figures, and the assumption that Solvency II penalises investment in equity is not confirmed. Monitoring will continue, and the framework can be improved, but they do not consider it is a 'disaster'.

In Italy, in the equity alternative investment market, companies issue €50 million, with only one third really floating on the market. There are also companies issuing only mini-bonds of €10 million, and these amounts of money are too small for any institutional investors. Italy has recently launched individual savings plans whereby a certain amount can be invested each year with less taxation if it is a long term investment, and at least part of it is in SMEs, which could help to eliminate some obstacles.

Another public authority speaker stated that until now, insurers could invest in sovereigns and get a good return; now, the return is usually a loss. A regulatory body representative responded that there are still incentives to invest in sovereigns, since Solvency II like other regulatory frameworks, does not have a capital charge for EU sovereigns.

IFRS 9 could also have some negative effects, since certain assets would be mark to market after the rules come into force, creating undue additional volatility and preventing insurers from investing there. >>>

>>> Regarding the CMU, one speaker stated, it is often thought that many measures after the financial crisis exaggeratedly favour stability at the expense of growth. In particular, too much investor protection limits investors' ability to invest in securities that are necessary to finance growth; the prospectus is an example of this, being 'useless and expensive', and something completely different is required.

The slow development of a number of funds, especially the ELTIFs, is another obstacle.

2. Developing the financing of SMEs

There is a mismatch in the market between financing demand and supply, which is a result of the new market conditions (reduction of the role of banks), the consolidation in the banking industry at the pan European or national level and the new monetary policy. These new market conditions force agents to behave differently from how they behaved pre crisis, which creates huge transitional frictions in the market, especially for SMEs.

The strategies that can be used in response to the new market conditions differ for the debt and equity space. The debt space has promotional lenders; however, securitisation needs to be 're invented', as, without it, banks will be unable to offload the risk they have originated. As soon as this issue is dealt with by the European Parliament, promotional lenders will be able to cushion the risk factor, providing banks with a neutral method for SME lending syndication. Ultimately, the main issue is offloading risk once it has been originated.

Part of the reason why the private equity market is so small compared to the US is that in the EU it takes too long for the fund managers to raise the money. Although the fundraising timespan of fund managers could be speeded up, in the short term the solution can only come from those private companies entitled to hold citizens' savings, benefiting from a friendlier environment which would enable them to make private equity investments. Institutional investors may envisage increasing their contribution to such securities provided that the level playing field between the various institutions who buy on the stock exchange is restored.

Demand is also key. The industry needs SMEs and companies that open their capital and issues in order to be invested in. To do so, incentives and appropriate culture are required: one example is the Italian stock exchange, which has created SME inductive programmes, called the ELITE, to teach companies how to go to a bank to ask for a loan and how to be more transparent in their reporting.

In the view of one speaker, rather than working on optional and opt in requirements, some legislative impediments should be lightened. Indeed, SMEs need dedicated requirements regarding a larger major shareholding threshold, and mandatory bids related to takeovers.

Retail investors also need to be educated in how to act in a long term manner; people need to understand that direct access is required, and to be taught that returns and risk are connected. In addition to level playing field issues, increasing the size of the stock exchanges in the EU is necessary; in France and Germany, there have been attempts to exempt a given amount invested for five or six years in the stock exchange from tax, which could be incorporated into the EU framework of reinforced co operation. The other incentive should be a similar concession for the retail investor in the form of a tax exemption to invest in ELTIFs set up by the European Commission.

3. Is there a lack of funding or a lack of bankable projects?

From the perspective of insurers, there is funding available, but there may be a lack of large infrastructure projects. One public authority representative noted that their institution has launched a European Investment Project Portal, which currently has some 150 projects covering more than €52 billion.

On the other hand, there has been a move downwards in the percentage of assets invested in equity over the years since Solvency II was prepared and implemented. Although equity markets are improving and there is more investment, one speaker stated that their organisation's asset managers would invest more in equity if there was a chance to revise the regulatory capital charges.

In Germany, the belief is that there is no lack of projects. There is a PEPP initiative to raise private pensions and savings to build bigger pots of funds that are available to be invested in the mid or long term in such sustainable projects; something like this could contribute to growth rates in the EU. If there is a lack of finance for such projects, the industry needs to investigate why; this leads to the question about how a PEPP product should be designed.

The challenge is to match long term investment opportunities with financing supply. Long term infrastructure is often discussed, but the other sorts of long term projects are those that arise with corporate entrepreneurs. The CMU is about trying to broaden the demand and supply side, and understanding whether SMEs can find entrepreneurs and investors to give them money. >>>

>>> One industry representative added that the key issue is also uncertainty: after the financial crisis, many economic and regulatory uncertainties have deterred both investors and economic agents from long term investment. National promotional banks and institutions (NPBIs) can invest long term, and return trust and confidence to economic agents.

4. The role of the public sector

Public support is needed to invest in the current environment. Public and private long term investors are important because they can act as catalysts for other investors and project owners; having an NPBI on board is clearly an asset. Long term investors are also important in helping project owners to structure and set up bankable projects. Technical assistance, financial engineering and financing are complementary facets of the long term investors' role, and are important for addressing the problems encountered in Europe.

What the industry call 'investment platforms' consist of a portfolio of projects financed through tranched liabilities, with the EFSI adopting a subordinated position in order to crowd in and attract private investors. These should be further developed with the extension of the Juncker Plan, because they allow long term investors to finance smaller infrastructure projects. The EIB needs NPBIs in different countries to help it roll out financial instruments.

Non conventional monetary policies have affected all market participants, and national promotional banks, multilateral and development banks should adapt to subsequent evolutions. There is notably a need for public support, but there should be less, and it should be smarter. The final objective must be to act as catalysts and as a crowding in tool for more investment from the private sector. This can partly be achieved by providing a 'comfort zone'. In project financing in general, there is also a need for standardisation to give the private sector more confidence. The Project Bond Initiative by the EIB is starting to consider about this, and this issue needs to be revisited.

The new digital industry, provides interesting case studies. There, two demands have to be considered as risk increases: first, most costs are being spent before the production phase; and next the possibility of quickly increasing the scale of the company and investments. There is therefore a need to rely more on what exists in different countries in terms of local clusters, networks or ecosystems which accelerate the identification and structuring of such projects.

5. How to channel more private funding towards investment

One speaker advocated designing a private pension product for the future with a modern plan design facing the target group, which is younger people in the EU. As younger people regularly change jobs and want to work across Europe, the industry needs to open their minds and consider the new modern plan design for such a PEPP. Studies carried out by the Commission two years ago showed that, the gap that needs to be filled to maintain the level of pension in relation to the level of a lower salary can be huge in GDP terms, and failure to encourage everybody in Europe to save for their retirement will create a 'catastrophe'. The Pan European Occupational Pension DC scheme which aims at the same objective as the PEPP, was also quoted.

In these areas, an economy of scale needs to be created, because the pension market in the EU is highly fragmented. For this purpose, any product that is created should be simple, standardised, easy to sell, and have limited investment options, with some safeguards. The product must be a true pension product, and from inception, the purpose of the whole mechanism must be visible. There is an accumulation and a decumulation phase. It must be as simple as possible, and there must also be a guarantee of the value of the capital saved over the period and an indemnification of clients if an accident occurs during their lives. The two problems that exist, therefore, are the question of tax and the issue of solvency. ●

Leveraging savings to develop cross-border investment in the EU

1. Cross-border capital flows in the EU: recent evolution and stakes

A monetary union has been established so that the disappearance of the exchange risk within member countries can enable savings from all the monetary union countries to be used to finance the most effective investments within the monetary area. However, the financial crisis has shown that capital mobility was not without a dark side: during >>>

>>> the decade from 2000 to 2010, the Eurozone's capital mobility funded often inefficient investments and contributed to massive current account deficits. The 2011-2012 sovereign debt crisis halted the circulation of capital flows between eurozone countries and the European Union, which led to large financing problems for banks and sovereigns and an amplification of the economic downturn. The 'great retrenchment' of cross-border capital flows has only been partly reversed. In such a context, a public decision maker stated that private risk sharing is much more important for the smooth functioning of the EMU than public risk-sharing. Looking, for instance, at successful monetary unions like the United States, private risk-sharing has four or five times the role of public risk-sharing in relation to smoothing out asymmetric shocks across the various states.

The Chair recalled that the euro area benefits from a savings surplus of more than €200 billion a year, or 2% of GDP. What should be done with this money, knowing that, in 2008, Europe had €2 billion cross-border capital flows while, nine years later, the figure is just €1.26 billion? There are five proposals: firstly, reinforcing the Investment Plan for Europe, possibly with the assistance of the European Fund for Strategic Investments (EFSI); secondly, whether there is a need for a European product, such as a savings, retirement or investment product; thirdly, whether there should be pan EU banks; fourthly, increasing cross-border equity flow; and fifthly, whether it would help solve the non-performing loans (NPL) question to go back to the cross border investment.

In a recent poll, the EIB asked 12,000 non-financial companies throughout Europe what the major and minor obstacles to investment are. The first was uncertainty about the future; the second, surprisingly, was the lack availability of staff with the right skills; and the third was business and labour market regulations, followed by the availability of finance. This is considered by 40% of European companies to be a major obstacle to investment. There is also considerable dispersion across countries. In particular, those countries where companies do not have very many internal resources and have difficulty accessing external resources cause concern. These companies are mostly in Southern and Eastern Europe, which emphasises the importance of what the Juncker Plan is trying to implement. Europe has now mobilised 58% of the total €315 billion target that was set by the Plan. The investments approved under the EFSI are in all the 28 countries, and around 400,000 SMEs have been financed. At the European Investment Fund (EIF), a co-investment equity platform with 30 national commercial banks and institutions from 19 countries in Europe has been created.

The programme is very ambitious, and there is also a need to be pragmatic at the same time, because of the need to not only design perfect solutions, but to implement practical and successful solutions. The pre-crisis model of cross-border capital flows was not perfect. That is why well regulated financial integration is needed.

2. Addressing underlying issues of cross-border investment in the EU requires decisive actions both at the EU and national levels.

Capital mobility helped boost investment growth in cohesion countries, including Bulgaria, in the pre-crisis period. At the same time, large capital inflows contributed to some vulnerabilities and imbalances: for example, in the real-estate market and in Bulgaria's external position. The reduction in capital inflows to cohesion countries is not necessarily a bad thing. Research shows that the negative impact on the economy of the post crisis correction of the imbalances was less dependent on the size of the flows, and more about the structure or type of capital inflows. In cases where capital inflows were in the form of foreign direct investment (FDI), an orderly adjustment was possible. As the experience of Bulgaria shows, this secured the orderly adjustment of the current account deficit at low cost for the economy.

Uncertainty and risk aversion from the perspective of cohesion countries are major factors. Unfortunately, many current developments seem to add to this uncertainty rather than to address it. There remains notably a potential conflict between the prospects of a "multiple speed" developments and advancing real convergence between the euro area and the rest of the EU. The EU needs to move promptly on this issue, in order to address uncertainties.

The post-crisis saving-and-investment mismatch is not only within the EU but also within cohesion countries, which limits their investment opportunities; for example, the current account surplus in Bulgaria reached 4.2% in 2016. National authorities have responsibilities to implement their reform agendas, which should promote financial stability, fiscal solvency and tackle structural weaknesses and bottlenecks. There are some positive examples, but not many. The experience of Bulgaria may be indicative of what can be done: Bank lending is recovering. Furthermore, Bulgaria was running a broadly balanced budget for 10 years in a row until 2008, and is now back on the path of fiscal consolidation, balancing its budget for 2016 and keeping the debt-to-GDP ratio well below 30% (the third lowest government debt to GDP ratio in the EU). As for the structural reform agenda, much more remains to be done in order to resolve >>>

>>> remaining issues and help attract increased capital flows from the EU.

In other words, there is a need to focus on not only the size of capital flows but, more importantly, their effective and productive use. There is a need to adequately address uncertainties; otherwise, ongoing and new initiatives will have mixed results. Finally, Europe needs to effectively enforce rules, which involves the responsibilities of both the EU and the national authorities.

3. Towards more sustainable capital mobility within the euro area

Since the crisis, European policy makers have been taking several measures in order to alleviate the dark side of financial integration but they need to be enforced more vigorously. Moreover, increasing the efficient allocation of capital within the EU requires the completion of the Banking Union and the implementation of the Capital Markets Union (CMU).

There is a need to start with banking, because Europe is clearly a bank-based economy. Unless Europe builds a true Banking Union, it will never achieve the trust of retail savers and increase efficient cross-border flow of savings. Some of the issues to be addressed are politically very controversial, but are nevertheless required. These include the permanent backstop of the Single Resolution Fund (SRF) that would increase the credibility of the EU crisis management framework and the European Deposit Insurance Scheme (EDIS), which would underpin trust in the euro and achieve a uniform system whereby the same confidence in bank deposits as in money applies throughout the whole euro area. There is still a lot to do but, if EU institutions do it well, they will make a significant contribution towards building up a well-regulated and integrated banking system.

On the CMU side, equity is the key word. Equity financing in Europe needs to be improved. Europe is lagging behind in this area. The equity share of corporate financing is half as large as in the US-only 52% of GDP in the euro area, versus 120% in the US. The current mid term review of the CMU might help. 16 out of 37 actions have been taken so far. Clearly, however, more should be done, and the fiscal treatment of the famous debt equity bias is essential.

Nevertheless, the completion of both the Banking Union and the CMU projects would not be sufficient to unlock the full economic potential of the euro area and the whole European Union. Europe also needs to address market failures. Here, the Juncker Plan is fundamental, and is successful. But further action is also needed. If a grant component can be merged with a guarantee component, Europe will be able to address market failures and have investment across the whole EU area.

Since the crisis, European policy makers have been taking several measures in order to alleviate the dark side of financial integration.

The Macroeconomic Imbalance Procedure (MIP) has been created, which is a very important procedure. Unfortunately, there are still some issues with compliance, which is a phenomenon seen more broadly with European procedures. The MIP procedure is indeed the right one; unfortunately, fewer than 5% of recommendations are being followed. Some 40% of recommendations get some follow-up, but not the follow-up that was intended, and more than 50% have no follow-up whatsoever. MIP is not only the question of compliance, but it is also a tool which the Commission is not using as it should. It was also stated that MIP is fundamental, and means addressing symmetry, including in the current-account surplus and the capacity to be combined in a way that gives sense to the concept of a euro-area fiscal stance. Implementation should be addressed in this broader framework with a focus on aiming at and overcoming this saving and investment gap, while fully using all of Europe's new micro/macro prudential tools. Europe needs to avoid returning to the past, and to recover and create a truly single, integrated financial market. Europe has also strengthened prudential policies, which makes banks more resilient and this should contribute to restore cross border capital investments. On the macro side, these are countercyclical capital buffers and loan-to-value ratios. There is also a strengthened micro prudential banking supervision at the European level, with the creation of the SSM. The issue of NPLs is at least now under consideration, with a consistent approach emerging.

If Europe wants to develop a private risk sharing capacity across the EU and to benefit from an innovative economy, it must be financed through equity in a growing proportion. A lot of the volatility of these cross-border flows during booms and busts also came from the structure of capital flows, and the fact that these were heavily skewed towards debt financing. Debt flows go much more quickly into reverse when adverse shocks hit, and amplify business-cycle fluctuations. Therefore, it is of crucial importance that the share of equity and FDI in cross-border flows is increased. This requires notably changes to the taxation framework and increasing the efficiency and consistency of insolvency frameworks across the EU. >>>

>>> Indeed the tax deductibility of interest payments in most corporate income tax systems coupled with no such measure for equity financing creates economic distortions, impedes efficient capital market financing and exacerbates leverage. Companies with a stronger capital base would be less vulnerable to shocks. This is why addressing the preferential tax treatment of debt over equity would encourage more domestic and cross-border equity investments and creates a stronger equity base in companies. In this respect, the European Parliament looks forward to the Commission's studies on tax incentives for venture capital and business angels, for instance, coming up in June, and the broader issue of the Common Consolidated Corporate Tax Base (CCCTB). Taxation is an issue that needs to be resolved in the context of CMU discussions. Nonetheless, much of the CMU is about issues that are not directly within the remit of the people talking about it. Taxation is one; insolvency law is another area where finance ministers are uncomfortable accepting that it is their problem. However, it is not only the responsibility of only justice ministries to make the CMU successful. ●

2. KEY VULNERABILITIES IN THE EU FINANCIAL SYSTEM

Fostering private risk sharing in the EU and Eurozone

1. The lack of cross border private risk sharing in the euro area needs to be addressed

1.1. What private risk sharing is

Risk sharing is the ability to smooth adverse income shocks in a particular country, through channels that operate across borders. In a currency union it operates either by public or private risk sharing. The public channel involves some form of cross border fiscal redistribution, which can take the form of taxes, subsidiaries or social transfer. The private channel works through the operation of banking or capital markets. In Europe, the capital markets channel smooths around 5% of income shocks, whilst the banking channel accounts for another 20%. Public risk sharing is almost non existent. Although not usually incorporated into the various surveys, the ESM involves de facto a substantial risk sharing. It is an important form of public risk sharing, but intended as a last resort.

1.2. At present private risk sharing in the euro area is much lower than in the EU

The Economic and Monetary Union (EMU) demonstrably lacks an adequate degree of cross border risk sharing. By design, the EMU put the onus on the private sector to provide for the bulk of cross border risk sharing. Statistics indicate that the impact of an output shock would be three to four times bigger in the euro area than in the US. The current euro area institutional architecture does not provide for a supra national fiscal stabilisation in the EMU, and little progress can currently be expected in the short term. In such a context, the current priority of the euro area should be to improve private risk sharing via progress in the CMU and a fully fledged Banking Union.

1.3. The most resilient forms of risk sharing

Whilst promoting risk sharing, care must be taken of certain aspects of such risk sharing that may be detrimental from a financial stability perspective. Equity based risk sharing tends to be more resilient than debt based; retail credit risk sharing tends to be more resilient than interbank; and long term debt tends to be more resilient than short term. Improvements have been seen in all three dimensions since the crisis, but more is needed.

1.4. Comparison between the banking channel and the capital market one

The performance dependent return characteristics of capital markets differ greatly from those of banking systems, which changes the risk distribution and allows a better capability of response to shocks in the system. In addition, the connection between assets and liabilities is different. In some cases there is also a tendency for capital markets to prefer to invest in their own national companies, which boosts resilience and the ability to take shocks.

The risks introduced in moving further towards capital markets can create uncertainty for end investors concerning their returns. Therefore, the transition to an increased role for capital markets must be accompanied by a solid investor protection regime. Retail investors must rely on the same level of protection across the Union. This can be done through increased supervisory convergence.

1.5. Products, operating conditions and uncertainties of the EU project shape risk sharing

Certain structural features of the European financial system impact risk sharing. Product specific features for instance play an important role: the risk profile of the security and its transparency; the degree of standardisation of the product; its broad acceptability and reputation in the market; and the depth, nature and diversity of the investor base.

Operating conditions continue to hinder cross-border risk sharing, among them figure: national legal and tax frameworks, the quality of >>>

>>> disclosure regimes, the depth of the market infrastructure. Moreover, the risk profiles of some securities are not necessarily well adapted to the risk appetites found in different markets.

2. Improving sustainable private risk sharing in the EU

Europe needs to decide on its objectives in terms of risk sharing. Europe is clearly far from achieving a marketplace where a European bank can operate in any EU country in the same way that it operates in its home base. The Banking Union may be further along than the CMU, but there is more to be done.

2.1. Making the Banking Union a reality

Europe is a bank based area in need of consolidation, where alternative risk sharing methods have not fully emerged. Improving the situation requires reducing national differences in the interpretation of rules; a fully functional, transparent, funded and simplified EU resolution mechanism; and the establishment of a European Deposit Insurance Scheme (EDIS).

Despite the progress that has been made, it remains unclear whether there will be a Single Supervisory Mechanism (SSM) or two layers of regulation and supervision (EU and national). EU and domestic regulations are indeed not aligned, which makes consolidation in the banking sector more difficult and, although the ECB is working hard, the fruits of supervisory convergence are yet to be seen. Progress has been made in resolution, but the capacity to cushion shocks at the private level remains essentially national for now.

To further integrate Banking Markets, Europe needs end ring fencing behaviour and to achieve a true single rulebook. The efficiency of the SSM and the SRM needs to be improved. In terms of cross border matters, it would help to treat the SSM area as a single jurisdiction for the purpose of capital surcharges which are still defined on a solo basis and not on a consolidated one.

Fostering resilient retail banking integration could also assist. Indeed, a number of barriers to cross border banking exist, including a lack of common understanding of 'digital', varying interpretations of AML and KYC regulations across Member States, and the confusion arising from tax issues.

The EDIS remains under discussion and currently faces strong opposition. Critics argue that a mutualised scheme should not be in place as long as bank risks are not reduced and become more homogeneous across geographies. However, in November 2016, the European Commission launched a comprehensive package of banking reforms parallel to the release of a legislative proposal to harmonise the creditor hierarchy of senior debt across the EU. The new legislative package has the clear objective to further increase the resilience of EU institutions, which should contribute to achieving agreement on the EDIS proposal.

2.2. Accelerating CMU Implementation

Changing the financial systems in an economy is very difficult, but that is no reason not to change them. Capital markets currently play a smaller role in the EU, but it would be better to have a balance between a capital market system and financial markets, vis à vis the banking system. The financial system will arguably be more stable when capital markets play a larger role. A more diversified financial system with a larger contribution from capital markets would indeed deliver a higher growth path and better resilience to economic shocks.

The CMU must complete the Banking Union. Europe has recently made good progress on the CMU and has performed well in terms of the single rulebook. Supervisory convergence issues are now rightly a higher priority for EU decision makers.

But there is more to be done. For instance, the development of widely used, deep and liquid equity capital markets in the EU is urgently needed. In this respect, the importance of the pension systems issue must not be understated in developing capital markets and notably the Europe wide equity market. The structure and function of pension systems could indeed promote equity market development in Europe and more resilient risk sharing across countries through channelling the savings held in pensions into productive investment and the real economy. There are many caveats, but pensions are undeniably important funds that could be utilised.

The constraints on equity investments within the EU overall are no longer that restrictive, although there is still the issue of the risk attitude of people and parts of pension systems. Indeed a number of countries have national rules that are more restrictive than European ones that allow pension funds to invest some share in unlisted equity; it may be worthwhile looking at those national rules.

There is also a need for domestic structural reforms in capital markets activities. Some capital markets are underdeveloped for national reasons, which is the case for the NPL and distressed asset markets. There need to be changes in insolvency legislation and more harmonisation if Europe wants its distressed asset market to pick up. Europe >>>

>>> also needs to help Member States build their capital markets where these do not exist, particularly in Eastern Europe. The Commission has created a new service called the Structural Reform Support Service (SRSS), which now sends missions to Member States, that are no longer new, to help them boost their capital markets and move closer to the situation in the West.

The STS initiative is also very important and Europe is close to seeing its effect. Many initiatives have already been launched and must be finalised. Getting data on securities markets across the EU, for instance, is essential. Likewise, consideration must also be given to develop cross border investment on a proper basis. In this respect, the issue of aggressive CFD and binary options being sold from the UK, and damaging the rest of the EU, must be addressed.

There are currently insufficient instruments in the EU and capital markets to ensure that a national regulator sufficiently takes into account the risks they may create in other parts of the EU, which can undermine the CMU. Sufficient EU regulatory and supervisory mechanisms must be in place to ensure that the EU level perspective is sufficiently taken into account by national authorities.

3. Conclusion

Risk sharing mechanisms, private or public, can help smooth income shocks. Promoting private risk sharing is not only a question of implementing the CMU. Many aspects relative to the functioning and completion of the Banking Union must be addressed. There is a need for urgency and for EU public decision makers to urge for agreements. ●

CCP resilience, recovery and resolution

1. Ensuring CCP resilience

Central clearing has become mandatory for standardized OTC derivatives following the financial crisis, in order to improve risk management and transparency. CCPs have a central role now in the financial system and are concentrating an increasing amount of liquidity and credit risk. Their resilience is ensured by EMIR requirements in the EU and by the international Principles for Financial Market Infrastructures (PFMI) defined by CPMI-IOSCO. Assessments conducted in 2016 in a number of areas revealed no shortcomings for European CCPs except in the area of recovery planning which is a general issue for all CCPs and is due to be tackled in Europe by the upcoming CCP recovery and resolution framework (CCP R&R).

ESMA moreover conducted in 2016 the first EU wide CCP stress test, complementing EMIR-mandated individual stress tests, in order to evaluate the overall resilience of the system. Counterparty and credit risks were notably assessed, as well as the interconnectivity between CCPs and with their clearing members. These tests will be renewed in 2017 for all authorized EU CCPs and cleared products, with the addition of liquidity stress tests and an improved data validation process. Assessments of CCP interconnectivity through their common participants and of second round effects of loss-sharing arrangements on non defaulting members will also be included, as well as a test allowing a better identification of the breaking point of the system beyond the base case scenario.

2. The CCP recovery and resolution (CCP R&R) framework proposal

Although EU CCPs appear to be in good shape, a failure can never be totally excluded, which is why the EU Commission (EC) is proposing a framework for CCP R&R. Several panellists emphasized that given the existing lines of defence of CCPs, a CCP failure is a very remote risk. CCPs have coped well in the past with a number of major insolvencies and OTC clearing is nothing new for CCPs. In addition, while EMIR has a Cover-2 requirement, panellists considered that existing arrangements, including the default fund and incremental assessments, are in practice able to cover the default of the six largest clearing members of a CCP, who are moreover mostly G-SIBs and therefore subject to TLAC and resolution planning themselves. By the time CCP resolution is implemented, the whole global financial system would be in a very dire situation and the legal certainty that may be provided by the CCP R&R framework will be crucial, a panellist emphasized. Another speaker however considered that at that stage the approach might need reconsidering because saving CCPs might no longer be the primary concern of the authorities.

The panel generally commended the EC for its proposal and for its overall consistency >>>

>>> with global level standards. The proposal will now be run through Parliament and Council. Some changes can be expected to make sure that all safeguards are in place, but there will probably be no major amendments.

2.1. Relative importance of risk management, recovery and resolution

One speaker considered that too much emphasis is being put in the present debate on resolution, which may undermine the possibility of solving a problem at the recovery stage. Some other panellists considered that if public authorities are urging the implementation of credible resolution arrangements, it is to encourage the market to contribute to the default waterfall and if necessary to solve its own problems during the recovery phase. Resolution is there to support recovery, and to make it ultimately less likely to happen. Safeguards are however needed to ensure that incentives remain aligned in all circumstances and in particular to ensure that taxpayer money is not affected.

The relationship between recovery and resolution was moreover clarified. Recovery and resolution tools are fairly similar, the difference is who operates them. Having an impartial authority doing so in resolution (and not the management of the CCP that has failed) is important, a speaker believed, to make sure that the incentives are right. An early entry of the resolution authority into the process may however be useful in order to secure enough resources in the case a resolution is really needed. Resolution will only be activated, another panellist added, if it is clear that recovery is not working, meaning that the auction of the defaulting members' positions has failed. There is a point at which the likelihood of entry into resolution gets greater, and it has to be decided then whether tools such as gains haircutting or partial tear up need to be used. These tools are actually part of CCP recovery arrangements because of the CPMI-IOSCO requirement for comprehensive loss allocation which aims to ensure that every liability in the CCP is involved in recovery, bar the equity of the CCP owner which is protected until resolution.

Furthermore, some speakers stressed that the first requirement is having an effective supervision of CCPs with sufficient attention paid upfront to the governance of how risks are brought on to the CCP, to the provision of appropriate collateral and margins and to the definition of the waterfall. These are core objectives of EMIR. If the underlying quality of the collateral is high, there should be no such thing as a failed auction when recovery is needed. Moreover, CCPs should not be allowed to compete on risk and as soon as any clearing member shows weaknesses, the supervisor should step in, so that the stage of recovery and even less so of resolution is not reached.

2.2. Appropriateness of the CCP R&R toolbox proposed

Panellists generally considered that the tools proposed in the EC proposal make sense, but that care should be taken of the potential financial stability implications of some of them, given their pro cyclical nature and the interconnectedness between clearing members. A speaker noted that the public authorities have a right of veto before tools are used and also decide on when a CCP should go into resolution.

It is also important that the tools should achieve an appropriate alignment of interests. One speaker emphasized the need to have appropriate safeguards in place regarding how and when tools may be used, particularly if any investor money may be involved. Some other panellists encouraged the public authorities to clarify the implications of the tools proposed (e.g. partial tear ups or variation gains haircutting) for different market participants and to ensure in particular that the burden put on clearing members is not excessive. Some tools should be avoided, some speakers stated, as they may de-incentivise central clearing; this is the case of forced loss allocation, which may lead some participants into a position that they cannot manage, or initial margin haircutting, which is inconsistent with the ring fencing approach that exists in the bilateral environment. Some other tools should be limited in their use, some suggested. For example variation margin gains haircutting should occur only after the CCP's resources and equity have been used up, otherwise it would take resources that the CCP is not entitled to. Partial tear-up which in effect takes the CCP out of the transactions concerned, may also only be used at the tail end of the auction process to rebalance the book, with a pricing set by the resolution authority.

There also needs to be more clarity concerning the implications of these tools for market participants, one speaker suggested, and some form of compensation should be provided in order to maintain an alignment of interests. In one speaker's view, some of the resources involved (i.e. cash call or gains haircutting resources) should be thought of as being cash compensation covering the cost for those subject to partial tear ups.

One panellist moreover suggested differentiating instruments between for profit and mutualised CCPs, given their differences in governance and the fact that members who are also shareholders are involved in the day to day management of mutualised CCPs. Some panellists also >>>

>>> proposed considering more specific tools and resources for non-default losses resulting from risks solely under the purview of the CCP management team (e.g. operational or cyber risks). Currently these losses would be borne by CCP equity, and if insufficient the CCP would enter into insolvency.

2.3. Balance between predictability and flexibility

Panellists stressed that having an appropriate balance between predictability and flexibility in the CCP R&R framework is essential. Some degree of predictability is necessary in order to clearly determine who should bear the losses and how to keep interests balanced. Some flexibility or discretion is also needed regarding the timing of entry into resolution or the choice of tools, notably in order to react to unpredicted crises. Some speakers considered that the EC proposal achieves the right balance in this respect. There is the 'presumption' that the resolution authority will apply the contractual waterfall, but deviation is permitted if the resolution authority considers it necessary on financial stability grounds, subject to a robust no-creditor-worse-off (NCWO) standard in the proposal, a speaker stated.

Some panellists advocated prescriptiveness and having a sufficiently presumptive path, notably for the clearing members of for-profit CCPs. Their main concern is avoiding uncapped liabilities in the default loss waterfall, which may turn out to be unmanageable. Another speaker added that the need for flexibility is somewhat exaggerated. There are indeed limited choices as to who may bear the losses. What can be adjusted is the way tools are used. For example some steps such as cash calls on clearing members could be skipped going directly to gains haircutting, in order to avoid undermining them. It is however important that any flexibility should be exercised against a strong NCWO safeguard.

One speaker stated that an appropriate balance also needs to be found in the functioning and decision-making process of CCP resolution colleges between the domestic and the European levels. Some decisions made by a national resolution authority may indeed have huge implications for financial stability in other countries, in which case solutions need to be found quickly with an appropriate mediation process.

3. Possible need for specific requirements regarding euro denominated clearing post Brexit

A question currently examined is whether, from a financial stability perspective, there is a case for specific requirements for euro denominated clearing activities, 30 to 90% of which are carried out in the UK, depending on the instruments.

One panellist was in favour of Eurozone location requirements for such activities on the grounds that after Brexit, it will be difficult for the EU authorities to exercise their financial stability mandate if a significant part of clearing activities is taking place in an offshore centre. In case of stress regarding an EU sovereign debt for example, it would indeed be impossible to guarantee that there is always an appropriate alignment of interests between the EU and the UK authorities. The relocation requirement may be implemented, the panellist added, through an amendment to Article 25 of EMIR on the equivalence of third-country CCPs, introducing a threshold of clearing activity in EU currency beyond which an equivalent CCP would no longer be recognised as qualified with regard to EMIR. This would lead to higher capital charges for the clearing members of this CCP. Operationally, the netting losses of relocation may be possibly alleviated by portfolio margining between different types of instruments.

Another speaker considered that such a policy would be 'irrelevant and retrograde' in the current context of global markets and with major on-going technological changes such as DLT and the cloud.

While acknowledging the financial stability implications of Brexit for the EU27, some other panel members were in favour of considering alternative solutions to CCP location requirements, in order to avoid a fragmentation of global markets and liquidity pools. Fragmentation may lead to huge extra-costs for the industry in terms of capital, collateral and default fund requirements, some believed. The financial stability consequences of reducing the current level of netting and liquidity in the marketplace were also stressed, as well as the operational and legal issues a relocation would involve.

What is needed is effective governance, oversight and cooperation between regulators, several speakers suggested. A possible source of inspiration could be the framework in place for the clearing of swaps denominated in other currencies such as AUD or USD, significant proportions of which are also cleared in the UK. Those authorities accept this because appropriate supervision is in place. Increasing direct supervision from the EU authorities would make sense, some believed, because at present, once equivalence has been granted EU supervisors have to rely on the home supervisor and have limited information and power of intervention on a day-to-day basis. This needs to change because regulators have different incentives and ways of looking at issues and there will always be a natural drive for regulators to focus first on their domestic markets, a member of the panel argued. ●

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

1. Existing practices and tools for mitigating vulnerabilities from asset management activities

1.1. Risk management practices currently used by asset managers

Although fund liquidity and leverage risks are the key risks to tackle from a systemic perspective, the issue of investment risk is broader and multi faceted, and requires a holistic approach. In one speaker's institution, portfolio managers (PMs) are those who are primarily responsible for investment risk, tailoring their management to the characteristics of individual funds and the clients targeted. PMs are supported by independent specialised risk managers who monitor and stress test portfolios on a daily basis. This institution also has a separate trading and liquidity function which aggregates liquidity and uncovers latent liquidity, and an internal advisory group which works with the PMs to identify events or market scenarios and analyse how they will affect funds.

Another speaker stated that as their firm is an integrated group, including banking and asset management, they also use specific tools for managing potential conflicts of interest including transparent fees and best execution rules. Beyond this, the main issues they are tackling at present are the implementation of MiFID II investor protection rules and the risks associated with the increasing digitalisation of value chains and the related outsourcing of activities.

1.2. Strengths and weaknesses of EU fund frameworks

With UCITS and AIFMD and the recent addition of the Money Market Fund Regulation (MMFR) there is now an extensive framework for addressing the vulnerabilities identified in the asset management sector. There is also a great deal of reporting, which can be used for conducting local or micro level supervisory tasks, and also aggregated analyses at a macro level. There are also liquidity management tools in place in many Member States such as swing pricing, redemption fees and gates.

Regarding leverage, article 25 of the AIFMD directive allows National Competent Authorities (NCAs) to put a leverage cap in place in exceptional circumstances. This article has not been used over the last few years, a regulator stated, because they have not had any real concerns regarding the leverage of funds in their jurisdiction. However, in the future, the situation might change, and this is why NCAs are working with ESMA to identify examples of situations in which a leverage cap could be used. Article 25 also involves some coordination at the EU level, with the possibility for ESMA to recommend the implementation of a leverage cap in individual EU jurisdictions.

The greatest weakness of the UCITS and AIFMD directives, a panellist stressed, is their inconsistency, because certain areas such as stress testing, reporting and liquidity management are addressed by both directives in different ways, with different rules for the same entities or different approaches for supervisory tasks.

ETFs raise specific issues, because some of them, the newest ones, could involve an 'illusion of liquidity' with underlying assets not matching the liquidity of the ETF itself. This mismatch could cause a concern, which needs to be worked on more at the international level, given that the number of ETFs is continuously growing. A 'circuit breaker', which is mandatory in France, could be a useful tool for limiting problems. The French regulator however has also pointed out that in many market circumstances, ETFs could have a counter cyclical effect.

Regarding Brexit, it is too early to express an opinion on what the situation will be in two years' time and whether it will have any implications in terms of systemic risk mitigation, but it appears likely that the UK will adopt an approach consistent with EU fund rules, which will ensure that UK products are safe. The main issue at present is the risk that the UK and the EU may fail to reach an agreement on fund distribution in particular, which would increase costs and impact investors if firms are forced to duplicate efforts.

1.3. Approach at the global level regarding vulnerabilities from asset management activities

IOSCO has been given a mandate to propose further guidance regarding investment fund vulnerabilities and is in the early stages of doing so; a paper will be out for consultation shortly concerning liquidity risks, and the aim is to issue a second >>>

>>> consultation paper on leverage by the end of 2017. The objective is for the new guidance on liquidity to have been implemented by all asset managers in two to three years' time. IOSCO is focusing on asset managers as amplifiers of risk, and is trying to address liquidity mismatch in order to avoid run risks or herding behaviour. The leverage issue is more complex: IOSCO has been asked to come up with a simple, transparent and consistent measure of leverage, which is very difficult to achieve. The solution may be to build a series of measurements, rather than a single one.

In these assessments and recommendations it is important to consider the differences between the banking and asset management industries in terms of 'systemic ness'. Asset management is an agency business and therefore potential risks need to be tackled at the activity level and not at the entity level.

2. Possible need for additional tools and actions

2.1. Possible need for additional fund rules at the EU level

There is no need for additional investment fund rules in the EU, the sector being already highly regulated, several speakers stated; what is needed is an appropriate implementation of existing provisions and also having sufficient data to analyse the impact of rules that are already in place.

Concentration risk might be a remaining issue to tackle if there is a major inflow of capital into specific UCITS funds, a speaker suggested. Having an appropriate investment process involving portfolio managers and risk specialists is key for managing such risks. Existing requirements regarding institutional investors and retail investor protection rules will also help. However, attempting to impose additional investment limitations on the investor side would not be consistent with the agency business of asset managers.

2.2. Prospects of macro-prudential tools

One regulator believed that developing macro-prudential tools in the asset management sector would help to better cope with vulnerabilities. This does not mean more regulation but building an increased capacity to monitor potential threats, and being able to more accurately differentiate real threats from perceived ones. This will require capacity building at the ESAs' level and also an adjustment in the supervisory approach, from one based primarily on investor protection to one that includes also macroprudential supervision. Supervision also needs to be proportionate, to take into account the specific features of the asset management industry and should be supported at the macro level with cross-fertilisation between the ESAs and the ESRB.

An industry representative emphasised however that the diversity of asset owners and investment strategies needs to be considered, and that macroprudential measures should apply to all asset owners. This requires improving the data available in many areas, such as separate accounts, sovereign wealth funds, family offices, pension funds and insurance companies, in order to better understand how the system works. Applying macro-prudential measures only to asset managers or a sub-set of funds may indeed lead to pro-cyclical behaviour from fund end-investors; in addition measures such as margin haircutting or liquidity buffers may prevent asset managers from applying adequately risk protocols that may have benefitted end-investors. Moreover, ordinary market risks should be clearly separated from systemic risks in these evaluations.

2.3. Optimizing the use of stress tests

Stress test obligations are included in UCITS and AIFMD directives at the individual fund level, but the framework of these tests is not regulated. The industry argues that putting a precise regulatory tool in place for stress testing all or part of the asset management sector and centralising stress tests would be impossible, because each market and each fund is different, a regulator claimed.

One official however considered that stress testing should be both 'from the bottom and from the top'. 'Top-down' stress testing may be meaningful provided that it focuses on similar funds and it would complete stress tests already occurring at the fund level. An industry representative emphasized that the asset management industry cannot be looked at in isolation in this context because it only represents a small part of the overall asset universe. Another industry representative suggested that a process such as the Supervisory Review and Evaluation Process (SREP) which focuses on the assessment of the internal stress testing of banks could be useful in the asset management sector in order to evaluate whether stress tests are conducted appropriately, with consideration for the characteristics of the fund. The suggestion was also made that EMIR data on transactions could be used for identifying risks and possibly for stress tests.

3. Prospects of the new European Money Market Fund regulation (MMFR)

The recently adopted MMFR was considered by the panellists to be a good compromise. It proposes an appropriate range of products with different >>>

>>> options including the Low Volatility NAV MMF (LVNAV), a new product designed to address the risks emanating from Constant NAV MMFs (CNAV), by providing a stable price in normal market circumstances. This new product will allow the industry to propose to investors an alternative to CNAVs for managing their cash, thereby avoiding the disruption to funding that the suppression of prime CNAVs has caused in the US.

The MMFR also contains liquidity management requirements. Over the next 18 months, the possibility will be given to every national competent authority to have access to all MMF portfolio holdings in their jurisdiction and ESMA will also have this possibility at the EU level, allowing the monitoring of market activity in real time. This transparency may be used to ensure that funds are holding sufficient liquidity; that there is sufficient liquidity in the marketplace; and that firms are not taking inappropriate risks to obtain higher yields. There will also be a completely new obligation by which the asset manager has to know who its unit holders are. These requirements will be valuable for assessing the liquidity mismatch between the assets and liabilities of MMFs, and will aid with liquidity management overall, but may be difficult to put into place, a panellist considered.

In terms of international consistency, although there has been a great deal of divergence and disputes during the development of MMF proposals, the amount of consistency and convergence that has been achieved between the EU and the US is encouraging, a speaker noted. There is consistency in at least four areas between the EU and US, which is a positive development: diversification ratios, stress testing to maintain a stable NAV, requirements for daily and weekly liquidity ratios, and new restrictions, gates and fees. ●

Accelerating the resolution of the NPL challenge

1. The issues raised by high levels of NPLs have an EU wide dimension

1.1. The size and scope of the NPL challenge in Europe

As of the end of 2016, NPLs in Europe are likely to be below €1 trillion. 10 Member States have an NPL level above 10%, and comparative studies indicate that when a region goes above a level of between 5% and 6%, this starts to have a material impact on the lending capacity and profitability of its banks. This ratio has been declining since 2014 but based on evidence from the US and Japan, NPLs may not be down to pre crisis levels until more than 14 years after the start of the crisis. The policy priority is therefore to accelerate the reduction in the NPL ratio, and the way in which balance sheets are cleaned. The size of the problem makes this a European issue, but NPLs are distributed asymmetrically across Europe. This is also a reputational issue: 2017 marks the fourth year in a row that the European banking sector has been portrayed at IMF meetings as one of the top risks to global financial stability.

1.2. The different dimensions of the problem

There is clearly a material rating impact on those countries that showcase high NPL ratios, at the industry and bank level, including countries like Ireland and Spain that have begun work on addressing the problem. NPLs, as a tail risk in Europe, is having an impact on earnings, tying up capital, and attracting management attention. At the European level, the persistence of this issue has undermined the completion of Banking Union, and has also brought into question the effectiveness of European credit management tools and policies. This problem may remain extant for some time.

In the view of one speaker, the current problem stems from the impact of the financial crisis on the real economy, which comes back into the financial sector through NPL exposures. Though high NPL ratios are concentrated in some Member States, high NPL ratios can also pose systemic-wide risks of spill-overs to other European countries and generate negative externalities. In addition, the profitability of banks is impaired by NPL exposures and NPLs lock capital in banks to back unproductive assets instead of funding new projects, with crippling effects on the bank lending channel for the transmission of the monetary policy: if banks do not have the capacity to raise capital, they will need to comply with prudential ratios, impeding their ability to lend to the economy and decreasing the amount of credit available.

In some European countries now, a bank is actually two banks: one with good assets and >>>

>>> profitability that is in line with others at the European level, and another one that is a burden, hindering absorption of capital and profitability. If banks are not able to rid themselves of this burden, it will be very difficult for them to increase their profitability or to raise capital in the market. It is therefore critical that these banks can demonstrate to investors what their business plans will be if they are able to remove these burdens from their balance sheet. Shareholders also need to accept that they face a haircut.

1.3. A top priority for the ECB

Addressing asset quality issues has been one of the top priorities of the ECB Banking Supervision since its establishment. In this context, the High Level Group on non-performing loans was mandated to develop a consistent supervisory approach to the treatment of NPLs. The ECB Guidance to banks on NPLs– which represents ECB Banking Supervision's expectations on NPL workout and resolution going forward - is an important step towards NPL reduction across the euro area. It should drive banks to gain a better understanding of their NPL portfolios and identify the most appropriate option available to workout NPLs, also depending on external conditions such as the liquidity of secondary debt market.

While a speedy workout of non-performing loans in European banks' balance sheets would clearly support the economic recovery, an orderly reduction in NPLs is crucial to avoid financial stability concerns. An effective strategy for solving Europe's NPL problem should also take into account the current state of the banking sector, which is facing the challenge of operating in a low interest rate environment.

However, addressing Europe's NPL problem goes beyond the supervisory domain. The deliberate and determined reduction in non-performing loans requires concerted action from all relevant stakeholders – both at European and national level. In this context, the ECB Banking Supervision published a Stocktake report on national supervisory practises and legal frameworks related to NPLs for eight Eurozone countries, and is working to extend it to the remaining SSM countries.

1.4. A call for EU action

It is highly unlikely that the legacy issue of high NPL will solve itself spontaneously. In one speaker's view, NPLs is an issue that requires a European solution. Enhanced efforts at national level, especially what regards bank supervision and marked improvements in the legal /judicial framework are indeed necessary but are certainly not sufficient. This speaker underlined that Banking and Capital Market Union or strengthening the EMU should not be discussed if Europe cannot solve this issue appropriately. However, the situation is slowly changing: the Asset Quality Review in 2014 allowed Europe to map the problem, and the SSM clearly looked at it and addressed it. There is growing awareness that this issue will not be solved at national level, but requires attention at European level.

Proposals for a mix of policy actions should be looked into further. Europe should not wait to address this problem until it has fixed all of the insolvency regimes at the national and at the EU level, and the question of the restructuring of banks will need to be addressed. Once this has been agreed, there needs to be political leadership and a political decision. There is also a need to consider the debtor angle, as not doing so may mean solving a problem for creditors while preventing the continuity of economically viable, but financially stressed SMEs.

2. Policy measures to accelerate the resolution of the NPL problem

2.1. The EU Commission supports a comprehensive agenda addressing all the dimensions of the NPL problem

A speaker stated that the solution needs to involve various actors, both national and European, and parallel action taking place at various levels. The European Commission has various roles: the first is regarding the proposal on restructuring and recovery, which could have important effects on the efficient management of defaulting loans while helping to reduce an accumulation of NPLs on banks' balance sheets. The Commission also has a role in relation to loan enforcement, and can address NPLs via the European Semester and other general measures such as the Italian Guarantee on Securitisation of Bank Non Performing Loans (GACS). It is also looking very carefully at the development of a secondary market, and is keen to coordinate efforts to offer support to Member States, although it would also like to avoid mutualisation of obligations. Finally, there is the possibility of liquidation aid, provided that a bank does not persist in the market to the detriment of other banks.

2.2. 'Leaving the crossroads'

A public authority representative stated that to solve the problem, Europe has two obstacles to overcome: the state aid approach, which provides little flexibility to address the systemic nature of the problem, and BRRD that was designed for a steady-state, which is still far from the current >>>

>>> situation in financial markets. Once these obstacles have been addressed, the main issue that will then need to be tackled is that of waivers and the provision of a backstop. This is not a national problem, but a European problem, which requires an EU concerted solution from all Member States; it needs to be dealt with quickly, in a synchronised fashion, and as such, it is necessary to ask the European Stability Mechanism (ESM) whether they have the available capital and the willingness to provide a backstop notably in a context where Member States have different amounts of room to manoeuvre to provide this capital due to their level of debt.

2.3. The EU crisis management framework: a possible impediment?

There is an ongoing debate about BRRD, as well as about the 8% of total liabilities to be bailed in before assessing any form of state aid which has different interpretations. Some in the European Parliament believe that implementation of BRRD might have been mis timed: Europe should have cleaned up its banks better, with some kind of recapitalisation, before progressing to the implementation of the packages as they now are.

One speaker commented that the framework that is in place was agreed democratically by Member States and by the European Parliament; the solution would not be fairer outside of the current legislative framework. Another replied that there are cases in which banks might be viable but nevertheless not well functioning, and in these cases, the usual resolution tool cannot be deployed. Europe will need to consider the experiences it has had over the last few years, and possibly better flesh out the concept of restructuring. A third noted that some banks will have to exit the market, and some will have to restructure. The appropriate frameworks need to be in place to do both.

2.4. Way forward for the SSM after the publication of its guidance to banks on NPLs

A public authority representative stated that they support the concept of parallel progress: Europe cannot wait until all of the insolvency frameworks are harmonised to address this issue. The guidance that the ECB has issued followed a very extensive, transparent public consultation process.

A central principle of the Guidance is 'tone from the top'. The resolution of non-performing loans rests firmly with the institutions themselves. Management bodies must take full ownership of this problem. This includes the development, and approval of a strategy and operational plan to deliver the progress required. Furthermore, frequent and regular reporting to the board is necessary to ensure progress versus agreed targets is achieved.

The issue of targets is also a very important aspect; it was subject to a lot of scrutiny during the ECB's consultation process. Given the existing heterogeneity across the European banking sector, setting generic quantitative targets for NPL reduction in the strategies would have inevitably resulted in unrealistic targets for a number of banks. By contrast, if adapted to suit all situations, targets would have not been very ambitious. Therefore, the ECB explicitly decided not to set a single threshold for NPL reduction. However, allowing for bank-specific quantitative targets for NPL reduction does not mean that ECB Banking Supervision will not implement consistent supervisory standards.

While the Guidance is at present non-binding, any deviations from the principles set out in the Guidance would need to be justified. The Guidance now works as a basis for the supervisory dialogue with banks and is being incorporated in the annual Supervisory Review and Evaluation Process (SREP), thereby becoming business as usual supervision. In addition, banks with high level of NPLs on their balance sheets will be subject to additional reporting requirements and expected to disclose additional information related to NPLs.

2.5. Developing secondary markets and servicing capacities

Secondary markets for NPLs in Europe are under developed, and the volumes are small in comparison to the stock of non performing exposure. To address this, an industry representative stated, the starting point is the need to address the difference between the net book value and the potential market price of the transaction from the supply side. One of the main causes of this is data quality and variability; another is the length of legal proceedings in some countries, and a third is cost. There are several smaller potential buyers that make up the market, or may be entering the market, but these do not have the capacity to put in place proper services and recovery practices. A public solution could be very helpful in this respect.

The other important factor is the regulatory incentive, or disincentive. To tackle this issue from the private side, two things are necessary: time and capital. NPL strategy has been linked to SREP, allowing the right pressure to be created within a wider supervisory framework, and not 'squeezing' the market via too tight deadlines. Additionally, within the current regulatory framework, there is already the possibility of providing some >>>

>>> incentives for sales. When an entity sells NPLs, there is clearly a price gap that could lead to problems, but Article 179 of the CRR allows, under certain conditions, for the possibility of avoiding the LGD and stabilising it. Discussion with the supervisors is very constructive in this context: banks have to prove that their circumstances are extraordinary.

The other important component of this gap is the expected return of the investor; it will not necessarily be the case that this will be very high, provided that the other components are also addressed. Additionally, if banks are able to ensure that, via an important sale, they are de risking their balance sheet and are able to restore a certain level of profitability in the near future, then they can close the gap between the potential dilution of the shareholders via the internal rate of return of the buyer and the expected return that the shareholders can benefit from in the future.

Another representative of the industry added that developments in the secondary market follow a similar path: usually in the first period, there is a local player increasing capabilities, and then foreign investors begin to look at the market. A number of factors are relevant to reducing the differences between countries: the country's legal framework, data, provisioning, and the structure of operations. Some banks are now creating their own 'bad banks', and as such Europe is moving towards a structure that will help reduce these price gaps.

2.6. An Asset Management Company (AMC) at the EU level would be a welcome initiative

A public authority representative noted that if the secondary market is very shallow and liquid, and there are few buyers, it could be difficult for the banks to reduce their stock of NPL within a very compressed timeframe. An Asset Management Company (AMC) is a tool that can be used to achieve this. The EBA has tried to build a proposal on this, but has needed to recognise that assets are very different between countries; a Finnish mortgage cannot be compared to a Greek mortgage. What can be achieved, however, is to have clear European criteria on how the process should develop, framed in the context of the precautionary recapitalisation mechanism but simultaneously offering the right incentives to all players to move forward.

A full suspension of the existing state aid and bail in rules would be quite difficult, after having issued them a few months ago. On the other hand, a full private solution is not feasible, and Europe will need to walk the 'narrow path' in between these options. Data is also a critical factor: the EBA received a letter from Vice President Dombrovskis a few days ago, which gives them a mandate to develop a common standard framework for data dissemination and disclosure in this area. This will be crucial in developing a deeper and better functioning secondary market for these assets. ●

3. NEW TECHNOLOGY AND CLIMATE-RELATED TRENDS

Can digitalisation accelerate the implementation of a single banking market?

1. The EU single market has made some progress

1.1. there is very little cross border retail activity

According to the Eurobarometer, only 7% of consumers purchased products from another EU country in 2016, and when they are asked for their reasons, 50% of these are related to barriers. These might be de facto barriers, rather than regulatory ones.

There still exist very significant discrepancies across Europe in relation to prices and service offers to consumers. The first reason for this is specific national regulations for the housing market, regulated savings and fiscal incidence. The second is linked to supervisory barriers to the development of foreign subsidiaries in other countries, which could hinder the proposal that some banks have made to harmonise their offer in all EU countries. The most important barrier is probably cultural habits.

1.2. However, the ability to use current accounts and payment across the borders is making important progress

Several years ago, a student studying abroad found it very difficult to make payments. Much progress has now been made; it is almost always possible for an Erasmus student to use their bank account from their country of origin. Significant progress has been made in some areas: regulation, infrastructures, and institutional frameworks. The second Payment Services Directive (PSD2) also has huge potential, and the advent of instant payments is very important. However, some restrictions still exist, which need to be addressed.

1.3. The EU is far from being a single EU retail banking market and progress is still required to reinforce customer confidence and define a regulatory scheme for digital payments

Having a single European retail banking market would mean any European customer being able to open an account, make payments and transactions, request credit and be offered savings and investment solutions in any bank in Europe. In this sense, Europe is very far from having a single market for retail banking; although much has been achieved, a lot remains to be done, including the harmonisation of prudential supervision.

PSD2 is a remarkable piece of legislation. There is no need to make the case for the digitalisation of payments, but these will need to be regulated and dealt with by a regulatory scheme that is not PSD2. The need to encourage financial institutions and technology to develop is also critical.

The goal of faster payments has almost been achieved, but not in all countries. Having a level playing field is very important; however, both fintechs and banks complain that the playing field is not level for them. There is asymmetry within PSD2: it requires banks to open their platforms and provide standardised information to third party providers, which is not the case for GDPR. All stakeholders, banks and fintechs must act to ensure trust and security.

2. The digitalisation of retail financial services and its consequences

2.1. Fintechs are moving more slowly in Europe than other regions

Fintechs develop very quickly; the single European market does not develop as fast. In Spain, more than 50% of clients maintain a relationship with non traditional banking providers, which are not necessarily fintechs; in France, the figure is the lowest in Europe, with 36%. This is lower than the levels for China and India, and proves that these developments are moving more slowly in Europe than in other regions. This is because in Europe, the relationships between big European banks and fintech companies are still unclear, and because of the absence of regulation, which does not >>>

>>> benefit serious, long term investors. Knowing that, at some point, regulation will be put in place, but not knowing when or what this regulation will be, is a significant strategic risk.

2.2. Regulators and supervisors need to adapt to these new technologies

Regulators need to adapt their regulatory methods to fit these new technologies; for example the French Ministry of Economy and Finance is already trying to do so, and has set four main principles. These are transparency, openness to new technologies and ideas, neutrality, and proportionality. If the goal is putting the retail financial market into force across the entire EU, there need to be a consultation regarding whether there should be a new licensing category for fintech activities; whether the principles of technological neutrality, proportionality and integrity are appropriate to guide the regulatory approach to fintech.

2.3. Current work-streams of the EU Commission through the Task Force on Financial Technology

The Task Force on Financial Technology is looking at cyber security issues and data. The next workstream will be in relation to platforms and automated advice. The task force sees issues of access to finance and economic analysis of fintech in the context of its 'Startup and Scaleup' initiative, and sees the eIDAS as an enabler for cross border retail banking for the single market. Qualified e signatures is another tool that moves Europe in this direction. Finally, the task force is also looking at regulatory and supervisory innovation and outsourcing issues, including sandboxes.

2.4. Needs and challenges emerging from digitalisation

Banks will be obliged to become more consumer and customer orientated; otherwise they will fail. Indeed, payment initiatives and services are now in Payment Services Providers because these entities have developed new services, which are very useful for consumers and which were not provided by banks. However, there is also a need to be cautious: predatory lending in the auto loans industry in the US is an example of how digitalisation can lead to the worst practices, as well as the best, and regulators will need to identify how they will make sure that only the best aspects of digitalisation are adopted. Other issues that will need to be taken into account are big data, the concept that, in future, society will be cashless; the risk of fraud; and the need to offer an alternative to the 100% digital relationship, as this kind of relationship may not be totally applicable for some customers.

2.5. Main regulatory expectation from the industry in the context of digitalisation

One representative of the industry stated that, in some cases, the lack of harmonisation is creating imbalances or arbitrage opportunities; for instance, remote identification has been allowed by AML authorities in some countries, but not in others. Having a level playing field is very important, because the wrong incentives should not be created. Another speaker stressed that customers' expectations need to be heeded: in this respect customers want companies to understand their unstated needs, as well as their likes, and digitalisation is key to understanding these. There are also many benefits from digitalisation, such as tackling banking and digital exclusion. Some significant regulatory issues will need to be addressed: Simplicity is preferred to complexity, and sometimes regulators focus too much on the things that go wrong, as opposed to trying to facilitate what can go right with the digitalisation of financial services.

Finally, digitalisation will create a global market that regulators should address as a global issue, rather than as a European or United States issue.

2.6. New regulatory paradigms are necessary

Digitalisation has empowered the consumer, and the competition that has ensued is good and healthy, but the number of new entities may pose risks to financial stability and the transmission of monetary policy, and in the areas of consumer protection and investment protection. There is plenty of scope for the authorities and the industry to learn together, with open minds, rather than trying to prevent technology taking over the relationships between people in society.

In this context regulators should develop a clear regulatory agenda, including in the area of fintech, and this should be harmonised in Europe. The major mistakes that the regulators should avoid when creating this agenda are to think that fintechs only exist in sandboxes, and to look at fintechs through the traditional prism of prudential regulation. Not one regulator includes technological regulation and supervision; this is a completely new dimension that must be included in this new regulatory agenda.

3. Two important challenges are customer protection and financial education

3.1. One priority is customer protection

One panel member commented that fintechs have the ability to not only provide customers with >>>

>>> better service, but also to abuse customers in different ways. It is therefore incumbent upon participants in the market to ensure that customer and consumer protection are absolutely paramount. The regulator will always insist on consumer protection, the security of payment systems, data and privacy protection – with effective informed consent by the consumer for the use of their data – and financial inclusion. Europe could move very fast in improving mobility, simplicity and the development of fintechs, but, at the same time, should allow some time for actors to adapt, and to allow for the possibility of continuing to develop new systems for security and adapt to the rules on data protection.

3.2. Digitalisation contributes to simplify banking products

Financial education is crucial to enable customers to compare different products from different types of companies: the types of regulation attached to them, the types of protection, and what is protected – or not protected – by the deposit guarantee scheme. Making sure that this happens is the joint responsibility of companies, banks, fintechs, and the authorities. Another speaker added that, now, part of financial education is understanding that financial services can easily be provided without a bank.

3.3. Education is key and financial institution should be encouraged to further contribute to educating their customers on banking

Although banks are making efforts to educate their customers, Europe's citizens are still a long way from understanding the business of banking, liquidity and transformation; most European citizens are unable to deal with their own family budget and understand basic products. There is, therefore, a lot remaining to be done in this field; this is a matter of public policy, and either banks should be allowed to use some of their profits from other areas of activity to fund the other missions, or if this is not the case, they will have to be funded in another way. ●

Blockchain and Fintech contributions to capital markets: how and when?

1. Short term opportunities for DLT[1] applications and related benefits

Financial institutions and financial market infrastructures (FMIs) are currently looking for 'white spaces' in the market where Distributed Ledger Technology (DLT) and its main features (i.e. decentralised trust, distributed consensus, transparency and immutability) can be useful.

The best short term opportunities are in areas where automation and standardisation are limited, an industry speaker stated. The speaker's institution is currently exploring how DLT could enable them to become the settlement counterparty to the start leg of repo transactions[2] in real time. This system would enable the institution to share standardised information with its customers about positions and receive updates on changes as they happen. Another initiative is being conducted in the credit derivatives space related to the processing of CDS post-trade events and reporting. Plans have been announced to re-platform a repository for CDS contracts from its current mainframe application to a DLT network. This follows an earlier proof of concept which demonstrated that complex post-trade events inherent to CDS can be managed efficiently with DLT in a permissioned, peer-to-peer network. The objective is to reduce by 20% the costs of these operations, which have significantly increased since the 2008 crisis, with the implementation of new policy reforms and capital requirements.

DLT could also benefit other areas of capital markets where manual processing is prevalent, such as trade finance and gold trading and settlement, and where DLT can help to develop an infrastructure where there was none before. Another example is know your customer (KYC) requirements, which involve exchanging a great deal of similar information among many different parties.

A different area where DLT is used is for adding resiliency to existing systems and helping in business continuity planning. A major settlement agent in the US Government bond market has for example built a DLT database that backs up all transactions executed on their settlement platform in real time. They have kept their primary backup system and the DLT database runs in addition, providing stronger security through encryption, more transparency on the data (e.g. with the possibility of tracking securities ownership more easily) as well as additional possibilities >>>

>>> of performing predictive analytics (e.g. on settlement ratios and failures) or of monitoring the volumes and timing of the instructions executed (e.g. by inter-dealer brokers).

DLT is however not a 'silver bullet' that is going to solve all the problems within capital markets. This technology is mainly used at present for improving existing processes, notably less automated ones in niche markets, but new uses can be expected in the future, building on the main attributes of DLT (i.e. improved efficiency and reliability, enhanced reporting capacity).

2. Feasibility of wide-scale applications of DLT and key issues to be addressed

2.1. Feasibility of large-scale DLT applications

For making large-scale applications of DLT possible, there are still major challenges that need to be addressed. Earlier predictions that DLT would quickly replace traditional post-trading market infrastructures had not realised that existing technologies could already do same day clearing and settlement. RTGS, by definition, is real time gross settlement. What is preventing same day settlement at present is the organisation of the market, with customers in different time zones, some still using physical securities and intermediaries of different sizes. The new opportunities that DLT could bring in this market context still need to be more precisely defined, some panellists considered.

Another challenge for achieving wide-scale applications of DLT for DVP settlement of classical instruments (delivery-versus-payment), is finding a way to get cash on the DLT, a speaker emphasised. Commercial bank cash can be used on the DLT, which is sufficient for now; but this traps liquidity and requires pre-funding, so there is a credit risk. A consortium of banks is developing what they call the 'Utility Settlement Coin' (USC), which aims to propose a stopgap solution until central bank money can be put on a DLT. The core deliverable of the USC project is to provide an asset backed, multi-currency, digital cash asset on DLT. It will be designed to support the cash leg of any blockchain transaction, providing for exchange of USC digital cash versus digital assets. This however requires good regulatory scrutiny and talks have been engaged with regulators and central banks in that perspective.

Nothing is preventing central banks technically from moving into a cryptocurrency. The question is whether there is any need for it. There are already market infrastructures that allow digital electronic money. However, maintaining confidence in the use of such a currency is essential, because it is a method of transmission of monetary policy to the economy and needs to be under control. A central bank issued digital currency would have significant implications for the relationship between the central bank and commercial banks, a speaker considered, because some people would no longer bother to have a commercial bank current account in that context. Although there are potential benefits in terms of AML and counter-terrorism, a direct involvement of the central bank would also raise questions in terms of privacy.

2.2. Key issues and challenges to be addressed regarding blockchain and DLT

Although public authorities are considering DLT innovation positively, there is a need to tackle the risks and challenges that this technology raises, notably when it comes into contact with existing regulatory and legal frameworks. Many issues that still need addressing have been identified, including identity verification and privacy issues, scalability, standardisation and interoperability, legal certainty and liability issues. In order to deal with all of this, the EC is intending to actively engage in blockchain developments, and is aiming to set up a European centre of research and expertise on blockchain and its uses. A public consultation was recently published aiming to better identify the funding opportunities associated with DLT and blockchain, especially for SMEs, and implementation challenges.

The need for standardisation and collaboration in the industry for implementing DLT solutions was emphasized. One of the reasons for testing DLT applications in the credit derivatives space for example, was that very standardised information is used in that case and dealers and buy-side players need to cooperate to solve operational risk problems. Another implementation issue is making multiple blockchains work together and taking into account different national efforts e.g. in the area of e-government.

Regarding legal aspects, there is no need to have a new set of rules to cater for the implementation of DLT, and the same applies to other new technologies such as artificial intelligence and big data. Some issues may however need to be further examined, such as settlement finality, the law applicable to DLT, liability issues regarding the ultimate responsibility for events that take place on the ledger, as well as the question of the legal validity of data and documents produced and stored on the ledger.

Another issue is whether the blockchain is 'unhackable', a speaker stated. It was noted that with Bitcoin, the consensus seems to be that hacking the Bitcoin DLT itself is technically impossible. However, that does not mean that Bitcoins cannot be >>>

>>> stolen; with the key, anything can be done. The issue of 'hackability' is not necessarily a problem, but there needs to be a full framework around what happens 'if the unthinkable happens'. Another panellist stressed that people have to be very careful when stating that a technology is not hackable. The market structure being very complex, there are always going to be small players who will not have the resources to be able to adapt to new technology, which will create vulnerabilities. Another challenge is that DLT works on the basis of smart contracts, which are code, creating some additional vulnerabilities.

3. Regulatory and supervisory approach regarding fintech and blockchain developments

3.1. A technology-neutral and pro-innovation regulatory approach

DLT technology is still evolving and regulators will need to continue monitoring what is happening in the market in Europe and globally and how different technologies are being used. It is essential to identify the risks associated with blockchain and DLT technologies and to assess whether they can be contained, so that the opportunities created can be grasped. However, a balanced approach to risks is needed, not to hinder the opportunities that these new technologies represent and not to deter financial players from innovating. It is also important to consider other technologies that may be equally interesting, such as data analytics and artificial intelligence.

It is probably too early to say what the regulatory response to DLT developments might need to be, but the conclusion at the moment is that the current EU regulatory framework is workable and does not pose any particular obstacles to the use of DLT. The principle of technological neutrality of regulation and of 'do-no-harm', as it is put forward in the US, was supported by several panellists, who agreed that a rewriting of the current rulebook is not necessary for implementing blockchain, although specific areas of the regulatory setup may need adjusting (e.g. regarding smart contracts). A speaker suggested in this regard that the rule-making process itself may need adapting, because it is often not flexible or fast enough for updating rules if needed. Having a one-to-one customised dialogue between regulators and innovative fintech businesses and ongoing monitoring, as permitted by regulatory sandboxes, is useful for testing new concepts and identifying related risks. Global collaboration among regulators is also essential in this area because fintech has a strong cross-border dimension.

The industry is encouraged to point out any possible clashes of DLT with the current regulatory regime that regulators may need to tackle. One issue that needs to be considered, an industry speaker stressed, is that 'harm' can happen in different ways. It is important to assess for example whether certain regulatory provisions e.g. applying to record-keeping, may hamper the development of new technologies.

Another issue that needs to be considered is that regulatory authorities need to make sure that their staff acquires a good understanding of how these new technologies work. For them to get directly involved in some fintech developments, such as Regtech, may be helpful as well.

3.2. Prospects of Regtech applications

Supervisors are examining the use of Regtech i.e. technology and data solutions to help monitor and supervise capital markets and firms, but these developments are still very experimental. Once DLT applications have been more firmly established, supervisors could use them to obtain real time observations of what is happening in the market and also use DLT for improving the efficiency of their own supervisory processes. The EC is going to pilot some Regtech solutions, using blockchain and artificial intelligence to help supervisors. The EC also supports the 'once only' principle of e-government policy, by which data given for one purpose can be shared with other governmental users, in order to avoid repeated reporting.

The speakers on the panel emphasised that there is great potential in using blockchain for regulatory and transaction reporting systems. However one noted that many improvements are already possible without new technology. Generally speaking, there are more and more reporting requirements, which create duplications and inconsistencies. Standardisation and making sure that there are common data sources and ways of reporting should be a priority.

Another challenge is the availability of appropriate supervisory and enforcement capacity to make use of the data produced and to handle issues, such as misconduct that may be spotted by transaction monitoring systems. This may require further rationalising and prioritising of supervisory and enforcement resources in particular. ●

1. Blockchain is a type of distributed ledger technology (DLT). There are potentially other types of distributed ledgers, but in this summary we will use blockchain and DLT indifferently.
2. The 'start leg' is the portion of the repo transaction when the security is sold, while the subsequent repurchase is called the 'close leg'.

Climate-related and green finance

1. Increasing political momentum at the global and EU levels

1.1. Scope and size of green financing needs

There is universal agreement that the direction of travel needs to be towards a low-carbon, resilient, resource-efficient circular economy; the Paris Agreement and the Sustainable Development Goals (SDG) Agreement have been the largest ever exercises in levelling the playing field. A solid regulatory framework is also being established, and Europe is leading in this area.

The implementation of the Paris Agreement will require an urgent transition towards a low carbon and a circular economy, costing trillions in long-term investments in green and climate resilient infrastructure. The worldwide financing needs to achieve the SDGs and COP21 targets have been estimated to some US$ 90 trillion during the period 2015-2030[1], and enabling public budgets to provide these will be a significant challenge. Policy efforts that take place in this area also need to be linked to the goal of stimulating investment. To be more resource efficient is also a challenge that SMEs must address.

1.2. Policy initiatives underway in the EU

The Juncker Plan has been almost doubled to €500 billion, and Horizon 2020 is the biggest innovation programme in the world, with €80 billion. Regional funding also plays a role. Important recommendations are expected from the High-Level Group on Sustainable Finance.

However, there should be more transnational projects; the EIB has a very important role in this context, notably working in conjunction with the Commission. There also needs to be closer cooperation with the private sector.

1.3. Outcomes of the Task Force on Climate-related Financial Disclosures (FSB)

If the FSB task force is successful in meeting its goals, in a few years, every large corporation in the G20 countries will include climate related risks and opportunities in its annual report. The FSB task force received around 300 comments on its mid December 2016 report, which showcased a great deal of support for its recommendations. These required corporations to answer four simple questions: 'How are you organised regarding climate risk in your corporation?', 'How does climate-related risk feed into your future strategy?', 'How are you managing this risk from a risk management basis?' and 'Have you, as a corporation, given yourself metrics and targets?'

The report will go to the FSB in June, and then to the G20 in July. The European Commission has already identified the next group that will look at transposition in Europe in a broader sense, the High Level Expert Group on Sustainable Finance: its work has begun, not only on climate issues, but also on encompassing environmental, social, and governance issues. The interim report will be ready in Brussels on 18 July, and recommendations will then be presented in December.

Europe is already leading the world in the area of sustainability; it was Europe that was the most responsive in giving feedback on the work of the FSB task force. Attitudes on the task force itself were somewhat differentiated by region; so the result of its deliberations is a very good compromise that will help the world, rather than just Europe, to develop. The United States appears to be retreating from taking a leadership role in relation to sustainability and confronting climate change, and it will therefore be interesting to see the extent to which Europe can build a strong relationship with China in this area.

1.4. Important improvements in public policy are required

The most important requirement for decarbonising Europe is the existence of a properly functioning carbon market, with price signals throughout the economy that promote static, dynamic and allocative efficiency. Over the last five years, the carbon market has been 'completely dysfunctional'; over the last 12 years, extra allowances sold in the carbon market have essentially stemmed from static efficiency improvements from coal and lignite. Encouragingly, though, the EU Council has put forward a proposal for reforming the EU Emissions Trading System (EU ETS) that is even more ambitious than that of the European Parliament. If these amendments are accepted, the carbon market will begin to function again.

A properly functioning carbon price would significantly contribute to decarbonising the >>>

>>> two most important sources of emissions: the power sector, which is the larger, and the industrial sector. The carbon market needs first to encourage 'static efficiency' – i.e. a price that is sufficient to enable short term fuel switching, with gas plants more competitive than coal plants – and the next stage will be to have a price that is high enough to promote dynamic efficiency: i.e. to send a signal for investment in low carbon technology. Finally, the carbon price needs to feed through to end user prices, so that consumers are able to opt for lower carbon fuel sources of energy.

Over the last two years, the European Commission proposed almost all of the legislation that is necessary; the last big package, the 'clean energy package', was adopted in December, and the only area in which no legislation is expected in the next three years, is electro mobility for vehicles. There is also the potential for the European Commission to improve what it does in the area of financing, since there is a deficit in the capital market area, despite the increases in volume and performance in individual areas.

Indeed, member states have pledged €40 billion towards facilitating energy transition over the next five years. However, although the EU has the most advanced policy in the areas of sustainable growth and energy transition, as well as good policy targets, legislation and financing, it also provides too much state aid, and makes too little alignment with the private sector and capital markets.

2. Current financing trends and observed needs

2.1. Fast growing interest among investors for green finance

There has been a tremendous increase in investors' interest in green finance over the last three years. The FSB's global initiative and the European Commission's High Level Expert Group are both very useful at the global and European levels, increasing transparency and increasing information, and the implementation of the task force on climate disclosure will be crucial for bringing more funding and capital into the low carbon economy.

2.2. Green bonds showcase a very positive trend; however, there is still a lack of adequate and legible investment products

Green bonds, according to one industry representative, have been a 'wonderful' asset class, having emerged from insignificance to become a $200 billion asset class in only a few years. However, green bonds still only constitute a small fraction of sustainable investment among the assets under management. Although there are both financing demand and supply, the two are not connected well, and there is a need to identify products, as well as pipelines to further direct the money towards these kinds of products.

2.3. Product labels, which are consistent across the EU, and additional large public issues or investments, should contribute to expanding the market and reassuring investors

Investors want to be certain that they are investing in legitimately green finance, rather than 'green laundering', and as such, the European authorities should envisage creating dedicated labels. Public issuing would also be helpful, and the EIB is playing a valuable leading role in this area; the public sector can also assist in increasing the size of this market. Ultimately, however, what matters is the real economy, and the environment in which corporates evolve; corporates need to be put under pressure about how they are addressing their exposure to climate risks.

2.4. Improving the attractiveness of these investments

Green finance involves long term issues and investments, while the financial system at present is very focused on short term; the main question is how to reconcile these, and enable people to withstand short-term fluctuations while maintaining their illiquid long term investments. There is notably a need to examine whether adjusted prudential capital charges might be the solution, and a thorough analysis of this question should take place. The European Commission is notably working in collaboration with the European Mortgage Federation to ensure that the valuation of energy efficiency aspects is integrated into all aspects of the bank risk model, and a platform has been created utilising data from the Federation's members to help with this.

2.5. Conditions for further developing green financial markets

One industry representative commented that there are three pillars in the area of green finance: disclosure, incentives to drive forward the investability or bankability of issues, and increasing the scale of financing. There are also issues about how the public and the private sectors can most effectively work together, and a great deal of work is taking place in both the private and public sectors to create infrastructures and market classes. Standardising contractual and design terms >>>

>>> to allow green investments to be securitised is also very important.

2.6. By focusing on certain risks, multilateral development banks can further catalyse the involvement of the private sector, rather than crowding it out

Another significant barrier to the growth of green finance is insufficient supply. Support from the public sector for a first loss principle would make it much easier for private institutions to be involved with investments in project finance than currently, and should improve the situation of climate-related activities, in particular adaptation risk. There is a growing recognition that the public sector, in the form of multilateral development banks (MDBs), needs to contribute more to equity, and more to first loss tranches provision and guarantees. Certain parts of the risk in, for example, a large infrastructure project are risks that the private sector is not good at spotting up, and focusing on these areas could make a significant difference to the amount of money that is put into these sustainable investments.

2.7. A more proactive contribution of the private sector is also necessary

Encouraging climate friendly finance is not only a responsibility of the MDBs; banks also need to follow and encourage this move towards a low carbon growth path. One industry representative commented that their institution launched an initiative to do so in 2014, and has closed around 17 deals so far, using around $600 million of balance sheet among the various partners, with a total mobilisation of around $6 billion.

3. The CMU is essential for improving the financing of the transition to a low carbon, climate resilient, resource efficient and circular economy

In particular securitisation should enable a much quicker recycling of capital from the balance sheets of those entities who have taken on early risk in Europe – e.g. private equity – and also some pension funds, which have taken on operating or construction risk with a renewable energy infrastructure. The CMU needs to provide a supportive framework for this.

4. Adaptation challenges of the financial private sector

Global warming is progressing, and meeting the 'two degree world' goal is going to be a challenge. Even an increase in global temperatures of one degree will have a physical impact on most enterprises and on many countries, and this can be addressed via adaptation strategies.

An industry representative stated that he could not recall any bond having been issued that clearly related to adaptation strategies. Companies should consider the risks that they face from global warming over the long term and what initiatives can be undertaken to protect their business. Insurance is a different topic: the key problem, from a corporate perspective, is that financing for insurance is not cashflow relevant. Standardisation and transparency of information would help to improve this situation, and more can be done through regulation, such as zone planning and building permits and standards. ●

1. http://unepinquiry.org/wp-content/uploads/2016/09/The_Financial_System_We_Need_From_Momentum_to_Transformation_Summary_EN.pdf

IV. BANKING AND INSURANCE REGULATION

Priorities for progressing towards a single banking market

Introduction

The euro area needs an institutional framework that allows euro area banks to reap the benefits of a genuine single banking market, and, in the context of a monetary union, to improve the allocation of capital: credit allocated efficiently, and without reference to location. Better EU financial integration should also enhance competition, broaden the access of customers to credit and new financial products, enhance risk diversification, and improve private risk sharing. Reversing fragmentation would be another expected benefit; this would contribute to breaking the 'vicious circle' between banks and sovereigns, and improve the resolution of banks, which would therefore reduce the risk of taxpayers' money being involved in bail outs.

1. Much has been achieved

In the summer of 2012, European leaders demonstrated committed to create the banking union, and European institutions worked very hard to complete these projects. Since this time, the banks have become better capitalised, and have more liquidity; everybody agrees in principle that no bank should be too big to fail, and while it is possible that not enough has been done in this respect, a lot has been done. Major steps have been taken establish the Banking Union: after a comprehensive assessment of all significant credit institutions in the Banking Union, the Single Supervisory Mechanism was fully established in 2014, and the Single Resolution Mechanism has become operational in 2016. Macroprudential schemes are also now functioning in all countries.

2. Making the Banking Union a reality

2.1. Fragmentation is still an issue and the cross border banking activities have not been restored

Since 2008, the flows from European banks to foreign entities outside their own country have declined quite markedly; cross border operations in the banking sector have declined, and are still declining. There are clear signals that in around 2011 to 2012, there was a significant deterioration in all the indicators of integration, price and quantities. Although these problems have, to an extent, been remedied, cross border banking has not yet returned.

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

The lack of single-jurisdiction status, or the existence of multiple national jurisdictions, penalises banks operating across the Eurozone and impedes greater risk diversification. Cross border banks can face additional liquidity and capital charges on their subsidiaries located in the euro area, and the additional prudential requirements fail to recognise the new EU financial architecture, or to recall the mistakes made during the 2008 crisis. Opacity, complexity and fragmented supervision worsened the crisis.

The proposal to translate NSFR into European legislation on a solo basis, rather than a consolidated basis, was 'puzzling' to one speaker. It sends the message that although Europe claims to be in a Banking Union, it is not in practice. Another symptom of the lack of a single jurisdiction is the treatment of additional capital charges for systemically important banks related to cross border euro area exposures; these are still considered as international exposures from a regulatory perspective. In the view of this speaker, waivers should not be granted on a case by case basis; it should be assumed that no solo requirements applies within the Banking Union for consolidated banking groups unless there was a compelling reason otherwise, with the burden of proof on supervisory authorities' side.

According to a public decision maker, internal MREL arises from two different topics. In the case of the Eurozone, as there is a single resolution authority, decisions on resolution do >>>

>>> not need to be coordinated by individual Member States. However, there are other reasons to set the internal MREL, such as whether something is related to the resolvability of the entity and the existence of subsidiaries. If a particular bank only had branches in Europe, then given the existence of a single resolution authority, there would be no need to set internal MREL. The problem is that this EU bank also has subsidiaries, and there is a need to comply with the requirements of upstream losses and downstream capital in the event that there is a problem with an entity of the Group. There is also a need to comply with the 'no creditor worse off' principle, so that the creditors of the parent cannot be worse off as a result of resolution than in liquidation. This is not only a problem of authority, but a more complex problem.

The industry representative replied that these are good arguments, but ultimately, Europe needs to decide whether it wants cross border banking or not. They understand the technical reasons why their institution has also a Pillar 2 on its subsidiary in Italy and on its activities in France, but there comes a point at which Europe has to take a step forward, trusting other countries and relying on the authorities that have been set in order to resolve the problems.

Regarding the NSFR, there are a lot of good arguments, but what is underlying these arguments is the desire of national authorities to maintain their role. As a banker, this industry representative wants the Eurozone to be considered as a single constituency; otherwise, it is not clear why so many efforts to move towards a single monetary union and banking market were made, if companies will not be able to realise the benefits of doing so.

'Branchification' has been a phenomenon in some European countries; the existence of entities that have headquarters and branches outside of the euro area complicates the issue. One speaker stated that the main impediment to applying the same rules that exist for subsidiaries to branches is the complexity of legal structures, which need to be addressed.

When the de Larosière report proposed macroprudential policies and tools, this was on the basis that these policies needed to be different in different locations, but they could be done at the European level. Having 28 macroprudential authorities has meant that several types of risk, such as the build up of a bubble in the real estate market, would be tackled using very different tools, including higher risk weights or floors to loss given defaults (LGDs) in internal models and requests for loan to value ratios. Any streamlining that takes place will need to be more 'European minded'. The revision of the ESAs may be a good opportunity to act on this.

3. The causes of fragmentation

A speaker stated that two decisions have been the main drivers of fragmentation in the European Union: the 2008 decision to not set up a common European bail out fund, and the decision not to have the European Financial Stability Fund support the restructure of the banks at the European level, but to give the money to the Member States and to have national initiatives to restructure the banks. Now, when dealing with the issues of legacy assets and NPLs, it appears that Europe will opt for the national route again, which has generated segmentation.

Although there has been a debate in Europe about whether or not risk diversification was a good thing, it now appears to be generally agreed that it is. Europe's 'constructive ambiguity' was neither constructive nor ambiguous in practice: banks could only be resolved via bailouts, which creates too many distortions in markets. In Europe, some authorities tackled the problem of the banking crisis in 2008; others did so in 2012, and others are trying to do so now, or in coming years. Problems related to legacy assets are therefore increasing, and this is probably because the right measures were not taken in time.

4. Short term priorities

4.1. Completing the Banking Union and simplifying the EU macroprudential regulatory framework

The first step is to complete Banking Union; the European Deposit Insurance Scheme (EDIS) will be critical to this. A common EU backstop for the Single Resolution Fund (SRF) must also be secured, and the legislation that was accepted at the time of the financial crisis must be reviewed, as much of it is too complicated and too national. If this can be achieved, it will mean the creation of the Deposit Insurance Scheme in the long term, the reduction of NPLs, and the simplification of legislation that will create incentives and possibilities for the true single European financial markets. This also requires European banks and financial institutions that operate across borders.

4.2. The quicker Europe can address the NPL challenge, the better

Resolving the issue of NPLs is crucial in order to restore a well functioning monetary union and single market; the quicker Europe can address this, the better. Doing so at the national level may >>>

>>> not be the ideal solution, but in the view of one speaker, it is the more rapid solution. In the past, the division of labour between the different levels and authorities has been too high, and these authorities need to be brought together and pressured to solve this issue.

Finalising and implementing a resolution system may be even more important for Europe than dealing with NPLs. A lot of progress has been made on this: Europe has created legislation, and communicated that a solid system is in place, but there is reluctance to implement this in full. Regarding the question of NPLs, one of the most important issues is how effective insolvency regimes are. If the problem were limited to the banks, it could be asked whether banks should continue to function if they are not capable of managing their NPLs; however, if the problem is the judiciary system and its efficiency, selling off these loans will not necessarily be very helpful.

4.3. The implementation of the EU harmonised resolution framework would reduce the level of fragmentation.

The regulatory framework already exists to tackle all these topics within the BRRD and the SRM regulation; the challenge now is to comply with these, and to implement the measures included within them. Europe now has the asset segregation tool, which it can use for the purposes of resolution if necessary. The best way to combat market fragmentation is to not use public money in the bailing out of banks; one of Europe's biggest problems is the credibility of the regulations and the resolution framework that was approved three or four years ago, and Europe needs to bear in mind the consequences of a reversion to the banking and sovereign loop.

4.4. Europe needs to demonstrate that the single banking market can be delivered for the EU as a whole

Europe's first interventions, which have put the emphasis on the resolution side, have been the correct approach. There is a need to fix the link through recovery and resolution planning and create a credible method for failing firms to exit the market; once this is in place, the prudential measures that now require European states to lock capital and liquidity into individual jurisdictions should be reviewed.

A public authority representative noted that all of the mediation cases that they have dealt with have been positive, but the host authorities can always take their own decision, which means that there is sometimes an agreement to crystallise segmentation or to let everybody take the actions that they think are required in their own jurisdictions. Europe should try to have more decision making take place on the European level, rather than allowing this to be only in the remit of the national authorities. This could be done by means of an independent panel.

4.5. Recognising risk diversification in the EU banking regulatory framework

When an entity acts as an insurer when present in different countries, it has lower capital requirements, as a result of the benefits of diversification. When it acts as a banker when present in different countries, it is penalised, because it is believed that it will be more difficult to resolve, and therefore more capital is required of it. More progress should be made in resolving this issue. ●

Future of the EU banking sector and banking business models

1. Future of the EU banking sector: stake and drivers for the current evolutions

Supervisors and policymakers, as well as leaders in the business, are trying to define how Europe can rebuild a sustainable, successful and well-functioning banking system and how business models need to change in order to achieve this. This is a complex issue since the challenges the industry is facing are defined by a multitude of issues. In particular, the financial crisis triggered in the EU two reactions which impact deeply the banking system, one is macroeconomic in the form of a specific monetary policy and the other regards banking regulation.

An important reason for the complex regulation and the thick CRR is that there is so much lobbying and so many details for which another subparagraph is required. Everyone would like to return to much simpler regulation, but this needs to be an initiative driven by both parties.

Problems with revenues, low interest rates, pricing power, appetite for credit, costs and distribution, branches, fintech, balance sheets, liquidity >>>

>>> and capital are faced by franchises around the world. The problems that banks face in some respects can be largely grouped into three categories. The first is uncertainty about things that are going on, and their destination. The second is the fact that the cost of equity has not gone down as a result of the measures taken during the crisis in parallel with the reduction of risk in the sector. There have been discussions with central bankers and regulators who cannot understand why the cost of equity has not gone down. This is an area in which an understanding needs to be reached. Finally, the biggest problem for banks is the number of equations to be solved at the same time. All of this together creates uncertainty. In addition, the ability to cope with all those problems is restricted by political developments. Europe is entering the process of Brexit; some European countries are facing elections where the outcome is not yet clear, and Europe also has to deal with diverse or disparate signs from the United States.

However, there is no single EU banking system; there are many banking systems in the EU, including "good" and "less good" ones. Indeed, in Europe many banks are still devoting a great deal of attention and resources to dealing with legacy issues while for other banks the impact of the financial has been absorbed and are now focusing on preparing for the future. EU banks are facing common issues and have also to cope with idiosyncratic challenges. All banks are dealing with regulation, IT and the low interest rate environment, etc.

Consequently, for some banks, the challenges currently being confronted are daunting hence could endanger their mere existence sometimes because their business model is simply not viable while for others it is only a matter of adjusting to a new IT environment because their business model, as it stands today, is and will remain very strong going forward.

Nevertheless, banks are at the beginning of their journey and it is very difficult to figure out how all the looming changes will play out. The litmus test on business model rests with banks' ability to generate profit and capital, and "absorb" what is expected and what is unexpected. Finally, the society also needs to be clear about the nature of the banking system that it wants, and how much competition or protection is wanted. This will give a very clear steer to the leaders of banks as to what they need to deliver.

2. Risks (and opportunities) the banking industry is confronted with: rapidly evolving technology, new competitors, regulatory and taxation uncertainty, NPL, a challenging macroeconomic environment...

A distinction has to be made between current challenges and strategic ones for the future. The main challenge at the moment is still the weak economic environment, especially for banks deeply embedded in the real economic system. Banks cannot prosper if the economy does not prosper. The economic environment has improved, and the recovery is hopefully consolidating. There are two additional issues in Europe that will influence business models dramatically. The first is that there are more than €900 billion of non-performing loans. Indeed, a result of the crisis was that the share of NPLs in all portfolios in many of the EU member states increased substantially: in certain larger member states, this stands at 17% to 20%. It is striking however, that in many countries the NPL ratio is very high, whereas in other countries, the ratio is very low.

Another important risk is interest rate changes. Low interest rates are more of a problem for other sectors, especially insurance in some countries, than for banks. However, the banks make money by exploiting the inclination of the yield curve, and when this flattens, there is a problem for banks as well. It has had some effect, but the evidence so far is that the effect on bank margins has not been as bad as anticipated. There is an indirect effect of the low interest rates, especially these low interest rates determined by monetary policy. Yet, if the low interest rates are to continue, it will have implications for the profitability of the banking sector. There is clearly a relationship between these low interest rates and banking profitability.

Furthermore, when high interest rates will return, the crucial point will be whether there is a gradual, orderly increase. In this case this would be manageable for banks. If there is a sudden increase it is important that supervisors should test the ability and the robustness of the banks to ensure against such an event. Europe has seen a very long asset price increase, which has helped banks' balance sheets tremendously. This might reverse, and if it does, there will be losses.

The regulatory overhaul, which started in 2009 and which is not yet finished, has also contributed to increasing fixed costs. This hampers in particular small- and medium-sized financial institutions, which finance the backbone of the European economies' medium-sized enterprises, though they performed well during the financial crisis. However, safety comes at a price. Basel III has been highly beneficial in terms of the safety of the banking system.

It is true that regulatory uncertainty is bad: Banks have said that this is an element that hampers their strategy making and also, to some extent, their development of business models. For good reasons, Europe has embarked in the direction >>>

>>> of reinforcing capital liquidity leverage, governance, and related topics, but there is also a great deal of uncertainty remaining. Investors have also incorporated the implications of BRRD in removing government support from ratings, because the public sector has said that no more taxpayers' money will go to banks. This might also need to be reconsidered in the light of recent developments, or because BRRD could be reshaped in a different way.

There is also the issue of tax, which is an element that can strongly affect banking market developments. However, the definition of the regulatory framework for banks is very close to conclusion. This will be good news, as globalisation for investors is critical in terms of setting the rules.

Another important risk stems from technology.

But there are many challenging developments. What technology usually does is to create great opportunities for society, and on the other hand also challenge incumbents. The threat for banks is more acute in those areas where there is high standardisation. Threats from outside the banking sector are based on unbundling banking services. There are potential efficiency gains to be made, but there are also complementarities across these services. The question is whether these complementarities are greater than the efficiency gains. The banking landscape is changing very rapidly and banks need to adjust; they are adjusting, and supervisors and regulators should also be prepared for that process. From a long term perspective, being aware of and being prepared for technological innovation is key to banks' future. Actually fintechs raise a number of issues, such as technological developments in payment systems. There is also the impact on credit, such as crowd-funding or peer-to-peer lending. The other area is big data. Cyber risk and accidents are also essential.

3. Accelerating technology changes is essential for the banking industry. It has also to do with regulation and supervision

The traditional models are based on technologies that were incrementally innovating, but the market is now at a point where technologies are exponential. The banking business is essentially a knowledge business based on data and information that can be managed in an intelligent manner in order to compile information, turn data into knowledge and then produce value from it. The power now is on the side of the client, and new clients are used to online connectivity, instant response and one-click demands. There are some supervisory institutions that understand these challenges and the need to balance promotion or acceptance of new value propositions with protection against the associated risk, consumer protection, investment protection, cyber security, and related topics.

A majority of banks existing today will not exist in 10 years' time. It needs to be understood that the skills in banks are changing, and IT engineers and data scientists are needed, Change is required within the banks in order to keep up with the competition of fintechs. Reflection will be required about what the definition of a bank is. It is no longer an institution that takes deposits and grants loans. Either they offer a bundle of financial services that permits people to realise the opportunities that are available to them, or they essentially do nothing. This represents a challenge, not just for the banks but also for regulators and supervisors. Supervisors and regulators should understand the issues and study them, in particular the financial sector technology developments. Regulators need to be 'ahead of the curve' in relation to technological change. It is important that in terms of the regulatory response, technological developments are not unnecessarily blocked or frustrated by regulation.

New risks such as cyber risk cannot be underestimated. This is a risk, not just for individual banks, but for the system and for economies. Developments can be pro cyclical; it can be that new parties enter the financial sector in good time and develop things, but when the situation worsens, they withdraw from the sector. This is not good, as it runs the risk of amplifying cyclical developments.

4. Observed consequences of the challenges faced by the banking sector: reduced ROE, high cost-income ratios, still increasing costs...

Looking at the current situation of European banking, it can be seen that the Returns on Equity (RoE) have been stable and positive, but at a very low level. There are banks that manage to earn money in this environment, however, income which needs to go up, is actually decreasing. Interest income is going down, as well as net fees. Costs increased last year for 60% of the banks in the SSM, but they did not decrease, despite all the cost measures that have been taken. The problem is not getting better, but is getting worse.

5. Though there is room for manoeuvre in many banks in this respect, the cost income ratio issue leads to overcapacity and consolidation issues

Looking ahead, there are two points to mention. The first is costs and cost-income ratios. It is important to look at the fact that there are great differences across banks. It is not an issue of 'banking system versus banking system'; it is more an issue of individual >>>

>>> banks that need to tackle these types of issues. This gives rise to the issue of potential overcapacity and consolidation. That may be overemphasised sometimes, but it has to be tackled, and doing so depends on the different structural and legal situation of various countries. Europe is facing a 'perfect storm' in terms of adaptation to the new environment. In relation to consolidation, cross border consolidation is a possibility, but there are many obstacles. Domestic consolidation might be easier to achieve. Another risk is that of concentration. Europe is aiming to have banking systems that have a balanced composition. If there are one or two suppliers fully monopolising the new financial technology environment, this also creates risks for the system.

6. The role of supervisors regarding the evolution of bank business models

There is now a joint common understanding that it is important for supervisors to engage in discussions on business models with banks, because this is key to assessing risks. Supervisors have been making this part of banks' supervisory agendas, with three more forward-looking elements in supervision introduced after the crisis: one is focused on banking business models and strategies, another is focused more on risk governance and culture in banking, and the third is more focused on macro-prudential relationships.

Supervisors have identified these risks, and are challenging banks. Banks might not always perceive this as help, but hopefully will do so in time. SSM makes sure that banks consider NPLs and find strategic ways to deal with them. Stress tests are an important instrument for testing what impact will be seen from these developments in the sector. There also needs to be not just a single stress test with one variable influencing the balance sheet, but scenario analysis regarding what the banking system may look like, and the impact of that on certain variables. In relation to the political uncertainties, there is a Brexit taskforce, which is very successfully working on this issue. On profitability, the SSM asks banks for their multi year forecasts and then back tests. Regarding whether problems can be spread over time, this sounds like a very good idea, but it has two drawbacks. The first is that uncertainty is not removed from the market by spreading it over time, and the second is that it requires a clear commitment that everyone continues lending whatever happens.

Some sympathy was expressed for the proposal of Andrea Enria to create a 'bad bank' that could solve the NPL problem all over Europe. Europe has to start from scratch, and this would be a good way to achieve that. There are two things that are being done on NPLs, and two things that should not be done. The first is that there is very strong attention being paid on the part of supervisors to the issue, action, and guidelines. Secondly, there are initiatives, such as the EBA initiative. The concept of an Asset Management Company (AMC), or several AMCs, is a welcome discussion. The two things that should not be done are to have an indiscriminate approach to the issue. There are banks that are perfectly sound that have inherited many NPLs from seven years of recession. In a way, this is unavoidable. Other banks, however, are facing much more difficult situations and need to receive special attention. The second thing that should not be done is to indiscriminately force fire sales. This is extremely important; it is vital to have a determined, but sensible approach to NPLs. ●

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

1. The ultimate goal and benefit from regulation in Europe including for financial stability reasons, should be to build a single market; this requires building trust between supervisors

1.1. An optimal use of liquidity by banking groups in the EU, improved cost efficiency, and financial stability are the main objectives of the EU single banking market

In some European countries, liquidity is trapped; in others, there is not enough liquidity. The European Commission has made a proposal about how to solve this, but this solution is complex and its conditions are difficult to meet, and there is no common ground on adopting this proposal. According to some panel members (representatives of the banking industry) the commitment to creating a banking union appears to be lost.

One panel member noted that one of the major advantages that US banks enjoy is their very large internal market. As the Basel Committee proposes to impose liquidity ratios at the level of >>>

>>> holding companies, it is clear that asking for compliance with those ratios at the level of each legal entity within a group might create constraints. To fully comply with the LCR, banks with several entities in multiple member states within the banking union will ultimately show a consolidated ratio that is much higher than 100%, around 120% to 130%, and this will be costly. An industry representative added that, although stability is required, there is also a need for European banks to be competitive with US banks and other competitors outside Europe.

1.2. Increasing the level of trust is a protracted task since individual EU countries are starting the process in different situations

This is an issue of trust: Europe needs to be patient in increasing levels of trust and considering the detailed proposals. The next regulatory steps may need to be rephrased to make them better nuanced, as different member states are in different situations; however, it is important that this process should proceed. The test of the global financial minimum standards that the European Commission has proposed may well be the extent to which the measures protect financial stability, how much they improve the banks' strength, and also how much they bolster market confidence.

1.3. Regulatory progress toward further integrating the EU single banking market has been made, but adjustments are required to both address certain domestic stability concerns and to enable banking groups to reap expected benefits

There is a tension between protecting depositors, which has been the minimum objective since work on the banking directive began, and improving bank financing competitiveness. The single market has existed for a long time, but large banks do not yet fully realise the benefits of it. However, it should be recognised that there are legitimate concerns with respect to domestic financial stability, especially on the part of host member states.

The ECB's regulation of banks is hugely different from 10 years ago, and represents a significant improvement, particularly in the ability to govern large conglomerates. Progress has been made with the implementation of the single rulebook and supervision, but liquidity remains an issue that the EBA should look into, notably by assessing the benefits of the recent regulation. There are also more technical provisions to look into, such as the interdependence of assets and liabilities.

1.4. Remaining challenges

The European Commission has tried to strike the right balance in relation to capital and liquidity requirements. It wants in particular to give supervisors the option to lift the requirements at an individual level, but as this is only an option, the supervisor will ultimately have to decide what to do. This solution does not please all parties, but allows for progress to be made while heeding the concerns of all sides. Another hurdle that is preventing big banks from benefiting from the single market, is the inclusion of the interconnectedness criteria within the banking union, among the criteria that qualify a bank as G SIBs. As there is now one single resolution authority and one single resolution fund, the idea that a non German Eurozone bank extending a loan in Germany is a dangerous cross border exposure is an 'oddity'. The discussion about a level playing field also includes having a level playing field within Europe, and this will only be able to exist if international rules are implemented in a consistent manner across Europe. At this point, Europe will also be able to compete with the US.

2. Taking into account EU specificities in order to optimise the capacity of banks to finance the economy, is an essential regulatory outcome

2.1. An accurate description of EU specificities is necessary

Europe is now well equipped to be active in the discussions at Basel, with a better European perspective. The role of EBA in producing evidence from the European perspective, supported with data and instilling a coordinated stance, should not be underestimated. EBA has contributed a large amount of evidence regarding the European specificities, and is in a good position to present this at a global level and ensure a common assessment of what European specificities are. However, the EBA also has a role in ensuring that Europe itself adheres to these global rules.

2.2. Achieving a wide political support in the EU, on the international banking standards, which are defined at the global level, requires them to take into account the EU specificities regarding SMEs, covered bonds, mortgages, securitisation

Covered bonds are a very well known feature of the European landscape, and are now under discussion. Securitisation STS was a major file, and represented a turning point. Progress has also been made in the area of mortgages, where EU structures are completely different and the EBA has been very clear that the structure in Europe is not risky. Despite the progress that has been made, however, there is still a 'stalemate' at Basel, and more will need to be done. Another panel member noted that the package that the Commission tabled in November contains trade offs, and these trade-offs need to be dealt with >>>

>>> one at a time. For instance, Europe wants to develop its market based finance, and therefore cannot necessarily just 'rubber stamp' what comes from the Basel Committee.

2.3. The economic differences between member states might also deserve specific approaches

Acknowledging that this is a provocative statement, a representative of the public sector commented that while it has been said for a long time that the same rules should apply throughout the banking union, when it comes to the application of these rules, there might be a need to reassess this statement, and try to understand the different realities inside the banking union for the sake of the banking union's survival. The differences between member states may create significant problems in the practical application of the common rule book.

2.4. However, just introducing exemptions and adaptions at EU level is not the appropriate approach

A public authority representative stated that with the Stability and Growth Pact, the starting point of the fiscal variations was a very simple framework, to which increasing numbers of exclusions from the general rule were added. The end product was hardly manageable, and Europe risks producing a similar result now if it introduces these numbers of exclusions in the Basel framework. Another public authority representative replied that although this regulation might be imperfect, it is better to stabilise it for a period of time and then move to supervision, which will produce more accurate data that can be used in the next regulatory forum. This is what has been done at Basel.

3. Harmonising international regulation while recognising differences leads to the proportionality issue

3.1. The initial consensus at the global level was to apply sophisticated rules to bigger banks and some more standardised rules to smaller ones

In the past, the European legislator decided to apply the Basel rules to the entirety of the European banking sector; there was consensus on this. However, since this time, the Commission has solicited feedback and, on the strength of this, has looked into the feasibility of introducing more proportionality into its banking legislation. It has now come up with a number of proposals regarding reporting and disclosures notably on banks that have small trading portfolios, which the Commission believes provide meaningful alleviations for banks that need them.

Finally, the same rules need to be maintained for banks that are roughly the same size, have the same business models, and the same types of interconnectedness. However, some consider that although the Commission's proposal probably reduces the amount of reporting, the regulation itself is not adapted to different business models.

3.2. Basel III rules were clearly designed for the structures and business models of large, internationally active banks

The Basel III rules were clearly designed to fit the organisational structures and business models of large, internationally active banks, which, at the time of the crisis, were the source of risk. However, the European banking sector also has a number of small and medium sized banks, with fairly simple business models, and a local or regional focus. It is therefore necessary to consider whether every bank ought to be regulated and supervised in the same way; it might be considered disproportionate to do so, although this has to be balanced against the goal of creating a level playing field. An industry representative commented that the principle that should be followed is that the same risk should be governed by the same rules; these rules might be stricter for smaller banks, which may not be able to measure risk in as sophisticated a manner as larger banks, but the crucial thing is that these rules should be simple, which is the most important thing. In this sense, Europe can learn from the US.

3.3. Proportionality applies to financial instruments such as repos

In the original meaning of the European regulation, being proportionate means being relevant to the purpose followed, and not overshooting in order to address specific targets; one relevant example is the treatment of repos and reverse repos in the net stable funding ratio. Some would argue that it is not proportionate to impose a punishing treatment for repos and reverse repos of less than six months' maturity; others counter that the goal is not to address the funding of banks through the repo, but to limit funding of illiquid assets in the shadow banking system. However, in the view of one speaker, to be proportionate, this rule should only be imposed on unregulated entities.

3.4. Three important objectives should be combined: reducing unjustified compliance costs, achieving similar soundness and resolvability whatever the size of a bank, and avoiding unnecessary regulatory complexity

The first goal that should be borne in mind is the need to reduce unjustified compliance costs, >>>

>>> but this should be balanced against the maintenance of banking as a public service, and with Europe aiming not to decrease the distance to default for banks. Although some people want to go further than what the European Commission proposed in November, one speaker noted that proportionality does not just relate to the size of banks, but also to business models, interconnectedness, and everything else that can be a source of risk. This leads to significant complexity, which, as far as possible, should be avoided; finally, the American system is as such extremely complicated, but applying it in Europe would probably require something that is even more complicated. ●

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

1. NSFR and FRTB identify the causes of the financial crisis which triggered a costly recession, namely the excessive reliance of banks on short term funding and insufficient bank capital to face up to market risk

The FRTB and NSFR are significant components of the Basel Committee response to the financial crisis, which was fundamentally a bank liquidity crisis. At the time, banks had held many assets in their trading books that were considered highly liquid, but when the crisis hit, the banks did not have enough capital to deal with the valuation losses that materialised. So the crisis also revealed concerns about the valuation of complex instruments, and therefore the new regulations seek to address these shortcomings.

For the NSFR, the goal is to limit reliance on short term wholesale funding, and ensure that less liquid assets are underpined by stable funding. Inter bank maturity transformation is penalised while maturity transformation is allowed if it is funded by a non financial resource; and the NSFR is expected to be neutral with respect to transformation between non banks. For the FRTB, one of the most important achievements is to draw a clearer boundary between banking and the trading book; there is also an improvement of the standardised approach by way of having a more risk sensitive entry, although it is still conservative with respect to hedging and diversification, and there is an improvement of the internal models approach with a move from the VaR to the expected shortfall.

The new regulations introduce specific trade offs: a general trade off between liquidity and leverage, between bank and systemic liquidity, and regarding hedging.

The FRTB and NSFR are now being transposed into EU law. In light of the EU's objective to develop market based finance further in order to have a more balanced funding of its economy, the Commission proposed adjustments to the calibration of the FRTB and of certain elements of the NSFR to mitigate their immediate impact on market-making activities.

2. Financial markets will benefit from more resilient banks but may be more limited in their ability to operate

The consequences of the FRTB and NSFR are quite different, because they target different issues, and it is difficult to know what these impacts will be in advance. The primary goal of the international agreements was, and is, to establish adequate minimal requirements for the risks that exist, and as such, both r propositions are valuable extensions of the regulatory framework. Markets will always benefit from more resilient banks.

3. The industry reports that certain aspects of the proposed frameworks fail to match the actual risk and short-term nature of certain EU specific bank market services, and products related to equity and fixed income markets

3.1. The NSFR ignores the short-term nature of the synthetic financings of EU equity markets as well as its effective risk

The majority of European equity financing is conducted through synthetic financing, primarily due to client demand, which is driven by the fact that the European market is more complex than the US one. In this sense, the issue with the NSFR is that its current form does not allow any recognition of the matched asset against a liability; indeed, the asset is looked at on a standalone basis, and this requires the investor to apply required stable funding (RSF). The impact of this could be to double or triple the financing cost of a synthetic approach, which has the potential to decrease liquidity. >>>

>>> 3.2. The NSFR imposes over one year sterile funding on repo transactions, which impacts fund cash fixed income markets and market-making although they are very short term by nature

Whereas banks provide finance predominantly for the equity business, the repo business tends to provide finance for the fixed income product on a more transactional basis. With the implementation of Basel III rules, leverage is becoming the binding constraint. The NSFR is challenging since the market is very short term by nature due to the specificity of the assets side of the balance sheet. One problem with the NSFR is that, based on the current funding patterns of fixed-income activities in some banks, it may create an NSFR requirement for activities that are short-term in nature, and hence require greater than the one year's funding that the organisation will need to invest in supplementary high quality liquid assets (HQLAs), which will further leverage the institution.

All these regulatory charges and costs eventually get pushed down to the operating businesses, and directly impact the pricing of their book and the type of businesses they can be in. One speaker anticipates that the NSFR will lead to 5% to 10% more leverage being utilised, without counting the 'quirks' regarding linked transactions in repo. Rather, the NSFR should have been designed as a top of the house metric.

3.3. FRTB is mainly perceived by the industry as a capital increase exercise, which could strongly impact financial markets

No panel members representing private institutions object to anything within FRTB from a policy perspective; improving the design of the market risk rules is the right goal to have. They stressed the fact that the FRTB was intended to be a commitment on the part of policymakers to revisit the market risk rules and refine them to deal with the problems that arose from the haste with which the market risk rules were initially revised; however, the industry now generally considers that the FRTB has bee, transformed into a capital increase exercise. A rule like the FRTB, applied across a broad swathe of the industry, has the potential to result in misleading impacts. Further, many of the impact assessments assume full model approval, while the numbers indicate significant cliff effects between the standardised and modelled outcomes.

4. Smaller financial markets such as Nordic forex or fixed income markets are specifically impacted

4.1. The proposed rules are particularly detrimental to the liquidity providers of the relatively small financial markets such as Nordic forex or fixed income markets

In the Nordic countries, liquidity is dependent on the banks' willingness to act as intermediaries in the financial markets. The Nordic markets are relatively small involving a limited number of market participants who provide market liquidity. Like other markets, the Nordics have observed shrinking dealer capacity and indications of declining market liquidity, to which much of the new regulation contributes, as well as accommodative monetary policies and high demand for HQLAs.

4.2. Non risk sensitive floors on internal models (FRTB) and overstated market and funding risks explain excessive capital increases, which will be passed on to end users or dry the liquidity of markets at the expense of financial stability

The particular concerns with the FRTB and NSFR are mainly in the Nordics' core markets: products like HQLA government and corporate bonds, FX, and standard risk management products. Holdings of HQLA assets are driven by the non risk sensitive floor on the internal model, and appear to be an overstatement of the credit spread risk for traded corporate bonds. Overstating the market and funding risk would unnecessarily increase capital and funding costs for banks. The lack of dealer capacity in the Nordic countries could lead to new systemic risks, and contribute to other forms of instability in the markets. Finally, some of the issues with proportionality are not about size, but have more to do with implementation and the impact of calibration. A lack of recalibration would trigger an average estimated increase of two and a half to four times regulatory capital on these markets.

5. The actual impact of the FRTB and NSFR is being closely monitored and potential unintended consequences will be addressed

It is generally recognised among regulators that the starting point is very low, and the crisis demonstrated that market risk was not supported by an appropriate level of capital, even after Basel 2.5. The Basel Committee recently published its latest Basel III monitoring exercise, which shows that the percentage increase of market risk minimum requirements would be significant. However, a number of elements should be noted: banks have not yet implemented the FRTB, no assumptions were made about behavioural response, and even a significant increase in market risk capital requirements does not necessarily mean an increase in overall minimum required capital.

During the implementation period of both the FRTB and NSFR standards, the Basel Committee will continue to monitor the impacts of the >>>

>>> standards on banks' positions and behaviour. If the evidence suggests unintended consequences then the Committee will address them and, if needed, re-examine parameters or provisions. That is just part of the Basel Committee's usual process. Currently, the Committee is looking at issues raised by stakeholders; under the FRTB, they are looking further at the P&L attribution test and the treatment of some risk parameters or activities, especially the treatment of ethic risk under the standardised approach. Regarding NSFR, they are looking further at the treatment of derivatives.

6. Key challenges associated with the implementation of the standards

A public authority representative outlined for banks, the main challenges should concern data quality and data management in order to allow for a timely adoption. The focus should not be therefore only on capital and liquidity: processes and control, IT and data will also require from banks further development work. An industry representative added that the industry primarily wants rules that are designed to be functional, without adverse impacts; they urge caution in that regard.

A public authority representative advised that consistent implementation of the standards must be ensured, or at least promoted, and rules clarified where possible.

The EU has also to ensure that they have international agreements that are implemented and work everywhere. Without these frameworks adopted globally, regulatory fragmentation and uneven playing fields will emerge.

7. It is still difficult to anticipate US regulatory directions and whether they will contribute to international regulatory consistency

The EU and the US have different rule making processes, so rules are not always proposed at the same time in Europe and in the US; at the current time, the EU Commission is significantly ahead while one panel member noted that the proposed rules would be phased-in for a period of three years from the implementation date agreed by the Basel Committee. Implementation is due in 2019, and the Basel Committee, as a process to monitor the timely and consistent implementation of the standards, will include the FRTB and NSFR in the scope of its assessments under its Regulatory Consistency Assessment Programme (RCAP). In due course, the implementation of those standards across jurisdictions will be then reviewed and the materiality of observed deviations will be assessed. Meanwhile, public policy representatives from Washington have indicated that under the current administration, it is difficult to project whether there will be completion in any foreseeable time period.

Panel members discussed the G20 finance ministers' communique: one speaker stated that the language on financial regulation was essentially copied from previous communique language. Another replied that there was very little intervention in Baden-Baden by the US, regarding the question of the financial markets and regulation; this representative advised that nobody should over interpret the fact that the communique has not changed. Whilst nobody knows what will happen in the US, the market has to await the US decision, and an announcement of who will represent the US. ●

Operationalisation of the EU bank resolution framework

1. Precautionary recapitalisation: issues and stakes

The Chair reminded the audience that the discussion would essentially deal with the minimum requirements for own funds and eligible liabilities (MREL). He stated that European Union rules require a bail-in of at least 8% of total liabilities, including own funds, before accessing any form of public financial arrangements, like the Single Resolution Funds (SRF). In this context, resolution authorities require bank-specific MREL-targets, in order to ensure that banks have a sufficient amount of own funds and liabilities eligible for bail-in, and thereby facilitating resolvability also in extreme crisis situations. Apart from the discussion on MREL, some national authorities in Europe are proposing to use a precautionary recapitalisation outside resolution if the relevant conditions for such a form of State Aid, as listed in the BRRD, are met.

The Supervisory Board at the ECB is trying very hard to develop proper practice in this area. The absence of bail-in eligible instruments is one problem, but there are others, including the fact that a significant portion of potentially bail-in eligible liabilities >>>

>>> and own funds are held by retail investors. These challenges cannot be resolved within the concept of precautionary recapitalisation in itself.

Precautionary recapitalisation is embedded in the existing EU law, and it is legitimate to think about it; however, it is supposed to be restricted to truly exceptional cases, rather than becoming established as a general way to circumvent resolution and continue bailing out banks, which is against the general principles of the BRRD. Allowing this to happen would destroy the resolution logic which has been newly established in the EU.

The most difficult element within this question is how to treat losses or potential losses, for which the precautionary recapitalisation tool cannot and must not be a solution. In one panel member's view, the way that this interaction currently works is extremely difficult to handle. It is hoped that, in the near future, this institutional setup can be reviewed. Another participant added that a step by step approach must be taken in relation to the implementation of the BRRD; there must be a transition period for the implementation of TLAC and MREL requirements, which should not be too high or too subordinated at the first stage, and the capacity of the markets to respond to these new requirements needs to be taken into account.

2. The EU crisis management framework is challenged by the legacy issues

2.1. Financial stability impact of MREL

In one panel member's view, the general concept of the BRRD, combined with state aid rules, is a positive idea. However, where the BRRD is applicable, and particularly where certain business models do not foresee holding bail in eligible instruments in sufficient amounts, it will be challenging for banks to meet the MREL target in the coming years. Then, there will be a serious risk of having to bail-in senior debt or even deposits in a crisis situation, which might trigger a systemic impact. The EU Commission has changed its regulation on state aid: entities cannot rely on being bailed-out in case of their failing so, depending on the systemic impact, insolvency or resolution proceedings will be applied. The most important message is that, with at least part of the framework in place, the different stakeholders can get together and manage situations in a way that is logical and does not harm them. Nevertheless further fine tuning will be necessary.

2.2. Dealing with retail investors that are misled in the purchase of bailing instruments

The Chair invited participants to comment on the problems that arise when applying the bail-in tool to senior or subordinated debt held by retail investors. An industry representative replied that the question of who is the holder of a liability is very different from whether that liability is bail-in or MREL eligible, and the two should not be confused. The issue of retail investors as holders of MREL or TLAC eligible instruments should be addressed via requirements on information policies, e.g. the layout and content of sales brochures and is much more important than questioning the bail-in or MREL eligibility of instruments. If something is eligible for bail in, it should be bailed in, and if there has been a problem of mis selling, that needs to be dealt with through the mis selling regulations.

2.3. Other issues related to holders of TLAC or MREL instruments

According to one public decision maker, the Basel framework contains a restriction on how much of the MREL/TLAC instruments issued by other international banks a bank can hold, which is important; the speaker's institution was 'slightly disappointed' by the dilution of this in the European Commission's proposal. The CRR is inconsistent with an important Basel standard linked to TLAC, which requires a bank that is buying a GSIB TLAC to deduct this from its own TLAC eligible items, reducing the risk of contagion if a GSIB enters resolution. As such, it is inconsistent with the level-playing field that Basel standards are intended to accomplish.

2.4. Should the implementation of the EU crisis management framework be postponed?

A public authority representative stated some people present the issue of transition in a way that indicates that until the transition is complete, the situation is hopeless. This is not the case; rather, the goal is not to impose on banks too high requirements for putting MREL in place. The goal needs to be an orderly replacement of that senior debt with instruments which are subordinated, whereby it is clear to investors that if the firm fails, after the capital instruments, they will be the next ones to bear the loss. This orderly process is now taking place.

3. Operationalising the bail-in tool

There are no transition periods for the resolution authorities, because they have to be ready to face a crisis in all circumstances. These authorities have to implement the tools and the powers that have been provided by the EU regulation, including the bail in tool, which needs to be implemented in a practical way. There are many conditions for its implementation: some safeguards need to be taken into account, such as the principles that no >>>

>>> creditor should lose more in resolution than in liquidation, and that there should be the equality of treatment of creditors with the pari passu rules.

The suspension of the listing of existing securities in multiple jurisdictions may be very difficult and challenging for large, international banks, because the regulations are different. It also implies several authorities. A number of practical issues need to be considered, such as delisting the bailed-in securities, listing newly issued shares with a multiple jurisdiction issue, and the right to compensation, including whether certain titles can be used. There is a need to be very precise and very practical on these issues, and the possibility of legal challenges needs to be considered. All parties need to work together in an international framework.

Executing the bail-in will combine efforts from resolution and market authorities, banks and market infrastructure. The FSB is working on these aspects, as well as other practical aspects, including control, funding and resolution, and continuity of access to financial market infrastructures.

4. Shaping the MREL framework is challenging

The first goal of setting the MREL target is to achieve a sufficiently predictable outcome for this target, but this has to be weighed against a consideration of bank specific adjustments for this target. The category of Other Systemically Important Institutions ('O SIIs') contains a large variety of banks, and much disparity in terms of business models. It is therefore difficult to identify what can actually be demanded in terms of bail inables and minimum bail inables, and requiring a bank to sell a certain amount of pre-defined bail inables may create problems rather than solving them. As such, it is essential for solutions to be carefully fine-tuned. In the view of one speaker, flexibility in relation to the second layer of banks should be completely guaranteed, because Europe is again in 'uncharted waters'. There needs to be a distinction between G-SIBs and O-SIIs. An industry representative responded that when player choose to enter the financial markets, they are required to respect some rules. Accordingly, they would recommend that the MREL should be as strict for O SIIs as it is for the G-SIBs. Some banks that have a more deposit based funding model will face a challenge, and in another speaker's view, this should be addressed via the time period they would have to build up their MREL.

BRRD II, in the view of another participant, is very proportionate, and this participant thanked the European Commission for the work they have done on it. However this speaker stated that they were concerned about suggestions that O-SIIs should be treated like G-SIBs, and that TLAC should be automatically applied to them, given the negative effect that this is likely to have on their institutions.

5. Pre positioning of internal MREL raises concern in the banking sectors

Internal MREL aims at ensuring a minimum recapitalisation capacity at the level of material entities which are located outside the resolution entity's home jurisdiction, to facilitate cooperation between home and host resolution authorities. One panel member stated that at the Banking Union level, it would be logical for no internal MREL to be required: the Banking Union should be treated as a single jurisdiction. Beyond the Banking Union, the calibration of internal requirements should, as provided by the FSB, be limited to material subgroups and capped by an explicit limit.

Internal MREL performs two functions: the first is to underpin cross border co operation for international banks, and the second is the mechanism by which losses are transmitted in a reliable fashion from the operating companies where they arise, to the resolution entity at the top of the group. Rather than being a 'terrible imposition', in the view of one panel member's institution, it is a necessary element of a single point of entry resolution strategy to articulate how the losses get to the resolution entity, and the bail-in occurs not only for cross-border subsidiaries and operating companies but also for domestic subsidiaries. It is also important that holders of operating liabilities in those operating companies should take comfort from the availability of internal MREL.

Another industry representative stated that there should be room for adjustment in the internal MREL requirement for non EU headquartered G-SIIs. This should be set by the host resolution authorities according to the institution's risk profile and the business model via which it undertakes activities in Europe, and is coordinated through the crisis management group.

6. The treatment of MREL breaches

The Commission's paper triggers automatic MDA restrictions if MREL is not respected, which, in the view of one panel member, is a major mistake. As debt is not the same as capital; there can arise problems respecting the debt portion of MREL for reasons which are market related, rather than linked to the health of the bank. Regarding the capital portion of MREL, if an entity loses this because it has made losses, it has a capital problem and will have a MDA restriction in any event. MDA related to debt issuance problems is therefore the 'wrong punishment'. >>>

>>> 7. Additional remarks

An industry representative stated that they would support further Europeanisation of insolvency law. It is very important to improve on the legal framework within which resolution activities are deeply embedded. Parts of this are fully Europeanised, and others are not. Many countries have begun serious political efforts to improve their capabilities on enforcement recovery and legal enforcement, which is highly welcome and very important.

Credit hierarchy is also important, and the speaker would not put this at the discretion of a resolution authority. The mandatory hierarchy approach that has been introduced in Germany has been a 'bold move', although it has created something of a burden and may face legal impediments in various countries. Ultimately, if the EU chooses a contractual approach, the price that will have to be paid is a lengthy de facto transitional period, and the speaker would prefer progress to be made much more quickly. ●

Proportionality in EU banking regulation

1. Four key needs were expressed on the occasion of the EC call for evidence: a better combination of banks' soundness and economy funding, to alleviate excessive regulatory burden and improve regulatory consistency, and to introduce proportionality in bank regulations

In November, the European Commission presented the conclusions of its call for evidence. The conclusions had been that the overall framework was sound, but improvements needed to be made in four areas: the funding of the economy, the overall regulatory burden and reporting in particular, inconsistency between various pieces of legislation, and proportionality. As such, the Commission proposed to introduce proportionality with respect to reporting and disclosure requirements; looked at remuneration, proposing to exempt smaller and less complex banks from certain requirements; proposed to allow such institutions to use less complex methods for liquidity and market risk; and is asking the EBA to develop an IT tool that can help small banks to navigate the complexity of the regulatory framework. A future additional legislative proposal is possible, but this will have to be well crafted, in order to avoid regulatory arbitrage in the single market.

2. The Commission has already identified the right regulatory areas to make bank regulation further proportionate without lowering quantitative requirements for capital or liquidity

2.1. Proportionality already exists to a large extent

One representative of a regulator stated that proportionality already exists to a very large extent. The EBA uses many criteria, such as the size of bank activities and even business models. However, reflecting diversity is difficult. A central banker added that the framework already contains proportionality, in the sense that supervisors can apply it with their supervisory discretion. The ECB can apply a risk-based approach. When the SSM designs the less significant institution (LSI) supervisory common approach, the ECB follows the proportionality principle.

2.2. There is room for making rules more proportional and clear, but it is not about lowering quantitative requirements

An official commented that there is still a year or more to go in the negotiations over the CRD package; institutions should do a good job with what is on the table, fine tune what the Commission has proposed, and then leave time for these new rules to bed down. A regulator added that one consequence of proportionality has to be that the limitations on institutions that are regulated in a simpler manner have to be more restrictive. A small bank, regulated much more lightly than a large bank, should do business at a very different level.

The view of the ECB is that the items that the Commission are selecting for proportionality are correct. Remuneration rules, disclosure rules and fit-and-proper rules can be simplified for the small institutions, but the frequency of reporting for even the smallest banks should not be reduced from quarterly to annually, because this would make supervision ineffective. One banking representative stated that, despite statements from regulators, the European approach to banking regulation still resembles a 'one-size-fits-all' approach. A regulator commented that there is a need to be >>>

>>> cautious when there is increasing complexity for small banks while, at the same time, making the big banks subject to very simple rules. SIFI and MREL requirements will be another very complex area, for which more thought is needed.

3. Proportionality - i.e. regulatory fairness - promotes fair competition and safeguards the diversity of the financial system

A central banker stated that they feel proportionality promotes competition and enhances the resilience of the financial system as a whole; having more proportionality safeguards the diversity of the financial system, which makes it more competitive. A 'one-size-fits-all' approach always creates inefficiencies, not only for institutions and banks, but also for supervisors. Another industry representative added that proportionality is about finding the right balance between regulatory oversight of the banking system and not rendering the banks 'sterile'.

4. Proportionality is not just talking about the size of the balance sheet or the administrative burden, but also the effective transmission of monetary policy, the impact of bank regulations on the financing of the economy and domestic financial markets, and the consistency of the regulations across all financial sectors

Proportionality is not just about the size of the balance sheet or the size of the net assets: the business model, risk profile and systemic significance of the bank also have to be taken into account. The discussion about proportionality is shifting away from its administrative focus towards a proportionate economic impact of regulations. Malta, where about 95% of the economic operators are SMEs, feels that the lack of proportionality may have an indirect impact on the financing of SMEs; other countries in Europe are in a similar position. Proportionality will also help to support the transmission of monetary policy in Europe.

An industry representative commented that proportionality is especially important in relation to specialised banks, which are often subject to special rules and requirements, and might have different risk profiles. Here it is important to ensure capital requirements that are in line with the actual risks that they take. The output floor from Basel is a problem in this context; Europe should find a way not to disproportionately affect mortgage banks, or other low risk business models. Additionally, Europe should try to protect its well functioning markets, and perhaps make them bigger; in the view of this representative, this includes the covered bond market. The rules arising from FRTB and from Basel IV will affect participants in this market disproportionately.

5. The definition of a detailed list of exceptions or the creation of a 'small-banking rulebook' are two possible but complex options to improve regulatory proportionality. This requires stabilising criteria beforehand to target small and low risk banks

A central banker stated that Europe has two options for improving proportionality. The first is to create a list of exceptions; the second is to create a separate set of rules, a 'small-banking rulebook'. Another speaker stated that if this were to be created, it should apply to banks that are not systematically important; even some small banks can be very risky, and the criteria should combine the size and riskiness of a financial institution.

An official commented that the size, riskiness and impact of institutions can already be taken into account within the current framework, such as the SREP model that is now being designed for the SSM: in this, a low priority institution that has small risk and a low impact will have an assessment every three years, and its information requirements will also be lower. However, if market conditions are bad, even a small bank can be deemed systemic, and Europe should not consider that merely having a high capital requirement should allow the cancellation of a large part of the supervisory framework for the small institutions.

6. Challenges posed by deviating from the idea of a single rulebook: an effective level playing field, preserved financial stability, the facility to identify the banks that fall under each framework, legibility for investors and retail depositors and the agility of the EU banking sector

6.1. The level playing field and the efficiency of bank regulation are at stake

A supervisor expressed the need not to deviate from the idea of a single rulebook: the system should be based on common and strong capital, liquidity, and governance rules. There is value in having a level playing field, and more importantly, it is necessary to have the safety that these rules provide. Being small does not mean that a bank is not risky: there can be consequences from liquidation for unprotected depositors, and small bank failures can have wider consequences. As such, the supervisor would advocate adhering to the single rulebook and accepting the existing benefits of the increased safety of the banks, but supervisors should >>>

>>> apply discretion and a risk based approach in their supervisory practice.

6.2. What restrictions on business models, size and risk taking would naturally follow from proportionality?

A regulator asked panel members to consider what sorts of restrictions on business models, size and risk taking would naturally follow from proportionality, and whether these would be acceptable. A central banker noted that in the United States, the Financial CHOICE Act would exempt small banks from a broad set of rules only if they hold more capital to fulfil a higher leverage ratio, which might be a model to follow. An industry representative added that small banks should not be engaged in big deposit taking or derivatives trading, and their markets departments should probably be restricted. There could also be a provision relating to the bank's local presence, regional presence, or national presence.

6.3. Achieving an appropriate awareness of all the stakeholders on the differences is an additional challenge

An industry representative added that Europe needs to consider what to do about telling the other stakeholders, including creditors, what the risks are if they do not impose these sorts of restrictions. There is also a need to consider whether there is a completely different way of resolving these kinds of institutions, or whether that should be tied together with the requirements where there is a lighter regulatory tranche.

6.4. Should we encourage both diversity and consolidation in the banking sector?

An official stated that proportionality can be good for competition if it is crafted well, but it can also be very bad for competition in the single market, and for this reason Europe needs to approach the issue with caution. There also needs to be consolidation, at least in some markets in Europe, in order to have a more efficient and more profitable banking sector. The 'small banking box' is an interesting proposal, but even though small banks may not be risk-takers in isolation, taken together they may be systemic if they act in the same fashion in the market in reaction to external events, or if they make the same mistakes in the management of their balance sheets.

An industry representative stated that the pronounced diversity of the European banking landscape calls for regulatory differentiation between large and complex banks and small and medium-sized banks on the other, that do not pose any significant risks to the European financial system. The most widely stated reason for harmonized regulation is its supposed contribution to achieving a level playing field. But the mostly 'one size fits all' approach embodied by the EU's Single Rulebook itself has introduced severe market distortions due to the disproportionate effects of regulation on smaller banks. Therefore, the usual rationale is a fallacy as it is actually detrimental to a level playing field. The industry representative's called for more proportionate regulation, explicitly however excluding capital and liquidity requirements as set by the Basel regime, as these were necessary to achieving a sound financial system. Equally, consolidation in Europe should not be a goal in itself and should also not be furthered by regulation.

7. The specificities of the US banking sector

A regulator added that the US example does not compare with what Europe would want, for three reasons: the majority of banks discussed in this context in the US are community banks, which only service their local community; the US solves problems with these small banks via liquidations, but the regulator does not think that Europe has the 'social appetite' to do this; and the price of the service to American consumers is very high, and the service is not very good. The US, therefore, should not be used as a benchmark. ●

Consistent and reliable use of internal models in the insurance sector

1. Supervising internal risk modelling notably on an international basis is resource intensive

Internal models really are complex, but this follows the complexity of business and balance sheets. Indeed, many panellists agreed on the fact that Internal models are not bringing in any further unjustified complexity. They considered on the other hand that, so far, the companies running internal models should be considered as the best supervised companies, although there is always room for improvement. >>>

>>> However, in this context the relationship between insurance groups and the supervisors, is very interactive, and the main challenge also for supervisors, is resource intensity. Consequently, for example in France, the supervisory organisation has been adapted to blend supervisory cultures, and identify good practices. Nevertheless, certain representatives of the industry stated that many additional expense are also due to multiple layers of validation and multiple supervisors looking at the same thing. They considered that this is one of the main reasons why certain insurance groups are taking some subsidiaries out of the internal model process.

2. Key success factors to maintain trust

The panellists agreed on the fact that internal models are there to enable managers to do the right thing and steer in the right way. Consequently, internal models must be understood in order to establish how to steer asset liability management, and how to use reinsurance to optimise the risk profile and the capital structure of a company.

However, since the world is very complex, and internal models reflect events in the real world, various panellists stressed that one key challenge regarding using the internal modelling of risk is trust.

One particular concern expressed was the comparability of the capital requirements resulting from internal models. A panellist pointed out in this respect, that observers have to bear in mind that estimating solvency capital requirements correctly means nothing other than estimating the value at risk over a one-year period at a confidence level of 99.5%, which corresponds to the insurance company being able to cope with the worst loss expected to occur in a single year, based on a one in two hundred years return period.

Another challenge to trust outlined was conflict of interest. Certainly, between supervisors, the management and investors, there are different interests when it comes to the size of capital requirement. A panellist explained that this challenge is dealt with by the use test, which requires that the internal model should be used in the internal risk management system and for decision-taking processes. Indeed, management will obviously care about getting the internal model right, because no one supports inaccurate risk assessment which leads to incorrect risk taking.

3. Main benefits and achievements in the area of risk modelling

The panellists acknowledged that internal models are better than standard models, because they are tailor made to the risk that the company is facing. Internal models can also be used to do more analysis, which is what is foreseen in Solvency II. They agreed on the fact that internal models are a true management tool, and are more and more used in this way. If major decisions are faced, e.g. acquisitions or strategic business changes, internal models can be used for support in order to govern and steer the company.

In this respect a speaker from the industry explained that for a global reinsurance company, the most important thing for an internal model is integration, meaning that the internal model is used to determine the economic capital, support the risks on the book as well as the risk taking and behaviour. The internal model is therefore embedded in the business cycle. At the end of the day, the most important thing is that the stakeholders should understand how the risk profile or the business model, which is being looked at, works.

Finally, a panellist explained that internal models are essentially more relevant to the insurance sector than to the banking sector. Indeed, in insurance, risk models also reflect insurance liabilities; they are the basis of the business.

In addition, a panellists stressed that since the major threat to financial stability is pro cyclicality, internal models allow for some diversification among the companies. Indeed, whenever there is homogeneity, there is a risk of all players behaving in the same way in the markets and this is certainly not good for financial stability.

However, various panellists stated that volatility is clearly an issue in Solvency II. The increased fluctuations in regulatory requirements corresponds to both the standard formula and internal models. However, in such context the conscious management of capital, which is needed, can be more precisely carried out by an internal model. Indeed, one speaker stressed that it is difficult to come up with a good single risk model that can be used.

Finally a speaker from the insurance industry said that it was worth emphasising that in the regulatory context internal models have been proven to work, both in Switzerland and in the European Union. He concluded by saying that in terms of capital needed for a given business, from an internal and regulatory perspective, the right thing is being done. He explained that there is a robust internal governance for introducing the model, with independent internal validation, an external auditor and the regulator. The independent internal validation that Solvency II introduced is a success. The >>>

>>> speaker added that investors have accepted that insurance groups are steered according to the internal model and have learned to live with it. Finally, even if the numbers have become more volatile, ultimately, this is acknowledged as coming from the volatility of the economic environment.

4. The ability to achieve an effective comparability and level playing field, and define appropriate minimum standards, still raises scepticism among supervisors

A regulator reminded the audience that the IAIS has more than 50 pages of Insurance Core Principles (ICP), 17 of which deal with solvency and the internal model. These are the foundation of any regulatory standards. He acknowledged that a standardised approach may not be able to fully and appropriately reflect the risk profile of each individual insurer; therefore, a supervisor should allow the use of a more tailored approach.

However, he stressed that the regulators at the global level are not totally convinced that they are going to begin the internal model 'journey'. Their lack of familiarity with the internal model approach notably due to the comparability challenge, explains why they are very sceptical.

The key challenge in this respect he said, is to settle the issues of comparability and a level playing field, since there is a need to eliminate any suspicion that internal models are meant to reduce capital, and this ensure that they are not meant to optimise.

The panellist was finally of the opinion that while the essence of this integrated model is about risk management, the question then is how to progress to using it for regulatory purposes. He said that consequently the worst thing that could result from such a regulatory extension is that the base, which was used for risk management purposes, would eventually not be there anymore.

5. Comparability

Regarding comparability, one area for work could be trust amongst supervisors, since when a supervisor validates the internal model, it often involves international colleges of supervisors. Whenever a model is validated, the other supervisors in the community should trust that the lead supervisor has been in charge throughout the whole process.

In this respect many agreed on the fact that priority should be given to obtaining that the risks under consideration in the company in question should be reflected in internal models, rather than focusing on whether the same parameter should be used across all models. This inappropriate priority would notably encourage a race to the bottom and would threaten the benefits expected from risk sensitive regulations. Appropriately reflecting risks is a key success factor to preserving trust among the supervisors and facilitating an open dialogue between them.

In this respect one speaker explained that supervisors also need to examine the ongoing monitoring of models. However, he acknowledged that different views remain and that a process will be needed to reconcile them. It is crucial to know how internal models develop over time. There are different methods, and the most promising method is to look at the relative changes in the output, and compare these with the relative changes in the input. If there is no clear explanation for the observations, then the underlying purposes need to be investigated.

The EIOPA has been developing this in recent years. The important point is to understand how the different elements in the model compare at the end of the day. There can be a very good explanation as to why different companies with different business models have different risk charges for certain types of risks, but this needs to be understood. A national supervisor quoted in this respect the very useful working group dedicated to comparing modelling parameters, which is led by the EIOPA. He added that it is appropriate for regulators to make continuous efforts to render more transparent the reasoning and advantages of internal models in particular at the global level.

Finally, many agreed on the fact that people should not be under the illusion that a standardised approach will create comparability. Indeed, if a model that is not tailored, is applied to very different companies with very different risk profiles, there will be no comparability.

A panellist stressed in this respect that there is a strong precedent regarding comparability, from Solvency II. Indeed, one thing that is entirely standardised within Solvency II, is the valuation of the balance sheet. Indeed, no internal model exists for such a valuation. However, this remains a challenge, since there are probably huge differences between valuations since all the elements being discussed are highly complex and specific.

6. In an environment where insurers are increasingly under pressure to deliver cash to shareholders and optimise their balance sheets, strong governance practices are required

A central question is how to avoid any race to the bottom in an environment where insurers >>>

>>> are increasingly under pressure to deliver cash to shareholders and optimise their balance sheets. This is a business reality.

However, a panellist warned that in this debate, insurance should not be compared with banking. He stated that banks were never really concerned with internal models; they actually dealt with internal parameterisation of a standard model. That is very different, because it means that what banks are operating on internally, is different from regulatory tools.

Therefore, the speaker proposed that, since in the insurance area a standard formula would create similar conflicts of interest, it required clear governance and a first and second line of defence. Indeed, this conflict of interest is a solvable problem, as long as transparency exists in the respective objectives. Finally, he acknowledged that setting benchmarking for comparability purposes is important, and he stressed that regulatory standards need above all to be acknowledged as a mere supervisory instrument.

7. Conditions for defining a common language within supervisory colleges

An international regulator reminded the audience that trust is at the heart of all global coordination and global consistency. In a supervisory college, in the European context as well as the global one, there is a need to establish trust in order to collaborate and work together. He reminded the audience that to achieve trust, the parties need to speak a 'common language'. They must understand each other and share the same views, all the more so as they already have some common elements that can be communicated. The question, he said, is therefore how to create this common language.

In this respect one panellist stressed that it was very clear from the beginning of the banking crisis, that the ways in which different banks treated risk weighted assets were completely different. On the banking side, this is much more of a parameterisation exercise, devising internal parameters for a more standard model, which is completely different from internal models in the insurance sector. He even questioned whether the individual approach to risk weighting assets really makes sense on the banking side, if the risks they are addressing are compared.

Conversely, he said, on the insurance side, insurance risks are entirely different between companies, and concluded by saying that first and foremost, this is the responsibility of the insurance company itself; the board of directors needs to accept the accountability for that.

Another speaker stressed that it is not clear what is driving the call for comparability and warned that on the comparability question, the more it is discussed, the more unclear the aim becomes. He concluded by stressing that it could be said that comparability comes through the use of 99.5% Value-at-Risk as the bedrock of Solvency II.

Nevertheless, in the EU the industry also consists of many medium sized and smaller companies, and there is a need to be careful how that is dealt with. However, it is worthwhile to have a consistent regulatory structure within the Solvency II countries.

Finally, although there has been discussion of a race to the bottom, people should keep in mind that most companies are far above the 100% solvency ratio. It is not correct to accuse companies of being involved in a race to the bottom. What the industry needs, collectively, is to ensure that this does not take place. However, since on the banking side, a race to the bottom would destroy internal models, that should not be the way that this issue takes in the insurance area.

8. Conditions for achieving the essential objective, which is to restore trust in internal models

There needs to be more consideration of how the trust of investors in internal models can be restored; investors are a very important stakeholder group.

Indeed, one panellist said that investors often make the point that they have even less trust in the comparability of numbers coming from the insurance side, because the level of freedom that is given to insurers in internal models is even greater than in the banking sector. Analysts and investors suggest that there is not sufficient information disclosed about the models themselves to make them comparable.

Investors should be reassured that the internal model is used to steer the company, and the results of thisl model should be clearly communicated to them. What has helped a great deal in this respect was discussing the sensitivities of the model, and how model results would change if market parameters or certain assumptions were to change. In this respect it is vital that when indicators concerning internal models are discussed, regulators and supervisors should seek to remain close to the individual insurance company. If they do not understand its business model and risk profile, this will not succeed. It needs to be appreciated that companies using internal models are the best supervised. ●

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

1. Challenges faced by insurance regulation: the complexity and volatility of Solvency II, recovery and resolution and risk emerging from digitalisation

The first challenge is to adjust Solvency II. Regulators are working with EIOPA and the European Commission (EC) to review the system. Addressing complexity and volatility are the two major objectives and the challenge will be to do so without hampering the other advantages of Solvency II. The aim should be to maintain risk sensitivity whilst reducing the volatility of a supervisor's reaction to the signal sent by Solvency II.

The industry should also avoid the insurance capital standard impeding insurers who want to invest long term in illiquid assets. This will be key for investment and growth if reviewed appropriately. Some see that the current weakness of Solvency II is that it does not specifically address the very long term products available in the savings or pension markets. From that point of view such a product does not have the same volatility if it is kept for 10, 15 or 20 years in an intra year cycle, and this should be taken into account in order to provide good products and returns for clients, and to better finance the European economy.

The worst outcome of a revision according to the industry would be to focus solely on the ancillary impact of market volatility and to solve it with only capital add ons. That would multiply the anti competitive factors impacting the industry in the EU, which would not necessarily maintain the financial stability of the market. There are already elements embedded in the current EU framework intended to address the volatility adjustment. The 'symmetric' adjustment to the equity risk model is not far from a countercyclical tool and, although thus far unused, the extension of the recovery period is another tool.

EIOPA and IAIS are currently looking into what they could have in place on recovery and resolution frameworks for insurance. That should be an important tool helping in many forms. The resolution plans should help supervisors. Having in place a recovery and resolution framework with pre emptive recovery plans at the level of each institution would also help institutions look at themselves.

In particular in the current context of the dramatic development of IT techniques, there attempts should be made to anticipate the risks for policyholders in the design, pricing and distribution of products, and what is special for insurance in the execution of the contract. But from this point of view there are problems concerning fintech and the proactivity of regulators.

2. A harmonised global capital standard for insurance companies for measuring and aggregating exposures at sectoral and inter sectoral levels, is an additional challenge

Work should continue towards a harmonised global standard for capital. Additionally, an ICS like or stress based method to calculate the exposure of companies would improve the way the systemic character of companies is reflected in the methodology for designating them as systemically important.

The IAIS's February press release makes clear their two focuses: the Insurance Capital Standards (ICS) and an activity based approach or systemic risk discussion in general. Version 1, field testing, will be produced in June with version 2, the regulatory consequence, to follow in 2019.

New activity based policy measures and the revised entity based approach methodology will be issued in 2019 and discussion of the new identification methodology of systemic companies will be achieved in 2020. Each will apply in 2022. An activity based approach and policy measures will be integrated into the IAIS ComFrame. The integration of issues on systemic risk into the policy measures is included in the 2019 timeline. ICS will be developed and applied in 2022. Both the ICS and activity based measures will be concluded in 2019, with implementation beginning subsequently.

Global regulation has some support, but should not focus solely on the financial stability problem, which is only one part of the issue for insurers. Indeed, Solvency II has been implemented and has given appreciable risk sensitivity. However, in other parts of the world the rules are laxer, which can create problems for a level playing field.

In order to be improved, the ICS must properly reflect the business model. It should be a >>>

>>> risk based system taking into account the specificities of the long term investment possibilities of insurers. To buy and hold investors, as insurers typically are, the spread risk is just default risk. The ICS should also go towards internal models, which provide a good tool to address the specificity of the business and to look at where risks are to be found.

3. A challenge ahead is also the definition of a potential macro prudential framework for insurance, which takes into account insurance sector specificities, and complements Solvency II

The first topic regarding a macro-prudential framework is the activity based approach; the second is the current capital framework and where to go with capital, by taking into account the macro or systemic issue.

Regarding systemic risks, everyone agrees that designating just nine G SIIs does not make the system any more secure. The solution is inadequate for the problems. Transparency is also needed on the designation process and the industry needs a proper comparison with other industries that are systemically important. Overall, the industry must have a level playing field. That leads to an activity based approach, which addresses transmission channels for systemic risk, for which capital may not be the solution.

If there is a macroeconomic or systemic crisis, any organisation must have adequate measures afterwards. A challenge is therefore, how to address the issue of the definition of a macro prudential framework in the insurance sector. Following the recent realisation that risk in one sector can affect the industry as a whole, there is also an increase of interconnectedness between sectors, alongside studies that indicate an increased systemic importance of the sector. In insurance, capital add ons cannot be the right solution to every problem of systems. Insurers call upon a specific and pragmatic analysis of the risks related to interpenetration and interrelation, before defining international standards.

Discussion thus far has mainly concerned the banking sector, which is very prone to liquidity and domino effect risks in the context of increasing interconnectedness. However, if one relies on the fact that insurance activities differ from banking ones, it may be missed that what may be done in the insurance sector can have financial stability implications.

Some argue that insurance is more an amplifier than a source of systemic risk. Others think that it is more an indirect source of risk and more prone to tsunami than domino effects. There must be a common understanding that insurance can have financial stability implications under certain circumstances. Regulators should decide in what form an appropriate toolkit and macro prudential framework might be needed in order to address insurance specificities.

The supervisory community must set an objective and define intermediary objectives that will assist towards that goal, along with an appropriate toolbox. Finally, one issue is to ensure complementarity and consistency between macro and micro supervision; the Solvency II review will be a good opportunity to have that discussion.

4. A cross-sectoral activity based approach is required for improving the individual designation process, favouring tailored macro prudential solutions, and taking into account both management practices and micro prudential rules that have a macro prudential impact

There are a number of concerns about the domestic and international individual designation process. The central concern is how to identify and measure potential threats to financial stability. The key is to start from the current consensus of the three systemic risk transmission channels: interconnectedness, asset liquidity and substitutability.

The decision of IAIS to develop an activity based approach is a good development, representing a natural evolution of the debate on how to properly assess systemic risk and designate systemically important insurance groups.

There is support for the IAS looking into an activity based approach. It allows for a number of improvements over the individual designation process, accounting for both the tsunami and domino theories, and allowing for tailored solutions. It also better accounts for internal risk management practices or micro prudential rules that would have a macro prudential impact.

An activity based approach also allocates more efficiently supervisory resources and creates a level playing field. It should be cross sectoral. There are a handful of activities going on in Europe and, to the extent that they are potentially systemically relevant, they should be addressed in the same way in all sectors involved.

5. A conceptual framework that describes what could create or transmit systemic vulnerabilities that have potential impacts on the whole market, is needed beforehand at the global level

It is important to have a clear picture of the objectives. The first step is to have a common >>>

>>> understanding of 'macro', 'micro', 'entity' and 'activity based'. Micro supervision is clearly in place to protect policyholders in the failure of single companies and has focused mainly on reducing the probability of failure. When discussing macro supervision, one should look at what goes beyond the company and could impact the system.

The second step should be a conceptual framework that describes what activities could create exposures and vulnerabilities that have the potential to impact the market through certain transmission channels. That could also be seen at the entity specific level, in the sense of what the impact would be of the failure of a single company. There is also the question of the replacement risk. But the framework must be developed before any decision can be made there.

The third step is to assess which policy measures are necessary for mitigating the systemic risk arising from the activity, which requires conducting a gap analysis notably to see whether there are policy measures for micro purposes that could play a role in achieving macro objectives. There should also be an investigation of whether there are policy measures for micro purposes that could be counterproductive from a macro perspective.

The gap analysis will be the core of the work. There are two approaches. First is an assessment using a total balance sheet approach referring to activities and exposures. Second, the gap analysis should be done as far as possible, taking into account cross sectoral aspects.

After defining policies relevant in an activity based approach, the next step is to question what it means for the entity based approach, and whether the risks are perhaps better mitigated in an activity based approach. Solvency II provided the first signals of macro risks in the EU. Supervisors are analysing them to better understand how they can implement the tools proposed by Solvency II and understand whether it is the right tool itself.

The starting working assumption is that the two approaches complement each other. A key issue to address over the coming two years is how the activity based approach can balance the capital policy measure, assuming that ICS has a systemic risk element.

If the industry takes the activity based regulation route, there are a number of activities where sectors other than insurance intervene. The insurance sector must be set in a level playing field with all the participants that provide collective, professional or individual pension plans. It will be difficult to regulate that kind of level playing field at the global stage, which must be taken into account when considering the features of the pension plan. Everybody loses if they take the fragmented approach in the context of global insurance. The IAIS are committed and appreciate all of those working to create a level playing field with consistent regulation.

The main challenge is to have a clear picture of what is really under discussion regarding incoming macro prudential challenges. However, determining externalities is a challenge. Very few activities meet the systemic risk criteria on transmission channel. The assessment of those will probably lead to the conclusion that there are just a few ways in which there is systemic relevance in the insurance sector.

In this context, the supervisors are working well at the IAIS, but struggle to define the ultimate goal. Much progress is to be made and deciding how that will continue is the main challenge. Once there is a clear understanding, the industry will perhaps have the courage to focus on the micro issue. ●

V. CMU IMPLEMENTATION

Delivering CMU with Brexit

1. Progress made with the CMU

Europe decided on the CMU for three main reasons: to increase the funding to its economy, to foster more diversity and resilience of funding beyond bank financing, and to provide growing companies with more appropriate financing, notably equity financing. The current situation can perhaps be described as market failure: there are likely more savings than ever, but these mostly have a short term horizon, as opposed to the volume of long term investment needed. The CMU is about trying to make those ends meet.

The September 2015 CMU action plan contained 33 actions; 18 months on, 20 are completed and the remaining 13 are in progress. There is now a need to move to a second phase of CMU, which should be as ambitious as possible. The situation has changed because of Brexit and fintechs in particular. Although the EU Commission (EC) hopes to put in place all the building blocks of the CMU and to restore the balance of incentives and disincentives by 2019, ultimately, it is up to the market to make the CMU work.

A panellist commented that although many legislative measures have been put in place, not all of the initial objectives underlying these measures have been achieved. For example the securitisation proposal has significantly deviated from the original intent. In addition, data shows, another speaker emphasized, that many capital market activities are actually decreasing in the EU. Some have increased, such as asset management, which has doubled over the past 10 years, but at the same time many other key activities such as market-making or equity underwriting and trading have gone down, and there is a move away from bonds or other rated instruments towards loans. There are many reasons for these negative trends: beyond monetary policy and political risks, there are also unjustified discrepancies in the treatment of some financial instruments under different regulatory frameworks such as Solvency II and CRR.

2. Upcoming priorities for the CMU

The feedback from the public consultation launched in January 2017 regarding the mid-term review of the CMU shows that respondents want the EC to remain focused on the core themes of the original action plan (i.e. improving the financing of SMEs, developing long term investment and sustainable finance, facilitating the access of retail investors to capital markets, developing cross-border investment...). The EU also needs to update the CMU strategy to tackle the EU supervisory framework for capital markets, the strengthening of local market ecosystems and the development of fintech.

Speakers on the panel agreed with these objectives, emphasizing the need for the private and public sectors to work together towards achieving them. The need to ensure that the CMU maintains close links with the financial markets located in London, which will inevitably continue to be substantial, was also stressed.

2.1. Improving the supervisory framework for capital markets

Several panellists emphasized that the supervisory framework for capital markets needs to be strengthened in the EU in order to improve supervisory convergence and reduce supervisory arbitrage. So far priority has been given to regulation, which was considered easier to agree on but Brexit has changed priorities to a certain extent, making a dual track approach both on regulation and supervision necessary in Europe. Post Brexit, the financial system will indeed be more diversified and distributed across the EU27, requiring more supervisory convergence and new tools to be introduced. In the capital markets area, there is a strong rationale for considering a strengthening of the powers devolved to ESMA, a speaker claimed. Some of the changes needed to achieve this are a continuation of on-going actions (e.g. centralisation of data gathering); but new initiatives are needed, including the joint or coordinated supervision of critical market infrastructures such as CCPs or CSDs.

Some additional changes are required to respond to Brexit challenges, a speaker suggested. The first immediate challenge is reviewing third >>>

>>> country regimes to fit a financial hub like the UK. It would be necessary in particular to have a unified approach in the EU in terms of equivalence assessments. The second challenge concerns the minimum standards that are required to receive authorisation and do business in the EU27, which need to be urgently clarified. A first step in this regard could be to provide the European Supervisory Authorities (ESAs) with the right to oppose the granting of licences or authorisations by national competent authorities if they think that European standards are not met; over the medium to longer term, some form of twin peak structure could also be considered. A third objective is to streamline decision-making within the ESAs differentiating focused administrative decisions (e.g. concerning a waiver) from regulatory decisions on standards which need more time and to make sure that the appropriate people are at the table when a decision is made.

A speaker however stressed that although improving supervision is necessary, this would not be sufficient for integrating EU capital markets and that further changes are also needed in legislation at the Union level, such as the harmonisation of certain elements of insolvency or securities law.

2.2. Strengthening capital market ecosystems across the EU and developing fintech

Local capital market ecosystems are essential to foster SME markets because they play a key role in building local communities that can bring capital to local start-ups and this can then help these companies to find other types of financing as they grow. Cross border capital markets are also required at the same time because part of the financing will be coming from foreign investors.

Regulation will play a role in strengthening capital market ecosystems across the EU, but a number of Member States lack the resources or administrative capacity to develop their ecosystems. Much can be learned from best practices and examining whether they can be introduced in other markets or scaled up at the EU level. The new Structural Reform Support Service (SRSS) which aims to help EU countries carry out structural reforms will provide assistance of the EC for all countries that need to build or strengthen their market ecosystem in the context of the CMU.

Developing fintech is another key objective that the EC is seeking to fully integrate into the design of the second stage of the CMU. It represents both a disruptive challenge and a huge opportunity for capital markets, opening new channels and business models. For fintech as well there should be both a local and an EU development, a speaker suggested.

2.3. Adjusting prudential and regulatory requirements

The need to adjust prudential requirements of Solvency II and CRR in order to support the development of capital markets was an output of the call for evidence. A first short term priority is the recalibration of Solvency II, regarding private equity and venture capital. The discrepancies between CRR and Solvency II regarding securitisation and infrastructure also need to be addressed, as well as those concerning the regulatory capital treatment of securitisation and covered bonds.

There is also much discussion about qualifying exposures for infrastructure and simple, transparent and standardised securitisation (STS), but the major questions are who determines that something is 'disqualified', how and when this is done, and how the respective consequences for both investors and issuers are taken into account, a speaker stated. Market making activity for STS needs to be improved; the industry also needs to develop capital markets for NPLs, restore the secondary market for securitisation, and go more into secondary markets for covered loans. Finally some regulatory measures that may have negative effects on market liquidity need to be examined, a panellist suggested; these include pre-trade transparency and research requirements in MiFID and also NSFR and FTRB measures.

3. Implications of Brexit for the CMU

3.1. Possible consequences of Brexit for the CMU

If Brexit means the creation of new barriers between the UK and the EU27, this could challenge the existential purpose of the CMU project which is notably about breaking down barriers between national markets, a panellist emphasized. There is the potential for a Brexit outcome that is 'less than optimal', which makes it even more important for the EU27 to develop capital market capabilities; however, Brexit also makes it potentially more difficult for the EU27 to build those capabilities, because for many of them the expertise and the liquidity are in London. Building a new EU27 network or ecosystem without access to London, the main existing network in Europe, will be very challenging. As such, existing supply and distribution chains need to remain open and functioning.

At the same time these are good reasons for developing EU capital markets and accelerating the CMU, other panellists considered, in order to alleviate the consequences of Brexit. Brexit is only one stage in the long term project of CMU; the EU's history gives reason to believe that crises >>>

>>> can be managed, however complex, when looking at the example of the Banking Union.

3.2. Suggestions on how to progress with the CMU in the context of Brexit

Some speakers suggested that improving the external and global dimension of CMU is essential for avoiding market fragmentation and has become more important with Brexit The EU needs to build an international system that maintains open markets, and access to pools of investment, wherever these are, because markets are global. This involves international regulatory dialogue and collaboration, covering both micro and macroprudential matters. What the EU27 needs in particular is to develop an enhanced streamlined regime for determining regulatory equivalency with third countries with more transparency about how interactions with a third country can work, rather than shutting off access to the EU market.. Barriers between markets may actually increase systemic risk.

The second issue is defining a proper framework for the long term relationship between the EU and UK, both with respect to regulatory convergence in order to preserve a level playing field and to the management of systemic risk. For integration to work, the EU needs to abide by international standards. However in a market setting as integrated as the EU28, international standards are not always granular enough and convergence at the EU level is also needed. Moreover, equivalence needs to be judged on a continuous basis by one authority in order to avoid 'forum shopping' among EU jurisdictions. In addition, there will always be significant interconnections between the EU and the UK and possible spill over risks that will need to be managed, and that can only be done via strong supervisory arrangements. As such, more centralised supervision in Europe for financial markets is all the more compelling, as it will facilitate information sharing in particular.

However in the shorter term, the risk of disruption of CMU related to Brexit is unavoidable. The EU cannot accept that a considerable part of its financial risk is managed by the UK as a third country jurisdiction. Not knowing what the new relationship is going to be like will have implications for CMU 2.0, and Europe will need to prepare for the worst case scenario, and build up its infrastructures and local ecosystems. ●

Developing EU equity markets

1. The importance of developing equity financing in the EU

Equity is consistent with a long term investment horizon, since its return is linked to the performance of the business. This makes it an important source of financing for companies and also an essential investment for individuals for the preparation of their retirement. Moreover, attracting individual investors to equity markets is appropriate because they tend to have a contrarian approach and proportionally invest more in SMEs than institutional investors. A speaker also stressed that direct equity investment should be promoted for pension savings because of the high fees charged by packaged products that reduce returns.

Developing more integrated equity markets in Europe, as proposed in the CMU, will also contribute to improving the stability of the European economy. The example of the US indeed shows that capital markets are the most effective channel for absorbing asymmetric shocks and therefore need to be developed in the EU alongside the EMU.

2. Main challenges to be addressed for the development of EU equity markets

In recent decades the EU has made positive achievements in the field of capital markets particularly for the funding of larger companies. However, a number of weaknesses have appeared since the financial crisis e.g. reduced number of IPOs, fragmentation of trading, reduced market-making activity.... Moreover European small and mid-cap markets remain under-developed which is a major concern since 99% of all non financial companies in the EU are SMEs.

Several issues need to be addressed for fostering a stronger development of EU equity markets.

A first challenge is the differences in maturity of EU equity markets. Although it is necessary to have a European approach to equity markets in order to foster stronger integration (e.g. lifting barriers) and the exchange of best practices, the CMU approach must respect local market specificities and avoid eroding existing local ecosystems. Local >>>

>>> development initiatives that are consistent with the objectives pursued at the EU level should be encouraged. National level initiatives are indeed essential for achieving an appropriate framework for equity markets (e.g. regarding which corporates can tap the capital markets, tax rules, rules impacting institutional investors, etc.) and for supporting the development of a stronger equity culture.

A second issue is improving access to equity research and market data. There is almost no research on cross border SME investments for retail clients and MiFID II rules on unbundling will reduce this further, potentially damaging the financing model of research. Consequently, if nothing is done to provide investors with more research, notably on small companies, clients will continue to purchase mainly domestic stocks and those interested in buying foreign stocks will turn to US ones, further diminishing the liquidity of EU securities. Some private sector initiatives that may help in this regard were mentioned e.g. some stock exchanges for example pay an external company to furnish basic research on all listed companies in their junior markets to provide investors with a minimum level of information.

A third objective is improving market transparency. MiFID II will help, a speaker believed, by encouraging the transfer of part of OTC volume into the order books. The higher the volume on regulated markets, the better price formation will be. More reliable information is also needed, notably for SMEs, on the buy and sell prices and interest of stocks. Two further points were mentioned regarding MiFID II. First, regarding the threshold that will be applied for trading on alternative platforms, most of these platforms are located in the UK, so the question arises of what data will be available and how the threshold can be calculated. Second, the transition to MiFID II rules scheduled on 3 January needs to be carefully managed.

A fourth issue that needs to be addressed over time is lifting the barriers that impede cross-border equity investment. This includes tackling withholding tax problems on cross-border flows, improving the consistency of property rights and corporate actions and reducing the cost of cross-border post-trading arrangements.

3. Actions underway for supporting the development of equity financing

3.1. CMU actions underway for developing SME equity financing

The CMU is a toolbox of initiatives, several of which should contribute to developing equity financing notably regarding SMEs. The CMU mid term review provides an opportunity to define possible additional actions that may be needed for fostering the development of equity markets.

Venture capital financing will be supported by the EU venture capital fund framework (EuVECA). The new requirements for prospectuses (with an increased threshold for drafting a fully-fledged prospectus) should also be a key ingredient in the creation of SME growth markets which will enter into force in 2018. The suggestion was made however that this new prospectus should aim to be proportionate and should take into account the specificities of mid-caps, rather than just deleting some requirements from the full prospectus, in order to make it meaningful for investors. Proportionality will also be introduced whenever possible for SMEs regarding EMIR requirements (in the context of the EMIR review) and reporting obligations (particularly to ensure there is no double reporting).

Concerning the investor side, capital charges are being reviewed for insurance companies investing in SMEs and in ELTIFs mainly focused on SMEs. The EC is also working on the cross border distribution of funds to remove the barriers that asset managers face when they want to use their passports to raise money cross border.

3.2. Existing market practices in EU Member States

Some members of the panel commented on interesting practices that exist in some Member States and on which EU initiatives could build.

Spain has two markets for small and mid caps. The main primary market has some special requirements: for now, a prospectus is not required, but investors are provided with the essential information on companies. On the trading side they are applying to small and mid caps the same rules as for blue chips in terms of transparency, and market-makers provide complementary liquidity, which is necessary to make the market work. A speaker also considered that the extension of MiFID II to non equity is good news, because it will extend requirements on transparency, and liquidity.

Another example concerned the Nordic and Baltic region. First North, the growth market in that region, uses the same rulebook for the seven countries it covers, and a standardised short prospectus focusing on the information that investors need about companies, rather than on legal disclaimers. The trading model is the same as for the main markets, the only difference being that for small caps there is an intra-day auction aiming at supporting the liquidity of these markets. >>>

>>> First North also endeavours to share best practices and tools across its markets regarding the way e.g. the pension system, taxation or investor incentives may be approached. The investor savings account in Sweden is an interesting example in this regard for example. The experience of sharing best practices shows that it is not easy, but it is essential for finding appropriate ways of improving equity culture and creating an environment where it is easier for SMEs to raise capital on the markets and grow.

4. Additional actions needed

4.1. Developing a Pan-European Personal Pension product

A European long-term savings plan such as the Pan European Personal Pension (PEPP) product proposed by the EC could foster more retail equity investment in Europe, several speakers considered, and would be an appropriate addition to the CMU action plan which does not currently contain any specific actions for encouraging retail investment in securities. Some countries have active pension funds but this is not the case of all EU countries and the EU landscape is quite fragmented in this regard. The timetable of the PEPP is still to be confirmed but a proposal should be available by the end of the summer. The EC is keen to ensure that the PEPP can deliver advantages for a broad spectrum of investors. Furthermore, in terms of investment policy, equity is a priority for the PEPP. A speaker suggested that direct equity investments should be allowed for the PEPP to be effective.

A further objective regarding individual investors is to develop their equity investing culture, which is insufficient at present in many EU countries. Efforts are being made in some Member States in this regard, e.g. encouraging retail investors to move short term deposits into UCITS, but more needs to be done, a speaker felt. Another action proposed is to improve the transparency of performance fees in long term savings.

4.2. The need to strengthen local equity market ecosystems

Providing a well functioning market ecosystem, connecting companies that want to grow and need capital with investors seeking profitable investments, is also essential for fostering equity investment. Stock exchanges, which are a central part of market ecosystems however need appropriate regulation to support their activity and help investors to achieve attractive returns, a speaker stressed. The best performing stock exchanges in terms of real rate of return, such as Sweden have been able to achieve this performance thanks to a very strong equity culture in the country, but also because the rules they are subject to are appropriate, notably in terms of disclosure. Sharing best practices across ecosystems is useful, but there is not a need to harmonize all ecosystems. Rules and practices should be adapted to each ecosystem and these must develop first locally before a broader European approach can be of use.

4.3. Developing crowdfunding at the EU level

Beyond traditional financial players, it is essential to consider the role that fintechs, and crowdfunding in particular, will play in SME financing in the years to come.

The European crowdfunding market is currently fragmented and concentrated in some countries and could benefit from a harmonised European legislative approach taking inspiration from what the US did in favour of small business funding with the JOBS Act. Such an initiative would be in line with the CMU project and the objective to find innovative solutions to broaden access to equity markets in Europe. At present, Member States are developing their own crowdfunding markets and legislations, with their own national specificities, which is good for starting the market, but a need for harmonisation will appear in the future. Defining a European framework would facilitate harmonisation and provide an end perspective for the market. The development of a crowdfunding passport was proposed as an example.

Two further ideas for developing crowdfunding were proposed. One would be to expand the role that banks are playing in this area, first by providing investors and issuers with a proper custodian service, possibly leveraging new blockchain technologies; second by developing the investment products that will offer risk mitigants and diversification, and ensure appropriate investor protection; and third by organising information sharing between investors and issuers, and ensuring calibration, validation and labelling of SME information.

A second option is to consider solutions for making crowdfunding business models more viable and reinforcing their role in the ecosystem. This could be done by distributing them on public IPO markets, which has been piloted with some success in Finland and Sweden. Another suggestion made is developing secondary markets for crowdfunding platforms regulated by a proportionate regime; this could help to create a funding path for start-ups which could first find financing on a crowdfunding platform, then move onto a junior market and eventually be listed on an exchange. ●

Enhancing the consistency of insolvency and securities laws

1. Common issues and priorities

The panellists generally called for a pragmatic and practical approach to issues regarding insolvency law, securities law and withholding tax in the capital markets and welcomed the EU Commission's (EC) initiatives in these areas. All three of these are deeply embedded in national laws and legal traditions, therefore attempting a top-down harmonisation seems very difficult, if not unrealistic. However some speakers encouraged the EU authorities to approach these issues in an ambitious way and to avoid getting side-tracked by secondary problems.

There was some disagreement regarding the relative importance of addressing these three topics at the EU level. Some panellists considered that the overall business case and incentive for tackling all three issues is significant and that it is essential for the success of the CMU. One speaker emphasized that for shareholders, insolvency and securities laws, which cover respectively the possible failure of a company and of an intermediary or depository, are equally important. Others suggested that the priority should be to address insolvency issues which are essential for economic activity and tax related problems which impact cross-border investors, while one panellist considered that the main focus should be solving conflicts of laws regarding securities law and withholding tax issues. A policymaker explained that the CMU should be considered as a toolbox; each piece of it, including measures being proposed by the EC regarding insolvency law, securities law and withholding tax, is important for achieving the objectives and needs to be delivered in the long term.

Contributions are also awaited from the European Post Trade Forum (EPTF), which is covering a number of these issues. The report which is still being drafted has identified a list of priority barriers, the first being withholding tax and the second being securities law. The following three priorities are corporate action processing, asset segregation, and how to improve post trade regulatory reporting.

The EC has launched some related work streams in parallel. A first one is a comprehensive streamlining exercise on reporting obligations stemming from all the legislation in force, including financial services legislation, which will be set on track in the coming months. The idea is to streamline the number of obligations and reduce them when possible in order to better adapt the obligations to the size, structure, and business model of market participants. Secondly, the EMIR review should also be published by the summer. The goal is not to substantially change the main elements of the regulation, but to adjust it, introducing some proportionality in the text.

2. Insolvency law

Insolvency laws raise problems at the national level, notably regarding the length of procedures, and also differ substantially across Member States. The EC has made a proposal for a Directive on preventive restructuring and second chance; it is the EU's first attempt to remove the barriers that stem from the high level of fragmentation of these regimes and moving this forward is a great challenge. Everyone agrees that differences in insolvency regimes across Member States represent a high barrier to cross border investment, but Member States are protective of their insolvency regimes and consider them as an expression of their social identity. As such, the EC has chosen to focus its initial work on achievable measures, and has proposed a number of focused actions that aim at restructuring and allowing honest entrepreneurs to be given a second chance, also in overcoming bankruptcy. The EC is also conducting a benchmarking exercise of national insolvency regimes to get a comprehensive picture of their different features impacting efficiency.

The panellists generally welcomed these initiatives. The difficulty of addressing this issue, which is contentious for Member States and is largely a national issue deeply rooted in national legal traditions, was acknowledged by the panel. There have been previous attempts at trying to fully harmonise procedures like this in the EU, but they did not succeed.

While the objective is to improve the situation at the European level, changes need to be made by Member States and the EC reform is a way to initiate this process, a speaker stressed. Member States need to be pressured to change and to be less protective of their insolvency regimes. However in its first stage, according to one public representative the EC initiative will probably mostly help to improve the situation in some Southern and Eastern EU countries that are lagging behind the rest of the Union notably in terms of recovery rates and it may therefore not provide the CMU with sufficient impetus, which is a downside of this approach. >>>

>>> Fixing common targets e.g. regarding the timing of procedures could however help to facilitate the negotiation, another panellist believed. Each Member State can then be left some 'room for manoeuvre' in how to achieve these objectives. Statistics indeed show major differences between Member States, some countries having very efficient systems and others showing a significant potential for improvement.

There is a need to be precise and specific when tackling insolvency rules. One of the most important issues is the timing of the procedure: it is important to have a process that is appropriate but also as fast as possible. Shareholder and creditor rights must also be taken into account. A panellist moreover appreciated that out of court proceedings are put forward in the approach, because companies are usually more robust following successful out-of-court proceedings and such proceedings can more easily help to form an agreement than in-court ones, which may however also be needed in the end in some cases.

3. Securities law

Securities law is a topic that has been regularly discussed in Europe over the last 15 years. Solutions have been proposed but have so far been met with strong resistance from Member States.

One panel member believed that all stakeholders can agree that having legal certainty in the securities markets is essential for securities markets to be efficient, safe and reliable at the European level. However current securities laws are still too fragmented across the EU because they are closely connected to national property laws.

To move forward on securities law, a pragmatic approach must be adopted, taking into account the way processes actually work. A number of requirements must also be fulfilled, a speaker suggested. These requirements are to focus on a number of specific items and risks, rather than aiming for a high level top down harmonisation approach; to take current realities and achievements into account, including TARGET2-Securities (T2S) which has helped to change the market ecosystem and to stabilise some concepts such as settlement finality; and to take into account the output of the European Post-trade Forum, which has inter alia been tackling securities law issues.

A proposal will be made within this year by the EC aimed at ensuring legal certainty on the specific point of conflicts of law relating to securities ownership. The panel generally supported this initiative; though one speaker observed that the meaning of legal certainty needs to be more clearly defined in this context.

A panel member noted that the work on securities law involves possible trade-offs between investor protection, operational efficiency and systemic risk questions. Another speaker however stressed the importance of preserving investor protection. Securities law should ultimately aim to give certainty to investors that when they put money into securities they can get it back. One speaker emphasized that legal certainty must be achieved in the custody holding chain despite differing national laws because this is essential for cross-border investment and is a key element for the CMU. At present European regulators and institutions impose restrictions on holding securities in custody chains, in order to try and mitigate existing legal risks; this is an 'absurd situation' that needs to be tackled; improvements in legal certainty can help to solve systemic risk problems, as well as other regulatory problems. One speaker also highlighted the importance of providing legal certainty regarding which law applies to each settlement or holding in the context of T2S; a contractual solution is currently being used to get around conflict of law issues, but more legal certainty is needed.

One fundamental concern for end investors that also needs to be taken into account is that the right to the securities they have bought should be guaranteed, which includes both the right to dispose of the securities and to exercise the rights associated with the securities (e.g. corporate actions, dividends…). Both are equally important and should be taken into account during on-going discussions. The revised Shareholder Rights Directive which still needs to be implemented with Level 2 measures covers these other issues.

4. Withholding tax

Withholding tax is a difficult issue, but it needs to be addressed because tax obstacles are, generally speaking, a major deterrent of cross-border investment, for retail investors in particular. The main problem is that withholding tax processes differ across countries on issues such as relief-at-source, reclaim and refund procedures and repayment periods. Several panellists hoped that the EC could help to harmonize the way of dealing with withholding tax at the EU level. This would simplify processes and also improve predictability for investors.

Taxation however means entering the 'difficult world of unanimity'. As a general harmonising of taxes across EU is an unrealistic goal, the EC has convened an expert group on withholding tax >>>

>>> to propose practical solutions to strenghten the efficiency of reclaim proceeding. Following an assessment of existing withholding tax processes and procedures in EU Member States, as committed in the CMU Action Plan, the EC is due to deliver a Code of Conduct on this issue by the end of the year. This will be a voluntary tool, but will nevertheless put significant pressure on Member States that do not endorse it. The expert group is composed by experts representing 12 Member States and the EC hopes that via peer pressure, this number will increase.

A panel member stated that the Code of Conduct should incorporate the logic of existing market standards relating to the relationship between issuer and investor. This is because tax events cannot be dissociated from corporate action events; a payment of dividends or interest by an issuer to an investor is both a corporate action event and a tax event. Rules concerning these two elements should therefore be closely aligned.

A public representative encouraged the EC to be bold. Taxes are an area of national competence but are at the same time an important motive for counter-productive competition between Member States. Improving the way taxation works in practice is useful, but there also needs to be pressure to work towards a common corporate tax base at the European level in order to achieve fairer taxation notably for SMEs. The EC is trying to provide some answers in this regard, especially regarding the taxation bias in favour of debt compared to equity, but whether the Council will manage to reach unanimity on this ambitious proposal is not yet clear. ●

Developing the EU cross-border investment fund market

1. Current situation and importance of developing cross-border fund distribution in the EU

1.1. Current situation of cross-border fund distribution

Cross-border investment fund distribution could be improved in the EU, several speakers stressed. Only 57% of EU funds (UCITS and AIFs) are marketed on a cross-border basis and one-third of UCITS are sold cross-border in only one Member State, while another third are not sold cross-border in more than four Member States.

Although the European fund market as a whole has been growing well (fund assets have doubled since the 2008 financial crisis), it remains fragmented with 30,000 funds compared to 7,000 in the US and many inefficiencies and a lack of economies of scale still need addressing. Moreover close to 80% of cross-border fund distribution is currently concentrated in Luxembourg and Dublin.

However, one speaker stated that the investment fund market is by far the most integrated retail financial market in the EU and that there are not that many regulatory obstacles to fund cross-border distribution. Moreover, foreign funds are widely distributed in some Member States such as Belgium.

1.2. Importance of further developing cross-border fund distribution in the EU

It is now recognised that investment funds form an important part of CMU and that developing sources of non bank finance is necessary. Globally, around 40% of financing activities take place in the non banking sector. Europe as a whole remains at a level of around 80% bank financing, and as such more needs to be done to develop capital markets and investment funds in particular.

In the US, mutual funds make up 46% of household financial assets compared to 10 to 15% in many EU States. There is also much evidence from other regions that the existence of a strong fund market diversifies the financial system, and provides access to both investment instruments and financing which would not have been available otherwise.

In the context of the CMU, it is important that cross-border fund distribution should start taking place more seamlessly in order for funds to play an increasing role in mobilising capital from retail and professional investors into the economy.

This will strengthen the EU economy, as well as the economy of each individual Member State and will help to allocate capital more effectively across the Union. >>>

>>> 2. Main barriers to cross-border fund distribution

2.1. Regulatory, fiscal and industry structure related barriers

Different types of barriers that are hampering cross-border fund distribution need to be addressed.

Regulatory and administrative barriers are a first category. The domestic requirements regarding how the content of communication has to be provided and how notification processes should be conducted differ across jurisdictions (e.g. in some cases regulatory approval is ex ante, in others it is ex post, in some cases the approach is principle-based in others it is rule-based). Taxation is another major obstacle (e.g. with difficulties to obtain refunds on withholding taxes).

Distribution models and rules also have a significant impact on the marketing of cross-border funds. Differences in the structure of physical distribution channels across the EU, the strong position of integrated distribution in many jurisdictions and the cost of promoting funds in foreign countries are all possible disincentives to the cross-border distribution of investment funds. Potential barriers may also arise regarding distribution or information requirements such as MiFID and PRIIPs or investor protection rules, if domestic rules differ significantly. It was however noted that some key MiFID rules such as those related to distributor remuneration are compatible with the existing models in Europe and that care should be taken not to diminish investor protection, when eliminating barriers.

2.2. Deficit of investor trust in cross-border products and home bias

Another significant barrier is a major deficit of investor trust regarding non-domestic funds. For institutional funds, there is not much of a national bias, and where it exists it can be overcome, but for retail funds, there is much more emotion and some psychology involved, which is why proximity makes a difference. Trust in cross-border EU retail funds needs to be increased, a speaker stressed, because this would improve investment strategies, particularly in the present context of low interest rates.

Most retail investors currently prefer to invest in funds supervised by their home National Competent Authority (NCA), except maybe for a small category of financially educated customers. At present only 7% of retail investors buy foreign investment products. There are also cultural and linguistic differences that need to be appropriately managed and differences in investor compensation schemes across EU jurisdictions that may create some confusion. A recent survey however showed that although roughly 60% of respondents said that they prefer home products; the remaining 40% are ready to consider cross border investments. This 40% should be assisted in better understanding the choices that they are making, a speaker suggested. The survey moreover showed that the most important factor for investing cross-border is costs, the second is liquidity, and the third past performance.

3. Actions for improving cross-border fund distribution

3.1. Possible need for additional regulation

Regarding possible solutions for improving cross-border fund distribution, what needs to be determined is the relative role of regulation and supervision and what needs to be addressed at the EU and at the domestic levels. While further regulation may not be necessary, in one speaker's view, there is nothing wrong with revisiting what is in place and fine tuning it further. There may be a need for a UCITS VI regulation, clearly focused on developing a pan-European fund market and tackling some issues such as the depositary passport. Another suggestion made was to improve product notification, but that does not necessary require Level 1 regulation.

3.2. Reviewing the supervisory approach in the EU investment fund market

Improving the supervision of EU capital markets is essential for implementing an effective CMU, several speakers emphasized. Regarding asset management, the supervisors' goal should be to achieve a genuinely integrated market, which requires having a well-functioning market, in which market parties and investors have confidence and maintaining the current level of investor protection. ESMA is moving forward in the right direction with its supervisory convergence agenda. Some of the issues that need to be addressed in this regard are the further harmonisation of the length and quality of notification processes and of the information requested. The 'naming and shaming' of supervisors should not be excluded in order to achieve more convergence and a 'commando team' could also play a role in providing a second opinion following peer reviews, a speaker suggested.

An appropriate balance needs to be found between the EU and the domestic levels of supervision. Although concentrating supervision at the EU level for some wholesale market activities such as rating agencies, trade repositories and possibly >>>

>>> CCPs seems appropriate, this may not be the best means of encouraging ordinary retail investors to buy more UCITS, a speaker believed. What is needed rather, is a dual role for central and domestic authorities with a well-functioning home-host model. The NCA of the Member State where the funds are marketed are the best placed to carry out the supervision of marketing tools and to check that investor protection is not threatened, a speaker considered. Some issues would however be best addressed at the EU level, another panellist suggested: in particular activities that require sufficient cross-border legal certainty, such as notifications and the calculation of regulatory fees, as well as definitions that need to be determined in a harmonised way. The list of requirements, when passporting a fund into another EU country, should also be centralised by ESMA and easily accessible. In addition 'gold plating' should be avoided in order to reduce the current level of inconsistency in the implementation of EU fund regulation.

The pre-approval of marketing material by supervisors is another tool to be considered in order to ensure that documents are understandable by individual investors and to limit litigation and investment risks. This approach has proved to be effective in some Member States, such as Belgium, where the number of claims from consumers about the quality of the marketing material has decreased by 70% since pre-approval has been put in place. One panellist however emphasised that such an approach may hinder the single market if it is excessively centred on the host supervisor and suggested that a European process would be more appropriate. With ESMA responsible, industry players could get approval for their marketing material in one place and there would be one point of contact if further information is required e.g. by investors. Another issue is the excessive length of prospectuses which should be more focused on the description of the main risks posed by the investment presented.

3.3. Digitalisation / Fintech

Digital distribution is more limited for funds at the present time than for some other kinds of savings; many people like the idea of proximity when they buy funds, which is another reason for the relatively low cross-border figures for those products. Fintech is becoming increasingly important and will eliminate some of the distribution barriers that exist, but there is a need for European and domestic supervisors to ensure that adequate and accessible consumer protection is in place, notably for investors who are less digitally-confident. Defining an appropriate supervisory approach to digital distribution at EU level should be possible, a speaker believed and there should normally be no difficulty in providing investors with a digital access to the information needed on funds and their investment account in their own language. ●

VI. GLOBAL OUTLOOK

Emerging risks in global and EU financial markets

1. Averting the risk of global fragmentation

1.1. The global economy in an uncertain environment

Decision making, in the context of so much uncertainty, is not easy; growth numbers from 2016 indicate that the year saw the lowest global growth since the global financial crisis. There are nevertheless encouraging signs, such as growth increasing in the United States and no 'hard landing' in China; however, total factor productivity growth still remains very low, and much debt remains. Many banks still struggle to adapt their business models to the realities of the post crisis world, and most importantly, there is much concern about whether the world is going to enter a phase of de globalisation. Despite this, however, financial markets are generally doing very well.

1.2. Threats to trade, financial integration and international cooperation are increasing

Events such as Brexit, and more generally a rise in protectionism and populism, may create trade tensions. In turn, these could rupture global value chains, for instance impacting global retailers, affecting consumption and investment, which would have eventually the effect of halting the recovery that is beginning to occur. Sudden stops of foreign direct investment and the deterioration of trade flows would affect financial stability. Although some now think that removing financial regulation could boost creditor markets, this might lead to new episodes of financial instability; therefore, prudence remains necessary as well, since capitalized banks offer more credit. There is a need to finalise regulatory reforms, and ensure that a robust, healthy financial sector is the best contributor to the real economy.

2. Adapting the business models of banks in the current uncertain economic and regulatory environment is challenging

Some people want to bring the process of regulatory change to a conclusion, but it appears that it will continue. In this environment, banks find it difficult to optimise returns. The current global forces appear, to one speaker, to be trending away from consistency and towards divergence. Although banks are told to simplify their business models and structures, the regulators, central banks, and regulation creates increased complexity and cost for the system.

3. US financial stability issues

Risks to the US, in one panel member's view, are in the moderate or medium range, and this person has identified four broad categories. These are risks from low long term interest rates, and the risk taking behaviour that this encourages; risks that emanate from other countries and are transmitted to the US, particularly political and financial stresses originating in Europe; risks that exist in financial institutions, especially growing cyber security risks and the stability implications of these, which stem from the interconnectedness of financial firms; and finally data gaps.

Interest rates remain historically low for this point in the business cycle, and are not expected to increase significantly. Every time that political or financial stress occurs somewhere in the world, people seek safety through US treasuries; this has kept down US interest rates at the long end, and one effect of this has been to encourage risk taking activity. The Federal Reserve has been clear that tightening will be a very gradual process, and this is not likely to have enough of an impact to offset the global pressures that encourage a 'flight into treasuries'.

4. The structural vulnerabilities in several banking systems of the EU

There is not much space for policy response in Europe to the eventuality that things might get worse, although this varies from country to country. Some of the problems that Europe is confronted with are deeply structural, including – given Europe is bank based – the profitability of the banking sector. Issues of asset quality will take a long time to solve. In the view of one speaker, it must always be >>>

>>> borne in mind that history is not linear, and things do not always go well; uncertainty is endemic. The sense of mutual trust among people and social groups in our polities is coming into question, which is a problem that needs to be addressed on a deeper level than just the financial one.

The issue of the excess capacity of the banking systems in the EU presents a formidable problem, which is similar to that faced by many economies in the 1970s and 1980s in traditional sectors like shipping and steel. These led to very significant industrial restructuring processes, high public expenditure, and large numbers of people losing their jobs. There is not a single plan at the European level for whether certain banks do or do not have a future, but there are rules and operational institutions, and it is clear that banks that are continuatively not able to raise capital will need to be resolved at some stage.

5. Will a sudden surge in yield be a major risk?

The search for yield in the US has led to elevated equity and commercial real estate prices, and a high – and rapidly growing – stock of US non financial corporate debt. Any surge in interest rates would represent, therefore, a significant risk to some institutions.

Much attention is being paid to the last crisis, and what caused it. Through models, stress testing and new infrastructure since the crisis, it is now easy to understand what will happen if rates, or property prices, increase or decrease. More focus should be put on to identifying the risks and understanding the shifts that would result from these variables changing. There is much more pressure on productivity in the economy concerning the sectors that used to support growth than is widely recognised, and this will most likely persist until new sectors absorb and replace them, which could cause rates to remain structurally low for some time. Another panel member added that monetary policy was never intended to be a substitute for productivity, or for growth enhancing policy; these two processes need to occur simultaneously, and communication strategies need to be appropriate, as well.

6. Emerging economies need to adapt to a less supportive external environment

Emerging markets could be significantly affected by headwinds coming from advanced economies; however, emerging markets have represented between 60% and 65% of global growth in the last few years, and have been a source of strength for the global economy. Such emerging markets will need to learn how to operate in the new context, and will have to address some of their structural issues, including governance problems and over indebtedness.

Conclusion

Summarising, the Chair stated that five themes had arisen from the panel session. The first is uncertainty, including the risk that politics might damage the open, free trade and finance environment;

The second theme is complacency, and if markets are too complacent, there may be a need to face the risk of market corrections.

The third theme is that many of the problems Europe faces are deeply embedded, requiring work that goes well beyond monetary policy, and achieving stronger growth will require a large number of structural reforms including those on the financial side. The goal also needs to be a better global policy mix that allows for an exit, in a reasonable manner, from the very low interest rate environment.

The fourth issue is banks. There is now a three tier banking landscape: the first tier is the American banks that adapted best after the crisis, and were the first ones to accommodate their business models. The second is European banks, some of which are struggling, especially those located in very low growth economies, and the third is emerging market banks, which have continued to do better but still face some specific challenges.

The final issue is regulatory uncertainties. The new administration in the US has introduced wholesale regulatory uncertainty. It is important that cooperation at the global level between different countries, which has been critical in making the financial system a safer place, is not undermined. There is a risk of endangering multilateralism, which would be a significant public bad news for the global economy. ●

Fostering investment in the Maghreb region: challenges and opportunities

1. Facilitating private investments and access to finance in Tunisia

Since 2011, Tunisia has undergone a political transition that is advancing positively, albeit slowly. Nevertheless, this has affected its economic situation. Tunisia's development policy will allow the country to get back on the path of growth and, in the medium term, to grasp more serious growth opportunities. It will aim to meet the various challenges that Tunisia faces, particularly unemployment; the country has a high unemployment rate, especially among young people and particularly university graduates. These challenges are also due to regional disparities in the country which experiences higher growth levels in the coastal regions.

Tunisia is engaged in a significant programme of structural reforms to improve the investment environment. Restoring security and political stability is a determining factor in the current environment; social stability is also a determining factor for investment. Tunisia's legal framework has been improving; the country has adopted a new law on public/private partnership, because the state cannot meet all the demands it faces in terms of infrastructure and public utilities, especially in more remote areas. It has also introduced a new competition law, and most importantly, a new investment code which simplifies the general investment framework.

Tunisia has worked on restructuring its banking sector, and, in particular, state-owned banks. The country has worked on restructuring these banks in order to open them up to private investors, initially institutional investors, as well as to identify sources of finance outside the banking sector. Today, Tunisia has a five year development plan into which all of these elements have been incorporated, and the government intends to gradually move its implementation forward with infrastructure projects, and public/private partnership transactions to take advantage of the new investment environment.

2. Promoting industrial development: the example of Morocco

Morocco has set up a new development model, which evolved as a result of the international financial crisis. The growth model it adopted sought to address the country's key challenges from three main angles: how to position the Moroccan product in the global value chains, what factors this new growth should be based on, and what new trade opportunities exist for the Moroccan products as a result of the persistent crisis in the Eurozone. Four high value added areas were initially identified: the automotive industry, the aeronautical industry, electronics and offshoring.

Morocco has identified two basic comparative advantages: its geostrategic position and a skilled, cheap workforce. With regard to its strategic positioning, the country created a large number of logistics bases, notably large ports. With regard to labour, Morocco created universities offering training dedicated to the needs of each sector. With regard to the opening up and diversification of its markets, the country launched a far-reaching process in a quest for new partnerships, whether in India or in China, pursuing a 'win win strategy'. After this 'emerging' strategy was adopted, Morocco made progress through an industrialization acceleration plan, which was launched in 2014 and which seeks to develop not only horizontal, but also vertical integration. An example of this would be a very important international investor going into partnership with local industry to promote the distribution of Morocco's industrial fabric.

As a result of this strategy, the automotive industry in Morocco is currently experiencing high growth, and has effectively become the leading export industry. Car production now exceeds 345,000 vehicles, compared with only 18,000 vehicles produced in 2003, and Morocco has thus become the second vehicle manufacturer in Africa, after South Africa. The aeronautical sector has benefited from the same strategy: this sector has welcomed the arrival of Airbus, Boeing and Bombardier, the world leaders in the field. In Morocco, the aeronautical sector achieved revenues of 9.2 billion dirhams in 2016 compared with 3.4 billion in 2008 i.e. annual growth of 12.5%. The same approach has been taken with the Green Morocco Plan, which seeks to empower agriculture against bad weather, and the result has been that during the worst drought in the last 30 years, while Morocco's cereal production declined by 70% in 2016, value-added agriculture only declined by 10%. Finally, the Kingdom of Morocco has launched a new strategy aimed at reducing the country's dependence on oil. It is developing renewable energy, particularly solar energy, on a major scale. >>>

>>> 3. Opening the banking sector to more competition and developing financial markets: the Algerian experience

The banking system in Algeria is experiencing gradual diversification and development. A few years ago, it was dominated by six state owned banks, but following deregulation and an influx of foreign capital, there are now 20 banking institutions in Algeria, including six state owned banks and 14 private international banks; 10 financial institutions, including a private equity firm; and 23 insurance companies. Algeria's financial markets must develop, especially with the planned opening up of the capital of certain banks and industrial groups. The government has scheduled the privatisation of a state-owned bank, and possibly two others that are considered less strategic but which are well established in retail banking.

There is a dichotomy between the private and public sectors in Algeria. The public sector is smaller but owns more assets: close to 83%. This is why the government today is able to put a certain number of banks up for sale, gradually, to allow these banks to become more universal and especially to create mixed capital, whether belonging to Europeans or other nationalities.

Algeria is an oil producing country that has suffered as a result of the oil crisis, but has nevertheless developed the capacity to be extraordinarily resilient. Its savings have allowed it not only to develop resilience, but also to maintain a growth rate of 3.7% in 2016, estimated to be 4% in 2017. Algeria also has exchange reserves of $114 billion, and insignificant borrowings, of the order of 2% of GDP. To overcome Algeria's dependence on hydrocarbons, the country launched a new economic growth model with a view, mainly, to diversify business activity. The sectors targeted in this diversification are mainly agriculture, industry, tourism and renewable energy.

4. There is a need to strengthen these Maghreb countries, as well as MENA countries in general, as these are the gateway of sub Saharan migration

Boosting private investment in North Africa is an important issue. Sometimes, disruptive politics – such as Brexit and the election of Donald Trump – acts as a distraction, but this is the result of people being more bothered by terrorism and migration than, for instance, NPLs. These fears, or problems, need to be addressed: refugees are a result of war, and there are humanitarian conventions on how to treat them, but economic migration is a different issue. It is a result of significant income differences between the north and the south, and will continue until these differences are at least narrowed, if not closed.

Malta is more sensitive than other countries to what is happening in Libya, the Maghreb, and other places; it believes more should be done in the Mediterranean. There is a need to strengthen these Maghreb countries, as well as MENA countries in general, as these are the gateway of sub-Saharan migration. Young people need to be offered hope, as, in many of these countries youth unemployment stands at between 20% and 40%.

Some of the problems related to lack of investment in North Africa are the same as those faced by the European Union, such as political instability. The Maghreb has other issues to a greater extent, such as corruption or lack of credit, but Malta wanted to draw the attention of the European Union to the fact that it is the closest to Africa of all the Member States, and for the EU to think seriously about this issue and coordinate its efforts. This has to be a cooperative effort, and with three large development banks and the EU itself involved, Malta wants these bodies to coordinate their efforts, monitor the issue more closely, and see progress being made.

5. Concluding remarks

One conclusion that can be drawn from the discussions is that employment will only be created by the private sector. Many enterprises in Northern Africa are not showing the same dynamism that the World Bank sees elsewhere in terms of job creation. This is linked to the banking sector, because the banking sector often lends more to the larger enterprises that are well known and have large collateral. In some cases, these are state owned enterprises, and it is therefore harder to get financing for small and medium sized enterprises and for young entrepreneurs. This is an area that development banks like the World Bank, the EBRD and the EIB work on and look at.

Secondly, promoting a good business environment in the Maghreb is vital to respond to the high level of unemployment, especially among the region's young people and women. This is a delicate area, which needs to be carefully thought through: the goal is to have both political stability and the changes that need to be made to attract more investment. A third element is the education sector, specifically strengthening the linkages between the private sector and the education sector, as one of the phenomena that the World Bank sees in Northern Africa is that many of the unemployed are highly skilled or highly educated, but are not finding jobs. There has also been discussion of how the >>>

>>> experiences of Eastern European nations and countries that are seeking to accede to the European Union, such as the Western Balkans, can be used to inform the dialogue further.

Finally, connecting economies via information technology and e commerce is a very powerful driver, and small companies in Maghreb countries could have access to not just the European market, but a global market, at an extremely low cost. The more connectivity there is between economies, the easier it is for good businesses to move and invest. ●

SPEECHES

Malta 2017

SPEECHES

Full transcript

Joseph Muscat

Prime Minister, Malta

Prospects of the economic, monetary and financial union in the global context

The prospects for European monetary union are fair. I believe the economic indicators are encouraging, and following the double blow of the global financial crisis and the sovereign debt crisis, I believe we can safely say that economic recovery in the euro area is moderate, but underway. Major forecasters project steady but unspectacular growth in the years ahead. Employment is expanding, but unevenly so, and in some countries unemployment is still unacceptably high. Fiscal imbalances are being corrected, but outlook risks are on the downside.

Growing protectionism and the retreat from international organisation pose, in my opinion, the real threats. Brexit is a significant source of uncertainty, even though I am more positive than others that the process will be plainer and less bumpy than many seem to expect. The global situation is unhelpfully complex and riddled by multiple tensions. Geopolitical tensions have intensified. Pressures relating to migration flows are relentless. Terrorism and the emergence of an intolerant, xenophobic populism are contributing to make this a very dangerous world indeed.

These few words should suffice to sketch the global context of the prospects and challenges of European economic, monetary and financial union.

Within the euro area, there are stresses along various fault lines. One of these is that different euro area member states face divergent economic situations, whilst sharing the same nominal interest and exchange rates. Secondly, while monetary policy is determined for the euro area as a whole, fiscal policy remains and should remain largely national. Thirdly, institutionally there is tension between the nation state and the supranational body stemming from the fact that the euro area is a monetary union, not backed by a common treasury. Fourthly, the single currency is embedded in a strong, yet incomplete, single market, and only a partial banking union. There are no easy solutions, as you all know. We need to devise mechanisms to allow for a greater rebalancing of the asymmetries among the euro area countries in terms of income and employment. Partly, this requires greater economic integration, as I said in your magazine; easier flows of labour within the euro area; and greater risk sharing, balanced against measures of risk reduction through financial integration, including the banking and capital market unions. National structural reforms are needed to recover or enhance competitiveness, offering more and better employment opportunities.

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>>> On the fiscal front, we clearly need to simplify rules. They have become too complex for ordinary citizens and companies to understand. We need more rather than less flexibility in national budgets, as these are economic shock absorbers. We need to enhance the qualitative dimension in our policies. Growth-enhancing investment, tapping idle labour resources and cheap financing, needs to be executed irrespective of fiscal position. Such investment would enhance rather than complicate long-term fiscal sustainability. Simultaneously, we may also need to increase the EU's budget size – which is problematic given that the next budget will see 27 rather than 28 member states contributing – and reorientate it in order to allow for more redistribution between member states.

As we work to resolve these very complex issues, it is worth recalling some basic principles we often tend to sideline. The treaty calls for constant improvement of living and working conditions, the reduction of disparities across regions and closer union of peoples across Europe. We must admit that in recent years we may have focused too much on stability, at the expense of growth. Even when we have promoted growth, we may have given too little weight to redistribution of income and wealth. Europe goes beyond a single market. It must have a social dimension. Our decision-making processes need to be more open and transparent. We need to seriously listen to our citizens, understand their concerns, and communicate in ways that everyone understands.

I believe that this is crucial, also, for the financial services industry. Success is, I believe, possible. Take Malta: the smallest EU and eurozone member state. We are enjoying rapid economic growth, virtually full employment, an exterior surplus and contained inflation. This reflects welfare reforms that this government carried out to encourage more people to work, increased public investment, a boost in foreign direct investment, and a major energy sector overhaul. This has taken place against a backdrop of steady improvement in public finances, which are now in surplus for the first time in a generation.

As we move forward, we must not forget Europe's advances over the last 60 years. By and large, this continent has enjoyed unprecedented peace, prosperity and growth. Democracy has taken root in those countries that did not have it. We have established economic freedoms to trade, to invest, to work, and many of our citizens enjoy and value these freedoms. We have a single currency that has gained popular acceptance, in Europe and in the world. It is time for us to declare that we will do whatever it takes to protect the EMU, while unifying economic policies, bringing prosperity and social justice to all our people.

Thank you very much, and I wish you all the best for this conference. ●

Edward Scicluna

Minister of Finance, Malta

Malta and the EU

Distinguished guests, it is with great pleasure that I welcome you to Malta, and to the Eurofi conference in particular, where we are holding this gala dinner. I take the opportunity to thank the organisers – Didier, David, and the whole team – for their impeccable organisation. Today, the country that holds the Council's presidency is the smallest member state of the European Union, and the Eurozone as well, lying on the most southern border nearest to the African continent. According to the centre periphery theory of development, it is the most disadvantaged country, being an island and lacking any natural resources to boot.

Malta's only resource is its location, lying smack in the middle of the Mediterranean Sea, coupled with the impressive deep natural harbours, giving real and effective protection to maritime vessels plying along the major shipping lanes a few miles off from our island. Early man – I am talking about 5,500 years ago – chose Malta to build several temples of worship, Stonehenge like circular structures with megalithic stones, which carbon dating discovered as having predated the ones in the UK – there you are. Sorry, David. However, they were the same builders; they moved on further north. It is true. This is history. There are six such temples in Malta, for those who are interested, and two in Gozo.

The importance of Malta's strategic location varied throughout the island's history, but increased phenomenally during the time of war, starting with the Second Punic War between Rome and Hannibal, that famous war strategist from Carthage. Brave and wise as he was, unfortunately for him, he was defeated. The Maltese were luckier; they sided with the Romans, so they became Roman citizens rather than slaves. Malta played home to several wars and battles, during the Knights of St John of Jerusalem's stay in Malta, and more recently, we had other types of wars – I am referring to the two World Wars during the British stay on the island. Incidentally, according to our history books, the Maltese had no democratic say as to who ruled them, whether they were Romans, Arabs, Normans, and even the knights. It was decided by other rulers, although the same books say that the British came at our own invitation, and stayed.

In any case, our economic history is marked by a series of business cycles; unfortunately, the business of war, with the harbour region and the whole island booming during the war years and in recession – and even depression – during the inter war years. Brexit from Malta – a mini one, perhaps, by today's standards – happened on 31 March 1979. That is when the last sails left Malta. As >>>

>>> agreed, seven years before that date, the UK decided to stop paying its subscription of about $36 million – by today's standards, quite a high sum – for the lease of the military base on the island. We said, 'Goodbye', and our friendship grew stronger after that date. Yes, there was a hint there.

Tired of wars and bad experiences of past superpowers, Malta opted for neutrality and peaceful economic activity based on manufacturing and tourism for its economic survival. Both activities were oriented towards the European market, and both flourished in view of our association agreement with the EU – at the time, the Common Market – which goes back to 1971. At the same time, Malta continued to do what it knows best: Mediterranean maritime commerce in its dockyards and free ports which, due to its trans shipment, is the 11th busiest port in Europe; its cruise liner hub, its super yachting centre, and the shipping register as well.

Since the early 1990s, two new sectors were born, and have now reached adulthood: financial services and iGaming. Together, they are estimated to contribute about 15% to 20% of our GDP. New sectors are now coming on stream: logistics, with new economic free zones elsewhere on the island, and the health service and tertiary education, providing services to outsiders, not to the Maltese but especially to the MENA region and elsewhere. Today, the Maltese economy is experiencing the highest growth in the EU. The same can be said for the rate of employment growth, while the unemployment rate – obviously being adversely related – is, at present, the lowest one in the EU.

That applies to our young people. I think it is the lowest, or second lowest to Germany. This is thanks to the various structural reforms, mostly aimed at the labour market, seriously aiming to make work pay.

As a result, like Germany, Malta now depends on migration inflows – mostly European – to sustain its economic growth. This growth is externally driven, not by pumping up our debt. In fact, in four years, we switched from an excessive deficit position to a fiscal surplus at the end of last year. Debt, in percentage terms, has been pushed down from a high 73% in 2012 to 59% last year.

So what makes Malta that attractive? A politically and economically stable EU member state, eager to do business, and with a strong work ethic, lying very close to a continent – I am talking of the southern continent – which holds so much promise, but where it is so difficult to operate at present. The labour force has an abandoned[?] number of highly qualified persons, especially in the areas of accountancy and auditing, law, and IT. They can support companies dealing with international business effortlessly and efficiently from the island, to do business further south.

The island has two official languages: English and Maltese. The first is the business world's international language; the latter is essentially Arabic, the language used throughout the whole MENA region and beyond. Regulators have also always been keen to keep to high standards and guard the island's reputation. As I said at the start of my speech, our particular geographical position has made us a natural bridge between the north and south of the Mediterranean. As such, we are very interested in the EIB's External Lending Mandate and its effect on the development of the MENA region.

We also want the G20's current Host Countries Initiative with Africa to succeed for the same reason. Unlike the refugee problem, economic migration will continue for as long as big income differences remain between the continent to the north and the enormous continent to the south of Malta. That is why, on the margins of this meeting, this very morning, we invited over five neighbours within the Maghreb region for a so called 'five plus five' meeting with their European and Mediterranean counterparts, because we truly want them to succeed – for their sake, and ours.

Overall, Malta's experience as an EU member has been positive. Both as with regards to the future of Europe and in the face of current or future adversarial events, the EU will find Malta as a small but strong member which tries – and often succeeds – to punch above its weight. Thank you. Enjoy your meal. ●

Mario Vella

Governor,
Central Bank of Malta

The Euro area economy, monetary policy and structural reforms

As we all know, the euro system continues to maintain a highly accommodative monetary policy stance. The governing council has kept key ECB interest rates fixed at low and even negative levels, and has reinforced its monetary policy stance through a variety of non-standard measures, including the various asset purchase programmes. This policy stance appears to be bearing fruit. The economic recovery in the euro area that has been underway since the middle of 2013 is proceeding steadily, driven mainly by private consumption. Following a double-dip recession triggered by the global financial crisis and then the sovereign debt crisis, real GDP levels finally surpassed the pre crisis peak in 2015. The outlook is fair. The ECB projections released last month foresee real GDP growth at rates of between 1.6% and 1.8% in the coming three years.

As the economy has recovered, labour market conditions have improved. Unemployment in the euro area, which had risen to more than 12% in the first half of 2013, has now dropped to around 9.5%. The latest projections see unemployment falling by another percentage point. Nevertheless, while real GDP is comfortably above its pre-crisis level, unemployment remains above the corresponding pre-crisis rate. It seems, therefore, that a considerable amount of slack persists in the labour market. This may be one factor behind the weakness of wage and price pressures in the euro area today. Indeed, after stripping out the effects of volatile components, such as energy and food, inflation in the euro area has not yet exceeded 1%. Bearing this in mind, the governing council is determined to maintain its monetary policy stance until it can be sure that inflation in the euro area as a whole returns, durably and sustainably, to a rate that is consistent with the ECB's objective of below but close to 2%.

Persistent high unemployment rates in the euro area imply a loss of income, weak purchasing power and human and social costs that affect a significant proportion of the population. Moreover, apart from high unemployment, especially amongst the young, the euro area also records high levels of under-employed workers. From a purely technical perspective, the waste of resources that unemployment embodies points to an economy that is failing to generate enough growth. Indeed, not only is unemployment above its pre-crisis level, investment is also below the share of GDP seen before 2008. Additionally, the consistent surplus of the current account of the euro area's balance of payments points to an economy that is saving more than investing. Unutilised labour and

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>>> subdued investment lead to weak potential growth. In fact, potential growth in the euro area has slowed down substantially. According to the Commission, potential growth is expected to average around 1.2% annually between 2015 and 2018, against an average of 1.8% between 2003 and 2007.

Why is this slowdown in potential output important? Potential output can be thought of as the rate of economic growth that can be achieved in the long run without generating undue price pressures. The lower the rate of potential output, the lower expected future incomes will be. This also entails stiffer challenges to ensure that debt, whether public or private, is sustainable. Lower potential growth also means that price pressures begin to build up sooner rather than later, and this evidently impacts on monetary policy stance.

I hope I have shown that rate of growth and potential output, and hence the output gap, are variables of key importance for central bankers. However, monetary policy has only a limited, if any, impact on them or any other real economic variable – output, employment and interest rates – in the long run. In the short run, monetary policy need not be neutral. In a cyclical downturn, an accommodative monetary policy still sustains economic activity. In so doing, it can help prevent a cyclical drop in output and unemployment from becoming entrenched. For example, a reduction in borrowing costs stimulates investment, which boosts current demand as well as future supply. In addition, by supporting aggregate demand, accommodative monetary policy sustains employment. This could also support potential growth, if it lessens long-term unemployment, which may lead to workers dropping out of the labour market altogether. The long-run neutrality of money implies that other policy actors have to play their parts in securing high levels of sustainable growth.

Raising long-run potential growth requires either an increase in the supply of factors of production, or an increase in the productive efficiency. Looking first at capital stock, there is clearly a role for fiscal policy in ensuring that physical infrastructure is maintained and upgraded. Although not all euro area countries enjoy the necessary fiscal space to be able to increase capital spending, those that can do so should, while those that do not enjoy sufficient fiscal space should consider reorientating their expenditures to this end. At European level, there is also scope for action to increase investment, including through the EU budget, the European Fund for Strategic Investments, and the Juncker plan. The efficient deployment of capital also relies on well-functioning financial systems, which points to the relevance of completing the CMU and the Banking Union as soon as possible. Policymakers need to ensure that small firms can also benefit from access to non-bank sources of finance. Given their role in the European financial system, however, strengthening banks will remain critical.

Investment in human capital is also important, and will become increasingly so as Europe faces the challenges posed by an aging population. We need to allocate more resources more efficiently towards education, training and retraining with an emphasis on outcomes rather than just expenditures. Measures to raise labour force participation, including that of women and other workers, are also necessary. The picture throughout the Union is certainly not homogenous. At the same time, policymakers should act to reduce structural unemployment by facilitating job mobility, flexibility and reduction of wage mark-ups.

Talking about my country, our own experience with labour market reforms show that this is possible. Since 2012, Malta's employment rate has risen by nearly 7%. Its female employment rate is converging rapidly with EU average, and unemployment has fallen to historic lows. In part, this reflects the increase available labour generated by a buoyant service-driven economy, but balanced with a fair factor of export-oriented production. However, it also stems from concrete measures designed to entice people into work. For example, we have raised the retirement age, and introduced incentives for people to work longer, and it is working. We have introduced free childcare, allowing parents with young children into work, and this working too. We have begun tapering welfare benefits to avoid an abrupt loss of benefits once the unemployed take up work, and that is working too.

In the current climate, with the UK leaving the EU and with the global commitment to free trade under attack, it is especially important to maintain open access to markets. This is of special concern to us, one of the smallest and most open economies in the world. Increased protectionism can be seen as the antithesis of the structural reforms we need. Raising trade barriers implies increasing inefficiencies, lowering potential output and raising costs and prices. Though it appeals to particular interests, it leaves the population at large worse off.

Finally, structural reforms of the sort I have just outlined increase the resilience and flexibility of an economy. This is especially important in a monetary union, where the member states have chosen to give up an independent monetary and exchange rate policy, in favour of a single currency. As the economy recovers and this monetary policy remains supportive, I would argue that now is the time to pursue the reforms needed to foster sustainable growth and jobs.

Thank you. ●

Mahmood Pradhan

Deputy Director,
European Department,
International Monetary Fund

Outlook for the EU 27 economies and financial sector

Good afternoon to all, and thank you very much for inviting me to talk about the EU.

What I am going to talk about today is primarily focused on some of the challenges of the euro area, but I will also touch on the EU 27. I will try to draw some common themes that I think are also present in the non-euro area EU members.

I would like to take stock of where we are in the euro area, following an extended period of not only very low growth, but substantial changes in the architecture and the governance framework of EMU. And there are undoubtedly more changes to come, particularly in the landscape for the financial sector.

While we should all celebrate a convincing and firming recovery in the euro area, especially after double-dip recessions, I want to draw your attention to what we should also worry about – in particular, the lack of policy space to deal with downside risks, and I want to focus particularly on this challenge. In a similar vein, while we should acknowledge the substantial progress in strengthening the architecture of the euro area – and the Prime Minister just referred to some of these accomplishments, which are very notable accomplishments – we might want to ask if more architecture can address the lack of real economic convergence among member states, and the persistent macroeconomic imbalances within the region, as the Prime Minister also mentioned. Finally, I will be a bit brave in this audience and delve into your domain, which is Europe's financial sector. That is going through a major transformation shaped not only by changes in the regulatory environment, and the potential changes that could be triggered by the UK leaving the EU, but also because of the more fundamental challenge posed by overcapacity and low profitability in the banking sector.

Let me, then, start with the economic recovery. After the 2012/13 recession, growth only picked up very slowly compared to the immediate aftermath of the 2008/09 recession, when it jumped to over 2% in 2010. With 2016 coming in at about 1.7% for the euro area, we have now had two years of relatively solid growth. This is still lower than what would be necessary to deal with some of the legacies of the crisis, particularly public and private sector debt overhangs, and I will come back to this. Despite the euro area's large current account surplus, recent growth is primarily driven >>>

>>> by domestic demand, which is encouraging as it tends to be less volatile than external demand. The recovery has been underpinned by strongly accommodative monetary policy, a mildly expansionary fiscal stance in the last two years, and stronger job creation. Headline inflation is also picking up, but the average is still far below the ECB's medium-term price stability objective, and underlying inflation remains persistently weak. This reflects the still large negative outlook gaps in some countries, and the impact of past import price deflation.

To summarise,the IMF's forecasts suggest that growth will hold up at around current levels for this year and next year. With regard to inflation, we should see some pickup in 2017. Our forecast last year, in January, was 1.4%. We should see a substantial pickup in headline inflation to 1.7 percent for 2017, and 1.4 percent in 2018. Our baseline view is that the ECB will achieve its price stability objectives sometime between 2020 and 2021. In the rest of the EU – and here I am primarily talking about the new member states in the EU, to the east of the euro area – the good news is that the output gaps are largely closed. They have largely recovered from the crisis. The outlook for external demand – and external demand is quite important in this area – and greater absorption of EU structural funds both suggest that they should be doing reasonably well. To put EU structural funds in perspective, if they fully absorb the EU structural funds in the next 10 years, that should give them a rise in GDP of about 18 percentage points. This is substantial. I will come back to convergence issues for these countries.

Let me come back now to the euro area, and talk about where we go from here. We are much less sanguine about the medium-term outlook, especially because of the many risks and the very thin policy buffers. Let me lay out a few things on the horizon that should concern us. Firstly, Europe's adverse demographic trends will be compounded by the unsolved legacy issues, such as substantial debt overhangs in some countries and higher structural unemployment in many countries. Secondly, high-debt countries will face higher borrowing costs, perhaps sharply higher, when monetary accommodation is eventually reduced. Thirdly, there is uncertainty about the stance of US policy and its external orientation. Fourthly, this year several member states have elections and some voters have already expressed scepticism about the benefits of integration. Political discord could lead to dramatic policy shifts with important economic implications. Fifthly, the process of disentangling the UK from the EU could take a toll on confidence. Negotiations between the EU and the UK on issues such as passporting and third-party equivalence could substantially change the distribution of financial market activities across Europe. At both the national and supranational levels, Europe needs to be ready to take on a heavier burden of financial market oversight. These are the risks on the horizon, perhaps also posed as challenges.

Let me turn to what I have already referred to twice, the policy buffers. External imbalances have improved, as many net external creditor countries have switched from current account deficits to surpluses, lowering their vulnerability to sudden external financing stops. However, the very large surpluses of net external creditor countries persist. This is the adjustment mechanism that the Prime Minister talked about earlier. Competitiveness gaps between these two groups of countries – the external creditors and the debtor countries – remain very wide. Partly because of this, there has been very little convergence in real per-capita incomes. Among the 12 original adopters of the euro, since its beginning, convergence has stalled and since the crisis there has in fact been divergence. This is worrying. Without further convergence, the monetary union will remain vulnerable to periodic bouts of political and economic instability. If we were to look at the whole club, the 19 euro area member countries, adding the seven which joined later, their convergence record to the average of euro area per capita GDP levels is substantially better, but we should worry about convergence among the 12 original adopters.

To foster convergence, all countries will need to contribute. Germany and the Netherlands, for example, as well as other large net credit countries will need to generate more domestic demand to reduce their excessively large current account surpluses. Italy and other net external debtor countries need to move much faster in implementing structural reforms to improve business conditions and raise productivity. Let me say a little bit, while I am talking about convergence, about the rest of the EU, the non-euro area. Here convergence has slowed substantially. Between 1995 and 2007, per capita incomes in that region rose by just over 4% per annum. But between 2007 and 2016, per capita GDP rose by only 1.5% per annum. This suggests that the process of convergence has slowed in the east as well.

Let me turn to the role of structural reforms to promote convergence. In our view, structural reforms at the national level are the only way to lift potential growth, close competitiveness >>>

>>> gaps, and foster convergence. Without these, economic convergence within the euro area will remain elusive. Changes in architecture, such as completing the banking union, or somewhat more fiscal integration, can help make the environment more favourable, but improved architecture alone will not raise productivity and potential growth. In our view, also, countries should take advantage of the current low rate environment to forcefully enact needed reforms, before the eventual monetary policy normalisation raises financing risks for the high-debt countries. Unfortunately, progress thus far on structural reforms has not been encouraging, and that is putting it mildly, with some countries even reversing previous reform commitments. Member countries have also been relatively poor at consistently implementing the European Commission's country specific recommendations.

More on policy space now. Turning to fiscal policy, in aggregate fiscal space in the euro area is relatively constrained and unevenly distributed due to high debt burdens in many countries. The few countries with fiscal space, such as Germany and the Netherlands, should, in our view, boost domestic demand and raise potential growth. This would also encourage external rebalancing and reduce their large current account surpluses. At the same time, high debt countries with little or no fiscal space need to rebuild buffers and save the windfall interest savings from monetary accommodation. Regardless of fiscal space, all countries can and should work towards a more growth-friendly composition of taxation and spending.

Given the uneven distribution of fiscal space, there is a compelling case for a central fiscal capacity to offset large, adverse country-specific shocks. However, building trust and political support for such a centralised capacity will require much stronger compliance from member states and credible enforcement of the current framework. It is regrettable that, thus far, compliance has been lax, and enforcement has also been weak.

Let me turn, now, to monetary policy, which we argue should remain accommodative for as long as it takes. Subdued underlying inflation and negative output gaps in many countries argue for maintaining the current very substantial monetary accommodation over an extended period. Negative output gaps are still substantial in many countries, such as in France where it is about 2%, and Italy where it is over 2%. Euro area core inflation has been stuck at about 1% for the past three years, and shows little sign of moving. Similarly, market expectations for medium-term inflation remain low at about 1.5%. Looking ahead, the ECB should look through any temporary inflation movements to ensure a durable and self-sustained return of area-wide inflation to its medium term price stability objective. Importantly, for some countries like Germany, where output gaps are mostly closed, this will mean inflation above the ECB's 2% objective, possibly for a prolonged period. This is the only way the ECB can meet its mandate. Inflation in some countries has to be above the average, for the average to be around 2%.

Finally, let me turn to the financial sector, and say something on banks and the Capital MarketsUnion. The stock of non-performing loans has declined from its peak. That is good news. However, the pace of reduction is still too low, given the large remaining stock. NPLs have fallen by about €150 billion in the last two years, but some €1 trillion of NPLs remain. These are concentrated in three or four countries. If we look further east, at Hungary, Poland, the Czech Republic, Bulgaria and Romania, with one or two exceptions, we have seen much more progress in that region on reducing NPLs post the global financial crisis. The SSM took an important first step in issuing its comprehensive new guidance on NPL management. Its second step must be stricter monitoring of banks' NPL reduction targets, backed by the imposition of additional bank-specific capital requirements, wherever needed. Even with that, supervisory efforts alone will not be enough. There needs to be continuous effort to harmonise and modernise national corporate and household insolvency frameworks, and develop markets for distressed debt.

The challenges for European banks, however, extend beyond high NPLs. The banking system in Europe suffers from chronically low profitability and a cyclical recovery alone cannot overcome this problem. Banks will need to restructure and consolidate, including through discontinuing unprofitable business lines, further cost cutting, and reducing the number of branches: concerted action, essentially, to tackle overbanking. This is, by and large, a private sector led process, but supervisors can also play a role, by pushing problem banks to restructure or to be resolved.

Despite the banking union's early promise for a truly integrated European banking market, ring-fencing of liquidity within national banking systems is still prevalent. The ECB and national authorities should work closely together to reduce this ring-fencing, because it is not allowing the banking union to deliver that early promise. I will not touch on some things we have said before and said repeatedly, such as that completing the >>>

>>> banking union also requires establishing a common deposit insurance, together with the associated risk reduction and a common fiscal backstop.

The CMU action plan is critical to improving the functioning of the single market, and enhancing the EU's resilience to shocks. Greater capital market integration would bolster national private risk sharing, which has so far been surprisingly limited in the euro area and the EU, compared to the levels of regional private risk sharing within other jurisdictions like the United States, Canada and even Germany. CMU could also help diversify financing sources for the real economy, away from its high reliance on banks. Key policy actions in this area include legislation on infrastructure creation to incentivise more venture capital, enhance SMEs' access to finance, address the debt equity bias in corporate taxation, and harmonise corporate insolvency and foreclosure frameworks.

Let me finish by saying that I hope I have left you with an optimistic message. You must remember the 'good news' part of my introduction! We should celebrate the recovery. But let us also use this positive backdrop to push harder on the many remaining challenges. We should worry about the lack of policy space and the very uneven distribution of that policy space in the euro area. And most of all, longer term convergence of real income levels will come from stronger actions, especially on structural reforms, at the national level.

Thank you very much for your time. I look forward to learning a lot more from the large number of experts gathered here over the next two days. ●

Valdis Dombrovskis

Vice-President for the Euro and Social Dialogue, European Commission

Key challenges for EU economic and financial services policy

I am happy to be back at Eurofi at a time when the economic situation in Europe is improving. For the first time in almost a decade, the economies of all EU Member States are expected to grow this year and next.

Real GDP in the euro area has grown for 15 consecutive quarters. Employment is growing at a robust pace. Unemployment continues to fall, although it remains above pre-crisis levels. Private consumption is still the engine of the recovery. Investment growth continues even if it remains subdued.

In its latest forecast, the Commission expects GDP in the EU to grow by 1.8% both in 2017 and 2018. This tends to prove that our economic policy mix – investment, structural reforms and responsible fiscal policies – is working. It is important to stay the course.

However, this positive outlook remains surrounded by uncertainty. Progress is uneven across EU countries. We still see high levels of public and private debt. Many Europeans do not yet feel the economic recovery in their pockets, and perceive increased inequalities in our societies. And Europe is facing new geopolitical challenges, from migration to conflicts and instability in our neighbourhood. For the first-time a Member State is leaving the EU.

These challenges invite a broader reflection, and President Juncker has launched this with the White Paper on the Future of the EU.

But there are a number of areas in the financial sector where we can act to reduce uncertainty and strengthen the recovery:

- first, we need to tackle remaining vulnerabilities in our financial sector, and non-performing loans are a case in point;
- second, looking at the future, accelerating Capital Markets Union will unlock additional financing for growth;
- and third, we need to develop our regulatory and supervisory framework to address new challenges.

Let me develop these three points.

First: non-performing loans.

A broad consensus has emerged that high ratios of NPLs in several member States are weighing on the performance and viability of the EU banking >>>

>>> sector. This has negative implications for economic growth and financial stability.

Based on historical experience and current trends, if we do not accelerate the NPL clean-up, it would take another 10 years to clear the total current NPL stock. If however we were to tackle NPLs, the capital relief could support lending by up to EUR 500 bn over the next years, in particular in the Member States which need it most.

Within the EU, the level and structure of NPLs differ significantly across national banking sectors. Furthermore, most of the policy instruments to address NPL problems are within the competence of Member States. This suggests that Member States remain primarily responsible for addressing NPL problems.

However, there is a clear EU dimension: weak growth in some Member States due to high NPLs affects economic growth elsewhere, and investors often perceive the value and soundness of EU banks more generally and as a function of weak balance sheets of just some banks.

These spill-over effects suggest that national authorities and European institutions should join forces by designing an EU strategy which would support Member States in tackling NPLs. There is no silver bullet against this problem. We need a combination of measures. Solutions include reformed insolvency frameworks, stronger judicial capacity, and measures to foster larger and more efficient secondary markets for NPLs, including the possibility to set up national asset management companies based on a common blueprint.

We are not starting from scratch, but we need to accelerate and join up efforts.

I hope that at tomorrow's ECOFIN we will see broad recognition that there is an EU dimension to NPLs, and broad support to agree on a common EU strategy with concrete deliverables.

The Commission is already actively contributing to a number of these efforts. We support reforms through the European Semester and the Structural Reform Support Service. We are helping Member States to design NPL measures within the EU state aid and resolution framework. And we are considering further EU initiatives to support legal reforms and secondary NPL markets.

This brings me to my **second point**: accelerating Capital Markets Union.

According to some estimates, the development of EU capital markets could unlock € 2 trillion of assets to invest in the EU economy and could lead to more than € 50 billion a year in additional financing for companies.

Building capital markets is a long-term project. We have to confront new challenges. Since last week, we have it confirmed black on white that Europe's largest financial centre will leave the single market. This challenge should focus our minds. I see that there is a growing sense of urgency for developing a Capital Markets Union amongst the 27 remaining Member States.

We have made a good start: the Commission has delivered on 16 out of the 37 measures of the CMU Action Plan. And we have high hopes that the European Parliament and the Council will soon deliver on their side, in particular on securitisation and venture capital.

It is now time to build on this and accelerate CMU. Our consultation which has just closed is showing strong support for the objective of a stronger capital markets system. This will help us launch a CMU mid-term review in the summer.

We will stay firmly focussed on the core policy themes of the CMU action plan: improving access to risk finance for SMEs; enabling institutional investors to invest in longer-term assets such as infrastructure and energy transition; more effective and rewarding retail investor engagement with capital markets; sustainable and green finance; removing remaining barriers to cross-border investment.

However, in the second phase of the project, we will refresh our strategy to make sure we deliver on our objectives, and establish Capital Markets Union by 2019.

And we need to ensure that we have the right supervisory framework for our integrated financial markets, which is my **third point**:

Since their establishment, the European Supervisory Authorities have contributed significantly to a robust financial framework for the Single Market, also underpinning Banking Union. However further progress in supervisory convergence is needed to promote the CMU for all EU Member States, improve integration within the single market and safeguard financial stability.

While the ESAs have started to shift attention and resources to analyse risks to consumers and investors and undertake more work to increase supervisory convergence, work in this area must be accelerated. The ESAs also have a major role >>>

>>> to play to capture the growing benefits of technological developments such as FinTech, whilst addressing any possible risks arising in this context.

We need to reflect on what possible changes to the current legal framework are needed to enable the ESAs to fully deliver on their mandates. In order to gather evidence, the Commission has recently launched a public consultation focusing on a number of issues related to the ESAs' tasks and powers; governance; supervisory architecture; and funding.

Our aim is to identify areas where the effectiveness and efficiency of the ESAs can be strengthened and improved.

An area in which Brexit will profoundly change the EU's financial landscape is central clearing of derivatives. Today the United Kingdom accounts for a significant amount of Europe's clearing activities.

So it is all the more important to consider how Europe's framework for the clearing market will develop. Let me mention four points on this:

First of all, our recent consultations showed that with EMIR we have a framework which is considered to have brought transparency and mitigated systemic risks in derivative markets, and which is here to stay.

Second, we will continue our efforts to make the system more efficient and reduce disproportionate costs and burden. We have received many sensible suggestions from stakeholders on: how to better calibrate the application of some requirements to specific actors, notably to non-financial counterparties, pension funds and small financial counterparties. We will come out with legislative proposals on our review very soon.

Third, Europe's clearing markets should continue to be part of integrated international markets. In this and in other areas we are committed to maintaining and developing strong international standards, and we expect the same from our international partners. Based on these standards, the principle of equivalence is key to EMIR. We have only recently extended equivalence to a number of jurisdictions. We have recalled the key features of our equivalence system in a Staff Working Document. And we are open to further develop equivalence where necessary.

Fourth, and finally, – not least due to the success of EMIR – ever larger volumes of derivatives are cleared centrally in a small number of CCPs which are of systemic relevance across the EU. As also set out in our consultation in the ESAs review, we will therefore need to consider how to continue developing the EU's supervisory and resolution system.

A specific issue in this context is how to deal with the fact that a very significant proportion of clearing activities in certain market segments currently occurs in the UK. That activity would in future therefore be outside the EMIR framework. This will surely be a matter of important reflection in the coming months and years.

Ladies and gentlemen,

There is a lot of work ahead of us. But let us not detract from one fundamental truth: For financial markets in Europe, and even more so in the future Europe of 27 Member States, integration is an existential question. Only together we have the depth and liquidity for markets to function efficiently, the scope for innovative finance to develop and scale up, and the strength to finance our economies.

I am looking forward to continue working with you to capitalise on the strength of the EU's internal market for financial services, in support of Europe's economy and its citizens.

Thanks for your attention. ●

Vítor Constâncio

Vice-President,
European Central Bank

Effectiveness of Monetary Union and the Capital Markets Union

In my remarks today I will link the role of monetary policy with the project of the Capital Markets Union (CMU). Monetary policy has played a vital role in bolstering euro area resilience to the large shocks that have occurred over the past decade. Indeed, it is the only expansionary macroeconomic policy in support of the resilient recovery now underway in the euro area. Nevertheless, we have not yet completed the task of attaining our goal of a sustained path of inflation close to but below 2%.

But while monetary policy has been successful at sustaining the area-wide recovery, it is unable to significantly counteract the effects on individual countries from asymmetric shocks, which have been substantial in recent years. There is an important role here for capital markets. By permitting households and businesses to draw on cross-border income streams and lending, deeper financial integration reduces the impact of asymmetric shocks.

The degree of financial integration in the euro area is currently insufficient. Indeed, in the recent crisis, the degree of financial integration fell, as interbank markets fragmented along national lines. This fragmentation exacerbated the overall impact of the shocks on the euro area, deepening the recession, lengthening the recovery and increasing the need for unconventional monetary policy measures. The single currency area provides fertile conditions for deeper financial integration and that deeper integration in turn helps build resilience to shocks and strengthens the effectiveness of monetary policy by means of a more homogenous transmission. Monetary policy and CMU are thus linked.

Let me start by discussing the current situation and the contribution of monetary policy in sustaining the current recovery before returning to discussing how CMU can help generate greater resilience to future shocks.

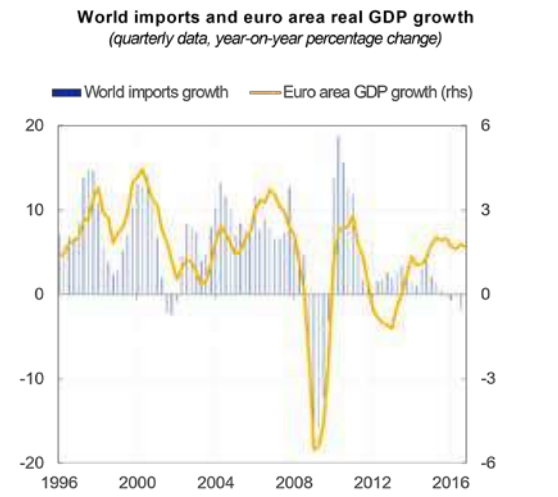
The current economic conjuncture

The euro area recovery is gaining momentum, broadening across sectors and countries. This is evidenced by 15 consecutive quarters of positive real GDP growth, unemployment at its lowest level since 2009 and over four and a half million more people employed now than was the case three years ago. Growth in manufacturing also reached its highest rate since 2011.

Moreover, the current recovery has shown considerable resilience amid an environment >>>

>>> of uncertainty. Typically, euro area activity closely co-moves with world trade, so if the latter slows this acts as a headwind for growth. However, the strength of domestic demand has enabled euro area growth to continue to expand, despite the marked slowdown in global trade (*Chart 1*).

CHART 1



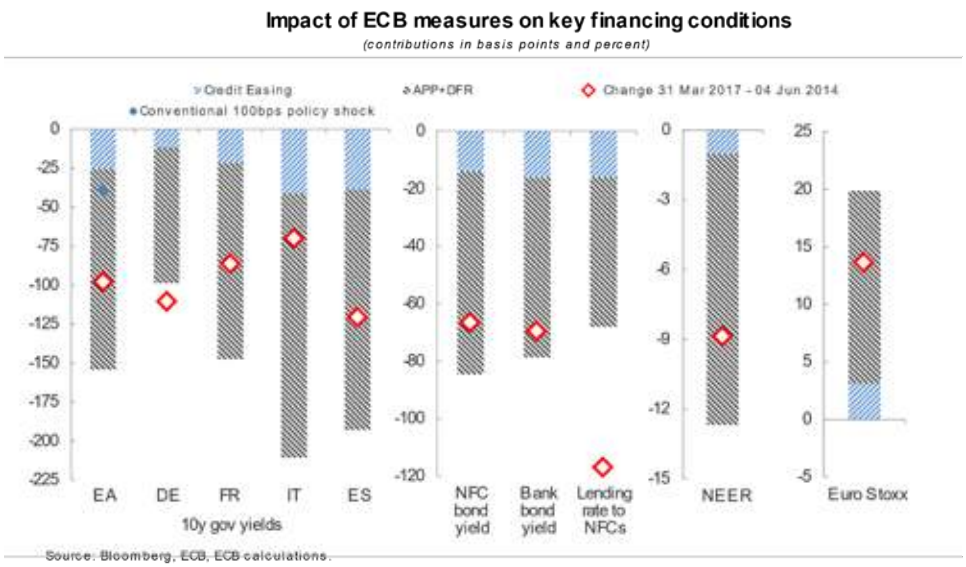
Sources: Eurostat, ECB staff calculations.
Latest observation: 2016 Q3 for world imports growth and 2016 Q4 for euro area

What, then, is supporting domestic demand? Employing a range of econometric models, ECB staff show that the current recovery has been very reliant on two factors: the exceptionally low oil prices in 2014-15 and our monetary policy measures. This monetary support can for the most part be traced back to the measures which the ECB started introducing in June 2014 in order to arrest the downward drift in inflation at the time and the risk of a self-sustained period of deflation.

These measures have had a considerable impact on euro area financing conditions. Bank lending rates for both firms and households are currently at historical lows, and lending volumes experiencing an upward trend. Borrowing costs in vulnerable countries have been significantly reduced, reducing fragmentation and small and medium sized enterprises are especially benefitting from the increasing pass-through of policy rates to lending rates. In this regard, monetary policy has had some success in mitigating the asymmetric impact of shocks.

To give an example of the contribution of monetary policy to this easing in financing conditions, ECB staff estimate that lending rates to non-financial firms would be about 70 basis points higher absent our policies (*Chart 2*). In combination with other factors, lending rates to non-financial firms dropped by 120bp from June 2014 to date. >>>

CHART 2



Source: Bloomberg, ECB, ECB calculations.

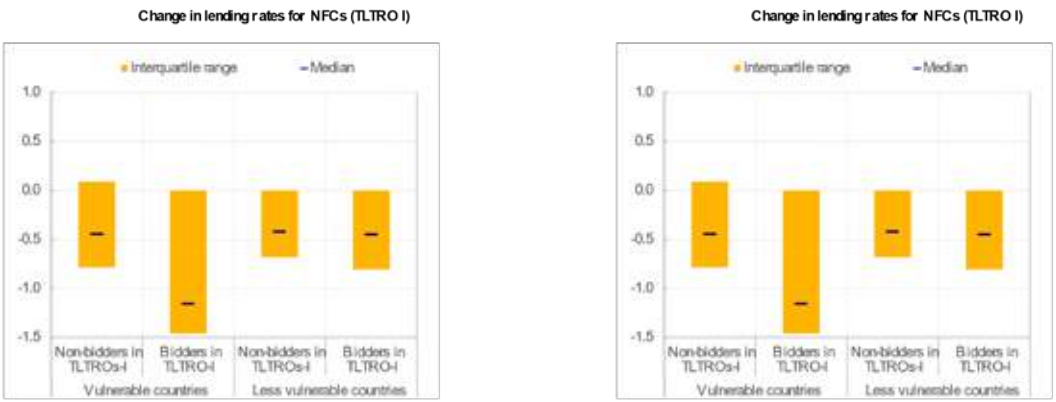
Note: The impact of credit easing is estimated on the basis of an event-study methodology which focuses on the announcement effects of September package; see the EB article "The transmission of the ECB's recent non-standard monetary policy measures" (Issue 7 / 2015). Th of the DFR cut rests on the announcement effects of the September 2014 DFR cut. APP encompasses the effects of January 2015, Decemb March 2016, and December 2016 measures. The January 2015 APP impact is estimated on the basis of two event-studies exercises by co broad set of events that, starting from September 2014, have affected market expectations about the programme; see Altavilla, Carboni, an (2015) "Asset purchase programmes and financial markets: lessons from the euro area", ECB WP No 1864, and De Santis (2015), "Impact of purchase programme on euro area government bond yields using market news", ECB WP No. 1939. The quantification of the impact of the D 2015 policy package on asset prices rests on a broad-based assessment comprising event studies and model-based counterfactual exe The impact of the March 2016 measures and the impact of the December 2016 measures are assessed via model-based counterfactual e
* Changes in lending rates are based on monthly data, the reference period for which is June 2014 to February 2017.

>>> The effectiveness of our measures is also visible from a more micro perspective, by examining the lending behaviour of individual banks in the context of our TLTROs. Incentives underpinning the TLTROs (Targeted Long-Term Refinancing Operations) are resulting in the cheaper funding costs being passed-on to customers, particularly in vulnerable euro area countries (*Chart 3*).

Euro area activity has been improving against this backdrop of easing financing conditions. Higher employment has boosted labour incomes and consumption, and investment has begun a cyclical recovery. Global growth prospects are showing signs of strengthening and may well further support the recovery. Indeed, despite the waning support from oil prices, growth has continued to broaden and gain momentum. While risks to the outlook remain on the downside, they are less pronounced than before.

Our latest staff macroeconomic projections were revised slightly upwards, with annual real GDP is expected to increase by 1.8% in 2017, 1.7% in 2018 and 1.6% in 2019. The impact of monetary policy measures on euro area GDP growth is sizeable, adding a cumulative 1.7% over the period 2016-2019 (*Chart 4*). >>>

CHART 3



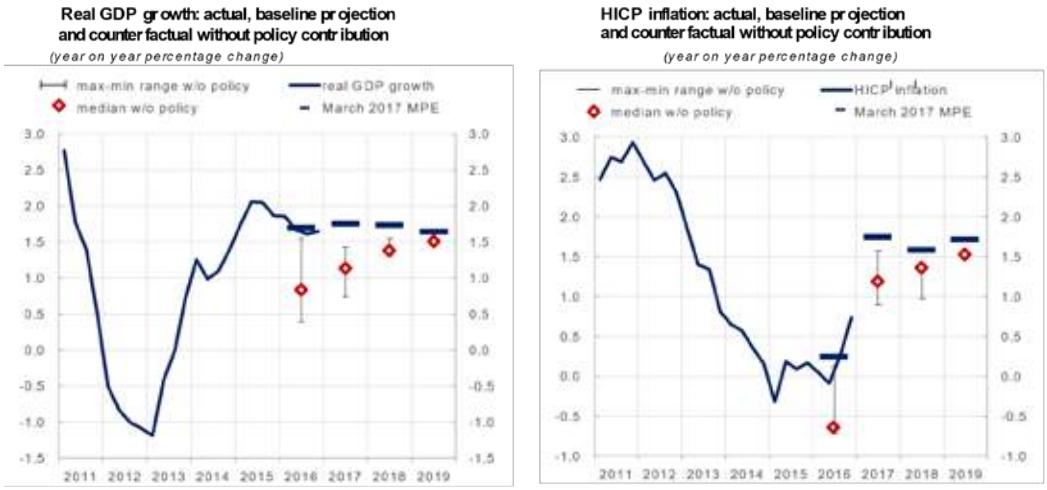
Source: ECB

Notes: The chart covers the period from June 2014 to July 2015. In "vulnerable" countries the "non-bidders in TLTROs-I" group comprises ten banks and the "bidders in TLTRO-I" group compri 49 banks. In "less vulnerable" countries the "non-bidders in TLTROs-I" group comprises 71 banks and the "bidders in TLTRO-I" group comprises 43 banks.

Source: ECB

Notes: The chart covers the period from June 2014 to July 2015. In "vulnerable" countries the "non-bidders in TLTROs-I" group comprises ten banks and the "bidders in TLTRO-I" group compri 49 banks. In "less vulnerable" countries the "non-bidders in TLTROs-I" group comprises 71 banks and the "bidders in TLTRO-I" group comprises 43 banks.

CHART 4



Sources: ECB staff projections and calculations.

Notes: HICP inflation and real GDP growth are based on the March 2017 MPE; the median and range reflect estimates of HICP inflation and real GDP growth over the projection horizon in the absence of monetary policy support. These estimates are obtained on the basis of a large suite of models, encompassing various dimensions in relation to the treatment of the financial sector, the degree of forward lookingness, and the way non-standard measures are implemented in the model Latest observation: 2016 Q4 for HICP and real GDP growth.

>>> But while significant progress has been made, it is too soon to declare complete success. Headline inflation has increased, but has yet to sustainably converge towards our objective. The increase mostly reflects rising energy and food price inflation, with underlying inflation pressures still subdued (*Chart 5*). The flash estimate for March shows that headline inflation has dropped to 1.5% from 2% in February and that underlying inflation decreased from 0.9% to 0.7%. We had previously warned that headline inflation could decline after March-April as a result of the reduced statistical base effect of comparing this year's price levels of oil and other commodities with their value a year ago.

The decrease in underlying inflation, however, is disappointing. The domestic drivers of inflation, namely wages, are not yet responding to the recovery and the narrowing output gap. According to our latest projections, inflation is expected to move towards 1.7% in 2019 (*Chart 5*), predicated on underlying inflation and wage growth of 1.8% and 2.4%, respectively. Without the foreseen increase in wages, the baseline scenario of our staff projections for growth and inflation will not materialise in 2019. At early stages of its recovery, the US also faced the same subdued behaviour of underlying inflation and wages that accelerated only later.

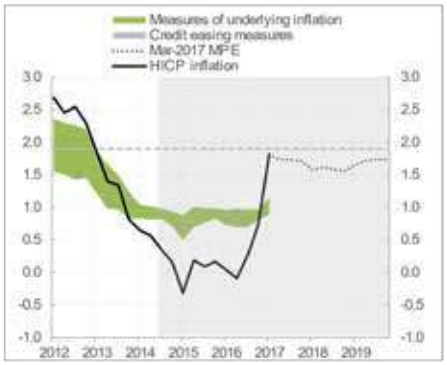
To achieve our goals concerning self-sustained inflation, we have to be sure that domestic drivers of inflation are behaving accordingly. In this perspective, it is worth mentioning that the projections rely on the continued substantial degree of monetary accommodation. Absent our policy package, inflation would on average be almost 0.5% lower than currently projected in each year over 2016-2019 (*Chart 4*). In other words, inflation is not yet self-sustaining. For this reason, the Governing Council at its last meeting confirmed the appropriateness of the current monetary policy stance. As ever, we are data dependent; we recognise that there has been improvement in the situation and if inflation gives signs of a sustained path towards our aims, we will reassess our present policy stance.

Improving future resilience

To recap, monetary policy is successfully sustaining a resilient recovery from the large shocks that have hit the euro area over the past decade. Our unconventional measures introduced since June 2014 are working. But that is not to say that monetary policy has been successful in completely eliminating the effects of those shocks on individual countries. That is beyond the ability

CHART 5

Actual and projected HICP inflation, and measures of underlying inflation
(year-on-year percentage change)



Sources: ECB, ECB staff projections and calculations.
Notes: The measures of underlying inflation (green range) include HICP inflation excluding food and energy, and U2 core and Super-core.
Latest observation: 2017 Q1 for HICP inflation and measures of underlying inflatio

of monetary policy. What other options are there, then, to build resilience in the euro area against future shocks?

First, it is worth noting the absence of other macroeconomic policies in sustaining the recovery. There has been little support from fiscal policy, and the progress on structural reforms has not been completed. We have frequently discussed how a greater counter-cyclical role for fiscal policy and more flexible economies can help reduce the impact of shocks and buttress the efforts of monetary policy. Those views remain true today. But there is a role, too, for deeper financial integration through the CMU to build resilience.

Well-functioning political, economic, and monetary unions are normally characterised by high levels of risk-sharing across regions. For example, evidence suggests that three quarters of shocks to the per-capita gross product of individual states in the United States are smoothed, and that capital markets and credit markets together account for around two-thirds of that smoothing, dwarfing the contribution from federal transfers (13%).[1] Similarly, in post-unification Germany around 69% of region-specific shocks to GDP growth are smoothed through capital markets and credit markets, and only about 11% through fiscal tools.[2]

In comparison, the overall contribution of markets to risk sharing in the euro area has, on average, been limited (*chart 6*).[3] At present, little more than 20% of the idiosyncratic shocks to a country's economy are smoothed, with changes in relative prices contributing the most to risk sharing.

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>>> Risk-sharing via cross-border ownership of assets increased substantially following the introduction of the euro, smoothing between 30% and 40% of country-specific shocks to GDP by the mid-2000s. But the contribution of capital markets declined substantially during the financial and especially during the sovereign debt crisis. The contribution of credit markets has been lower, and it even became negative during the financial crisis when European banking sector was particularly hit.

In the absence of a European supra-national system of taxes and transfers, it is more pressing than ever to boost Europe's risk-sharing potential through financial market mechanisms. The risk-sharing benefits of integrated financial markets could in principle be large.

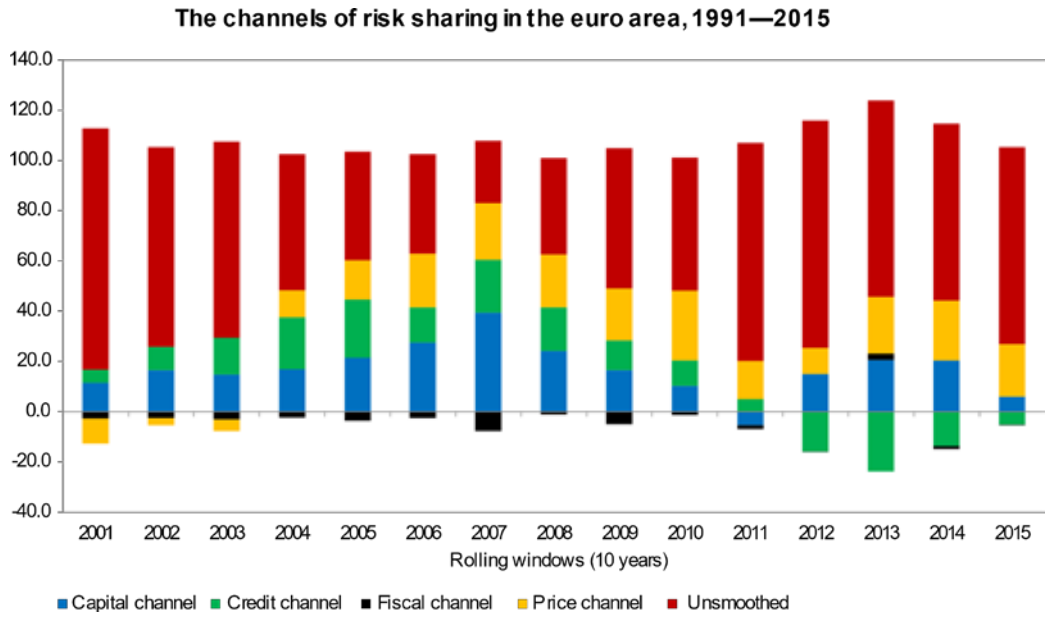
Another major benefit of the CMU is the contribution to convergent growth among member countries, resulting from the improved circulation and allocation of savings across the Union. In this perspective, Brexit makes it more crucial that the CMU is effectively implemented and that European growth can avail itself of the services of an integrated financial system. This is particularly true of a CMU focused on stimulating equity financing.

Indeed, equity and foreign direct investment (FDI), and longer-maturity debt in general, are leading to a more resilient form of financial integration. Deeper equity markets constitute an unquestionable advantage to the US, notably in relation to the role of venture capital in promoting innovation. For the expansion of such an activity it is important to create a deep equity market that can provide significant returns in successful IPOs (Initial Public Offers) that can offset losses incurred by failing risky projects.

The CMU is aimed at completing the single market for capital by building integrated markets for equity and bond finance. This should be achieved through both regulatory and non-regulatory actions, including the harmonisation of key legislation and policies related to financial products, such as investor protection and bankruptcy procedures.

A number of concrete measures are set out in the Commission's Action Plan to underpin the further development of large capital markets in the EU.[4] The same applies to improving financial literacy and to stimulating a shift in household savings from bank deposits to equity holdings. >>>

CHART 6



Note: The Chart summarizes the five-year cumulative contributions of capital markets, credit markets, fiscal tools, and relative prices to the smoothing, in terms of consumption growth, of a 1-standard-deviation shock to GDP growth. Each bar thus measures the parts of the shock to country-specific GDP that are absorbed by the respective channels. The remainder is interpreted as the unsmoothed portion of a GDP shock, i.e., the part of a shock to country-specific GDP growth that is reflected into country-specific consumption growth. Contributions sum up to 100 percent, and a negative contribution corresponds to dis-smoothing of consumption growth. The respective contributions are estimated over rolling ten-year backward-looking windows, based on annual data and applying the Asdrubali and Kim (2004) approach enhanced for relative price adjustments in the spirit of Corsetti, Dedola, and Viani (2011).

>>> We need a CMU that is ambitious; it should come with a roadmap in terms of goals and milestones to be achieved. Broad objectives such as deepening financial integration and achieving risk sharing should be matched with specific proposals such as facilitating funding for corporates in general and for SMEs in particular. Key areas such as securitisation, insolvency regimes, and tax legislation need to be prioritised. Cross-border barriers to clearing and settlement should be removed.

Financial stability concerns also need to be addressed, including an assessment of whether additional macro-prudential instruments should be developed. The proper regulation of financial products and supervision of financial entities, such as insurers and pension funds, as well as full transparency of new financial products, should be put in place as they are essential to convincing households to switch to more market-based forms of saving. In this respect, enhanced powers for the European Securities Markets Authority (ESMA) and better coordination with the national competent authorities will help strengthen the implementation and enforcement of rules.

Conclusion

Allow me to conclude.

The euro area is experiencing a resilient recovery, sustained by monetary policy. Outturns for high-frequency data so far this year point to continued momentum. But it is too soon to declare complete success: we have yet to secure a sustained convergence in inflation towards our goal of close to but below 2% over the medium term.

With the recovery underway, we should aim to build euro area resilience to future shocks. In this regard, clear progress on CMU will help put in place the right conditions to encourage a greater degree of financial integration in the euro area.

This in turn will help dampen the asymmetric effects of future shocks, bolster the effectiveness of monetary policy and enhance the welfare of our citizens. ●

1. Asdrubali, P., Sorensen, B. and Yosha, O., "Channels of interstate risk sharing: United States 1963-1990", Quarterly Journal of Economics, Vol. 111, 1996, pp. 1081-1110; Athanasoulis, S. and van Wincoop, E., "Risk sharing within the United States: What do financial markets and fiscal federalism accomplish?", Review of Economics and Statistics, Vol. 83, 2001, pp. 688-698. See also Del Negro, M., "Asymmetric shocks among US States", Journal of International Economics, Vol. 56(2), March 2002, pp. 273-297.
2. Hepp, R. and von Hagen, J., "Interstate risk sharing in Germany: 1970-2006", Oxford Economic Papers 65, 2013, pp. 1-24.
3. Balli, F. and Sorensen, B., "Risk sharing among OECD and EU countries: The role of capital gains, capital income, transfers, and savings", MPRA Working Paper No 10223, 2007.
4. See "Action Plan on Building a Capital Markets Union", Commission Communication, Brussels, 30 September 2015.

Peter Praet

Member of the Executive Board, European Central Bank

We need to complete the Banking Union

The EU moved in less than five years from decentralized banking supervision and resolution to the Single Supervisory Mechanism and the Single Resolution Mechanism, based on the Single Rulebook. This is part of an overarching effort to create a sound institutional framework for financial integration in Europe. But there still are a number of legal, institutional and political problems to overcome before a European bank can operate in the Banking Union as it operates in its domestic market. Several dimensions need to be taken into account:

First, private risk-sharing. The financial system is a private risk sharing device, but we have learned the lessons from the financial crisis in terms of budgetary costs, when excessive risk-taking by the private sector was eventually borne by the public sector. We do not want to revert to the old world of implicit government guarantees for risky behaviour of financial institutions. This entails making banks equally liable across countries for the amount of risk they want to take into their respective balance sheet. The general principle of the new European rules such as the Bank Recovery and Resolution Directive is to absorb bank losses by bailing-in shareholders and uninsured creditors. The new rules contain sufficient flexibility to deal with exceptional situations where public money may be required to ensure financial stability.

Second, public risk sharing. A certain level of public risk sharing is necessary to create confidence in the overall financial system. Even well-capitalised banks can fall victim to runs and contagion. This is why central banks act as lender of last resort and fiscal backstops should be in place to ensure trust in the stability of the financial sector.

In the Banking Union, both supervisory responsibility and the fiscal backstop need to be at European level, to underpin durably confidence in the area-wide financial system. Just as necessary is the establishment of a European Deposit Insurance System (EDIS). The current situation, where supervision is common, but the consequences of potential bank failures are still predominantly national, should not last. In such an incomplete framework, national considerations inevitably continue to affect supervisory decisions. This is not without consequences for the incentives for banks to become more European. Concrete examples include a lack of fungibility of liquidity or capital. The fact that the euro area is not considered as a single jurisdiction may result in applying higher capital buffers to euro area G-SIBs. >>>

>>> While the institutional underpinnings of the Banking Union do not yet meet the requirements of a genuine single financial market, the creation of the SSM has been a leap forward in the establishment of a coherent regulatory framework. One of the first priorities of the Supervisory Board has been to promote integration through harmonized implementation of Options and National Discretions (ONDs), thereby evening the level playing field in the euro area. Regarding liquidity requirements, the Single Supervisory Board can grant waivers at national as well as cross-border level on a case-by-case basis. In the current institutional context, where the free flow of liquidity within the same banking group but across border could be impeded, a prudent supervisory approach has led the ECB's Supervisory Board to still maintain a floor on the liquidity requirements of significant subsidiaries.

Overall, the banking landscape still resembles too much a collection of banking systems highly exposed to their domestic economies, with limited cross-border private risk-sharing. At the same time, one should recognise that the Banking Union is both an objective and a process of fundamental structural changes in the euro area's financial architecture. The next steps are clearly set out in the ECOFIN roadmap to complete the Banking Union. It is now urgent to agree on an ambitious timetable for its implementation. ●

Svein Andresen

Secretary General, Financial Stability Board

Perspectives on global financial regulation

Thank you – it is a pleasure to be here and to be in Malta.

We are now a decade from the start of the crisis, and substantial progress has been made in building a more resilient financial system better able to fund households and businesses in a sustainable way.

The financial crisis exposed deep inadequacies in firms' risk management and in most advanced economies' regulatory frameworks. Neither were able to meet the challenges posed by a financial system that had grown progressively more complex and globally integrated.

As a result, national authorities found themselves unable to address effectively the financial stability risks that developed nationally, or were transmitted through markets and financial institutions operating across borders – or even to identify those risks.

The objectives of the G20 reforms, set out in 2008 and 2009, were to correct the fault lines that led to the global crisis and to build a safer, more resilient system.

Ten years on from the financial earthquake, regulation of the global financial system has strengthened substantially – leaving a safer, simpler, and fairer financial system that can support open markets and inclusive growth.

Without the cooperation among authorities from major global economies and the standard-setting bodies, this progress would not have been achieved.

As we approach the tenth anniversary, it is inevitable that there is a degree of reform fatigue. It is essential, however, that we remember the reasons for the reforms. The social and economic consequences of the crisis were substantial. Without the actions taken by the authorities, not only to address the crisis but to build confidence going forward, the consequences would have been much more severe.

Effects of reform

The main elements of the reforms are on their way to being implemented. And with that, we can begin to ask if the reforms have had their intended effects.

So far, the answer is broadly, yes:

- The core of the financial system is significantly strengthened.

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>>> • Large banks are considerably stronger, and less complex.
- The infrastructure underpinning markets is more robust.
- Sources of finance are increasingly diversified between banks and markets.
- And the system is demonstrating an ability to dampen shocks rather than amplify them.
- This has been achieved while maintaining credit flows to the real economy and keeping the cost of finance low.

As the global recovery gains strength, it is important that we avoid complacency.

Now is not the time to risk these hard-won gains.
- Implementation must still be completed in some areas, including, for example, the ability to effectively resolve systemic institutions.
- OTC derivatives reforms are lagging in some areas, and there are challenges to achieving full effectiveness of the measures.
- Shadow banking activity has resumed rapid growth in some markets, and with it, related innovation and arbitrage.
- Conduct issues continue to create challenges, including for correspondent banking activity.

At same time, we must be alert to potential unintended consequences of reforms and address those that are material.

Last year, FSB members identified three areas that merited further attention: the effects of the reforms on market liquidity, the effects on emerging market and developing economies, and the need to maintain an open and integrated financial system.

As you know, we have found limited evidence of a broad deterioration in market liquidity conditions in normal times, though some evidence of less depth in certain markets. Fixed income markets are undergoing structural changes and we will keep monitoring this intently.

And although emerging market and developing economies (EMDE) have reported no major unintended consequences from implementing the reforms in their domestic economies, there is some evidence that global banks are reducing their presence and activities in EMDE markets.

Lastly, while agreement on global reforms has helped to avoid significant fragmentation of the system, consistent implementation of agreed reforms is needed to keep this at bay.

We will continue to monitor these three areas plus any new areas that merit ongoing attention, and will provide an update, when we publish our third annual report ahead of the G20 Leaders' Summit in July.

Priorities for 2017

Let me turn to the FSB's priorities for 2017:

The first priority is to support full and consistent implementation of the post-crisis reforms, including the finalisation of bank capital standards. Alongside this, the FSB will conclude the guidance on internal Total Loss-Absorbing Capacity and publish that guidance by the G20 Summit.

The second priority is to finalise, with the Committee on Payments and Market Infrastructures and International Organization of Securities Commissions (IOSCO), guidance on central counterparty (CCP) resilience, recovery and resolution in advance of the G20 Summit.

And **the third** is to address vulnerabilities from asset management activities. The FSB recommendations in this area are now being operationalised by IOSCO with work to address liquidity mismatches in open-ended funds to be completed by end-2017 and development of consistent leverage measures by end-2018.

Fourth, we continue our work, laid out in 2015, to reduce misconduct in financial institutions and will report to the Summit the actions taken and further recommendations to address misconduct risk. This will include a public consultation on guidance for the use of compensation tools to address misconduct.

Fifth, as the FinTech landscape continues to evolve, and investment in such technology to rise steeply, assessment of how FinTech developments intersect with regulatory frameworks is becoming increasingly important. We are currently working to identify the key supervisory and regulatory issues related to financial stability that may merit the attention of authorities.

Last, we are working to further enhance our analysis on the effects of reforms. To that end, the FSB, is completing the development of a framework for the post-implementation evaluation of the effects of the G20 financial regulatory reforms. This is being done in close collaboration with the standard-setting bodies and informed by work carried out by its members and other stakeholders.

The framework will guide analyses of whether the G20 core reforms are achieving their intended >>>

>>> outcomes, identify any regulatory gaps, remaining or emerging risks, and material unintended consequences that may have to be addressed, without compromising on the objectives of the reforms.

The framework will apply to individual reforms, as well as to the interaction and combined effects of those reforms. There are many challenges to this work, and the framework will help to navigate those challenges. We will begin modestly and build up our analysis over time.

The development of the framework and subsequent policy evaluations will be a transparent process. We welcome input from the industry, and will launch a 30-day consultation on the main elements of the framework in mid-April. Following the public consultation, the framework will be presented to the Leaders' Summit and published. Application of the framework will begin over the coming years, with public consultation also on the individual evaluations.

The analysis will be data-driven and will consider a wide range of interests. Evaluations should focus on assessing the social benefits and costs, rather than solely private benefits and costs that accrue to particular market participants or end users. We look forward to industry participation and engagement as part of this.

International Cooperation

Finally, let me underscore the importance of the international cooperation that takes place among the authorities that make up the FSB. Without this cooperation, the progress achieved would not have been possible.

Together these authorities and standard-setting bodies have developed a framework for building and maintaining a more resilient and open financial system. This includes more robust minimum international standards in a number of areas. These standards are not binding: putting in place requirements that apply nationally or regionally remains the domain of the national or regional regulators and legislatures.

Nonetheless, international standards agreed among national authorities are a critical underpinning of a globally integrated financial system.

Without international cooperation, or if international standards are not fully implemented, or set too low of a common bar, we risk fragmentation of the global system.

If that were to happen, then – rather than enhancing financial resiliency across jurisdictions, markets and institutions – financial system vulnerabilities and weaknesses could arise or remain unresolved.

In response to this, additional jurisdiction-specific measures would be taken to shore up resilience, creating divergences across countries, and a less even playing field.

If such a pattern emerges, it would erode authorities' willingness and ability to rely on each other's systems and institutions. In the process, it would fragment pools of funding and liquidity, create inefficiencies and frictions, reduce competition and diminish cross-border capital flows.

The net result would be less and more expensive financing for households and businesses, and very likely lower growth and higher risks in our economies.

It's critical, therefore, that authorities continue to act and coordinate at the global level.

The commitment shown by the G20 Finance Ministers and Central Bank Governors at their March Baden-Baden meeting to the timely, full and consistent implementation of the G20 reforms was welcome in this regard.

To avoid the potential risk of fragmentation, it is important that the private sector speaks up about the risks, and continues to engage productively and proactively with the authorities and make a clear case for the benefits of effective international standards.

In conclusion, authorities are reaching the end of the international policy work to address the fault lines of the crisis. This work has made significant progress in putting in place the underpinnings that a globally integrated system requires. And it has strengthened the relationships and trust between authorities which are essential for oversight in normal times and cooperation in times of crisis.

As a result of the reforms, we now have an open financial system that is better able to dampen economic shocks, not amplify them. The FSB's focus in the years ahead will be to deliver the resilience the reforms intended, monitoring and encouraging implementation of what has been agreed, and assessing the effects of the reforms, while remaining alert to evolving risks and to take action as necessary.

Thank you. ●

Sharon Bowen

Commissioner,
U.S. Commodity Futures Trading Commission

What future for global regulation of financial markets?

Introduction

Thank you for the kind introduction and good evening everyone. It is a pleasure to be here at the Eurofi High Level Seminar 2017. I attended the conference last year in Amsterdam, and found it so informative and engaging that I insisted on returning this year. Eurofi is a very important conference generally, but especially given recent unexpected events, it presents an opportune time for dialogue not only between European regulators and market participants, but also for those of us across the pond as well.

As a Commissioner at the Commodity Futures Trading Commission (CFTC), I am responsible for the policy decisions for the futures markets as well as the majority of the $400 trillion swaps market, including interest rate swaps, commodity swaps, and credit default swaps. Thus, it is from the vantage point of a market regulator of the vast, diverse and global U.S. derivatives markets that I address you today to answer the question: What future for global regulation of financial markets? There are three areas in which I think we, as regulators, need to cooperate, and where possible, harmonize, in order to best support our financial markets in the future: (1) market data; (2) enforcement; and (3) clearing. Please note that the views I express today are my own, and not necessarily those of my fellow Commissioner, Acting Chairman Giancarlo, or the Commission staff.

Data harmonization

One area in which we need harmonization, and not fragmentation, is in the exchange of market data. At the Pittsburgh meeting of the G-20 in 2009, one of the fundamental goals that international regulators agreed upon, in the midst of the 2008 crisis, was that all swaps should be reported. In the U.S., as in many of your jurisdictions, under our current rules, all swaps transactions, whether cleared or uncleared, must be reported to a trade repository. This information is then aggregated and sorted, so that we have transparency into the markets under our purview. This gives us a great view into the markets, but not a complete one. The derivatives markets are global markets. Thus, in order for any regulator to properly police them, we need to understand them from a global perspective. That is why we need to remove the regulatory barriers to data sharing across jurisdictions for the purpose of effective market oversight. It is vitally important that we work together

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>>> to achieve comprehensive and robust data harmonization.

I certainly understand the concerns about privacy surrounding data sharing. But there are other concerns that are equally troubling, namely, the prevention of another crisis like the one we endured in 2008. What tradeoffs are worth preventing another devastating economic crisis? The actual initiation of the crisis – the collapse of the U.S. housing market – certainly caused a serious economic convulsion, but what greatly magnified the devastation of this crisis was that we did not understand the underlying weaknesses of our markets, particularly the derivatives markets. We did not know the extent of our market participants' exposure to derivatives, or their degree of under-collateralization. We thought we knew our markets, but we had no idea what they were really like. We thought we were in a house made of bricks, when it was actually made of straw; a reality we only understood after the storm came. We cannot afford to make that mistake again. We need a much more realistic picture of the markets we oversee. For that we need data, all of the data; and in order to achieve that, we have to work together.

Sharing data is also essential for analyzing market risk. For example, at the CFTC, we use margin, as one indication of risk. We regularly review the amount of margin outstanding, and analyze the likelihood that market counterparties can meet their margin requirements under a variety of past and hypothetical market movement scenarios.[1] But without a full picture of the global market, we can get a skewed view of the actual risk profile of counterparties. We may think that a counterparty has a lot of one-way risk, when a full picture would reveal a much more balanced portfolio. The opposite is also true: we may have a false sense of security, when in fact there is cause for concern. Thus our ability to mitigate systemic risk is hampered by insufficient data; and so is yours. We need each other to address this.

Harmonization in Enforcement

Another area where harmonization is essential is in enforcement. As regulators, it is in our best interest to share information about potential bad actors that are moving from market to market harming customers, lessening efficiency and bringing otherwise functional markets into disrepute. It is all too easy today for a malfeasant in one jurisdiction, who is dismissed, to pick up and move to another jurisdiction and continue working. I call it the "whack-a-mole" problem. It is to everyone's benefit that these people are detected and prevented from harming other customers. This is not the moment to retreat or repeal the great strides we have achieved. With global regulatory coordination on enforcement, we can better achieve our purpose as regulators – to incentivize the formation of efficient, transparent, well-collateralized markets that are safe for counterparties. To do less, is to fail to do our jobs as protectors of our markets and of our citizens who rely upon them.

Global Clearing

Another area where harmonization is critically important, and where the danger of fragmentation exists, is in that of clearing. One of the other lessons learned from the 2008 crisis, which was highlighted by the G-20 in 2009, was that well-regulated clearing can be a powerful tool to stem systemic risk. Unlike many other parts of our economies, clearinghouses performed exceptionally well during the crisis. Why are clearinghouses so important in countering systemic risk? Because clearinghouses serve as a vital means to appropriately manage collateral requirements while also providing regulators with clear, timely visibility into these markets. Clearing thus shines much needed light on a previously dark sector of the market.

We of course need to stay vigilant about ensuring that our clearinghouses are managing risk effectively. November of last year, an advisory committee at the CFTC that I sponsor called the Market Risk Advisory Committee made recommendations to strengthen the risk management of clearinghouses. This diverse group of market participants including clearinghouses, banks, asset managers, and end-users just to name a few, highlighted several default management issues, including taking into consideration CCPs' such as the interdependence between CCPs and their clearing members and the challenges to porting customer accounts of a failed clearing member. [2]

Regarding market fragmentation, in the U.S., we have also been following the discussion in Europe about segmenting clearing based on location, because of oversight concerns. How have we at the CFTC dealt with this issue of clearing for U.S. customers occurring outside the U.S.? We recognize that, as members of a global market place, our U.S. customers need to clear a variety of products all over the world. We want our U.S. citizens to have safe and sound clearinghouses around the world that they can use. In order to do that, we register two types of clearing-based financial market infrastructures: (1) >>>

>>> Derivatives Clearing Organizations (DCOs) and (2) exempt DCOs. Any clearinghouse that wants to allow for both customer clearing, as well as proprietary clearing, for U.S. customers must be a registered DCO with us. They must demonstrate that they are a viable and well-managed organization that has, among other things, sufficient financial resources, effective system safeguards, robust margin methodology, and a primary regulator with which we have a strong relationship. And we must also be able to access the data that we need for oversight without hindrance, and make onsite visits as needed. As long as a clearinghouse is able to demonstrate that it meets these, and other, rigorous standards, they can serve U.S. customers, regardless of their location.

And we also register exempt DCOs. There are non-U.S. clearinghouses that only wish to clear for their proprietary accounts and for whom U.S. customers comprise a small percentage of their overall business. Such a clearinghouse is eligible for registration as an exempt DCO. In order to achieve exempt DCO status, the clearinghouse largely has to demonstrate that they are managed by a competent primary regulator within an effective and comparable regulatory regime. Moreover, while we require that exempt DCOs provide us with sufficient data to monitor the extent and nature of the U.S. business at that clearinghouse, we largely rely on the primary regulator for oversight.

Importantly, we do not insist that only U.S. entities handle U.S.-denominated products. In fact, the clearinghouse that serves most U.S. interest rates customers is outside of the U.S. But that does not concern us, because our oversight and communication with that clearinghouse is robust and we have a great dialogue with its primary regulators. Moreover, as regulators, we do not believe that it is in our purview to determine where the market takes its business – this is a global market so the solutions will be all over the globe.

With this paradigm, we are able to have the information needed to engage in the appropriate oversight of these clearinghouses all over the world. For non-U.S. clearinghouses that do significant U.S. business, we have considerable oversight. And for those that have much less impact on U.S. business, we have less so. But in both cases we have the means to meet our regulatory goals. Moreover, providing U.S. customers with the ability to centralize multi-jurisdictional clearing provides the opportunity for sensible, well developed, risk-based cross-margining. This frees up funds for investment in growth and innovation in our economy.

While on the subject of clearing, I cannot help but mention that while in the U.S. we have been successful in bringing widely used interest rate and credit default instruments, and other instruments, onto clearing, the gains that we have made are at risk. The application of a capital charge to the segregated funds set aside to secure cleared products is reducing the appeal and viability of clearing. While I understand that capital plays an important role in financial stability, applying a capital penalty on clearing is counterproductive, and risks driving many of our now, highly transparent transactions back into the darkness. We need to address this. It is clearly an unintended consequence when two sets of regulations, both of which are meant to buttress our financial system, clash. I am hopeful that ongoing discussions with banking regulators will address this unfortunate outcome.

Conclusion

In sum, regulatory harmonization is an imperative today. Our times are turbulent. And in the midst of these rapid changes, the electorate, in several jurisdictions, has responded in drastic and surprising ways. As regulators, we cannot control, nor predict, the political process. But, we can help to maintain stability regardless of the political turbulence. But to do so, we not get swept up in the emotionalism of the time. We should not punish markets and customers for the unpredictable decisions of a beleaguered electorate. Regulatory fragmentation does not help anyone; systemic risk has no platform or party. When a customer loses his life savings, it does not matter if he is a Republican or Democrat.

So let's work together on the front end to achieve the kind of reform from which all our economies would benefit. Let's avoid unnecessary and time consuming squabbles on the back end over matters such as equivalence. With our mutual legislative acts, we have all endeavored to create a transparent, functioning market with strong foundations. Let us not risk all that we have built, and continue to build, by getting swept up in a furor that was not of our making. Let us instead, stay the course – focus on building strong, harmonized, global regulation that provides our economies with safe institutions as well as the capital necessary for growth and innovation. ●

1. See e.g., «CFTC Staff Issues Results of Supervisory Stress Test of Clearinghouses,» (Nov. 16, 2016), available at http://www.cftc.gov/PressRoom/PressReleases/pr7483-16. And the Commission is actively engaged in discussions over appropriate recovery and resolution infrastructures for clearinghouses. See e.g., "CFTC Staff Issues Guidance to Clearinghouses on Recovery Plans and Wind-Down Plans," (July 21, 2016), available at http://www.cftc.gov/PressRoom/PressReleases/pr7409-16.
2. See "Market Risk Advisory Committee," available at http://www.cftc.gov/About/CFTCCommittees/MarketRiskAdvisoryCommittee/index.htm.

EXCHANGE OF VIEWS

Malta 2017

EXCHANGES OF VIEWS

Detailed summary

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

Klaus Regling - *Managing Director, ESM*
Pierre Gramegna - *Minister of Finance, Luxembourg*
Hans Jörg Schelling - *Federal Minister of Finance, Austria*
Sven Sester - *Minister of Finance, Estonia*

1. THE NOTION OF CONVERGENCE IS AT THE HEART OF THE ECONOMIC AND MONETARY UNION

1.1. What do we mean when we talk about economic convergence?

The Chair stated that the notion that the EMU would need some mechanisms to assure a degree of convergence was clear when the Maastricht Treaty was signed. When a monetary union was developed and designed, some degree of convergence was always seen as important. However, convergence can mean different things to different people, and the panel will discuss the question, 'What do we really mean when we talk about economic convergence?' In the Chair's view, countries can successfully function in the monetary union even with different income levels, as long as they avoid excessive macroeconomic imbalances. There have been some valuable experiences in that respect in the Member States.

Preventing imbalances is more important for a well-functioning monetary union than nominal or real convergence, even though the latter would be very desirable. Convergence should therefore be understood as achieving a better balanced economic growth path and more policy convergence.

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

A representative of a public authority recalled that, at the time of the creation of the common currency and the EMU, some thinkers argued it was not possible to have monetary union without a common macroeconomic policy, while others said that the macroeconomic policy had to be in place before a common currency could be contemplated; this was a 'chicken and the egg' question. There has never been a common currency like the euro, and that means there is not one single way to introduce it; there are many ways. >>>

>>> Europe can have, and does have, economies that have a different degree of development, different incomes and different specialities. Germany is very powerful in many areas, including cars, aircraft, and chemistry. France is well positioned in the area of luxury goods, while Luxembourg is very efficient in financial services. All Member States have comparative advantages, strengths and weaknesses, and it is an illusion to believe that the European Union could have a macroeconomic policy that would be the same for all of its members, that would deliver exactly what every country needs.

Europe is currently in an intermediary situation; EU Member States, and the EMU mechanisms, have done all they can at this point. This includes the Stability and Growth Pact (SGP), the Macroeconomic Imbalance Procedures (MIP), and the EU transfers and cohesion funds, which are not part of the EMU but have to be considered as part of the whole picture.

1.3. The European Union and the euro area have a remarkable economic governance toolbox at their disposal

The Chair commented that as long as there is no economic government in the euro area, there is a need for a rules-based approach, with the Stability and Growth Pact, the Macroeconomic Imbalance Procedure and the European Semester.

A representative of a public authority stated that the European Union and the euro area have a remarkable economic governance toolbox at their disposal to enhance convergence and reduce imbalances. Its full potential has not yet been used. The Stability and Growth Pact has been the cornerstone of the euro area economic and budgetary policy co-ordination on an equal footing with the monetary policy pillar. The deepening of the EMU depends very much on how Member States can jointly demonstrate an ability to follow a rules-based approach, although the speaker noted that they do not mean an automatic following of all the rules; there is considerable flexibility within the Stability and Growth Pact already. However, Member States too often try to bend some of the rules.

1.4. Some problems of the EU are not exclusive to Europe

A public authority representative stated that the European monetary union raises some problems that are not exclusive to Europe. In Italy, for instance, there are very significant macroeconomic differences between the north and the south, but there are also significant disparities between different parts of the United States and of China, where some regions are growing very quickly, and others are very poor. This is a problem faced by many countries; as long as Member States are responsible for their own economic policy, it is very difficult to achieve economic convergence. There is also the question of what is meant by convergence – whether this is real convergence, GDP per capita, or cyclical convergence – as well as what the roles of the different institutions, the ECB, the Member States, and the role of the European Union are. Everything that helps real convergence also helps cyclical convergence.

2. THE EUROPEAN ECONOMY IS DOING WELL OVERALL; THE EUROPEAN UNION AND THE EURO ARE SUCCESS STORIES

A public authority representative commented that there is a need to recognise the benefits that the EMU has already brought to Europe. The euro has repeatedly proven itself to be a robust currency, fostering a stable monetary climate and delivering material benefits: inflation has been kept under control and this has led to lower transaction costs; indeed all economic players benefit from lower interest rates: households, when they purchase a property, companies when they invest, but also governments and hence taxpayers. The euro is also simplifying day-to-day life for citizens and promoting capital market integration - financial markets are more attractive to domestic and foreign investors, more liquid, and thus more efficient –, facilitating easier price comparison which has increased cross- border trade and has given euro members a global voice on the international scene.

Another public authority representative agreed that the main task for politicians is to explain these benefits to EU citizens. One example is the campaign for the presidency of France: there, the extreme right suggested abandoning the euro. This was a possibility for some time, but now that their candidate has officially announced that this is her policy, there have been many arguments about what this would mean. The latest polls show that 80% of French people do not want to leave the euro, which, according to this speaker, is a positive indication that trends can be changed. It is important to explain to people what the benefits of Europe are, because the populations of European states take them for granted.

The single market is another good example of this: those who have it regard it as the most normal thing in the world, and only realise the negative consequences of not having it when it is taken away from them. This is demonstrated by Brexit: the United Kingdom wanted to leave the EU, but remain in the single market. If the EU single market >>>

>>> is very precious, it must be explained. When politicians explain the aspects that do not work, it should also be made clear that this is not generally the fault of Europe, but that much responsibility is in the hands of the Member States. Politicians find it easy to scapegoat Europe for decisions, and journalists rarely ask why these politicians did not object to these decisions during the negotiations. Politicians have to explain what is the responsibility of Europe, and where national responsibility starts, although this is not always an easy exercise.

The Chair stated that they agreed with this: it is not easy to do this, but it is necessary. The positive developments within Europe are not sufficiently recognised. For good reasons, there is a tendency to focus on what still needs to be fixed, but this often leads to forgetting that many things are not so bad. Economic performance is fairly good, but is an issue that goes beyond the economy itself.

Regarding the economic environment and income distribution, Europe is doing much better than is often perceived; from a per capita perspective, economic growth in the euro area is now back in line again with the US, just as it was before the crisis; income distribution has not deteriorated much in Europe over the last 10 years, while it has deteriorated massively in the US, China, and in other parts of the world. In other words, benefits from growth are spread more equally in Europe than in America. In Europe 80% of the population has seen real income growth in the last 15 to 20 years. In the US that was the case for only 10 20%. Europe's social safety net is the best possible answer to the growing scepticism regarding globalisation that can be seen in many parts of the world.

A third public authority representative summarised that although there is a great deal of discussion about the problems faced by the European Union, it needs to first be made clear that the European Union, and the euro, are success stories. The EU has been very successful, and is prepared to answer the questions it faces; it has demonstrated good judgment in handling the financial crisis. There still remain some weak spots to be handled, including Greece, but Europe has now set up a Banking Union, and it is preparing the CMU. It has built firewalls like the ESM, which are very important for the euro area and the European Union, and they are working very well.

3. THE EURO IN ITSELF CANNOT SOLVE THE STRUCTURAL PROBLEMS OF THE THE DIFFERENT COUNTRIES. IT IS THEREFORE ESSENTIAL THAT GOVERNMENTS SHOULD 'DO THEIR HOMEWORK'

A public authority representative stated that the economic policy community is discussing different proposals, such as increasing reliance on 'disciplining' market forces or the intergovernmental enhancement of economic surveillance for getting economic policy making right. It is necessary to discuss these options and evaluate them thoroughly. However, there is no need to wait for an improvement of the already well-developed and sophisticated multi-level governance at the European level. It is indeed the task of member countries to stick to the rules at the European level and strive for a bold structural reform agenda to restore the conditions for sustainable growth, prosperity and convergence. It is above all the member states' responsibility to set up the right conditions for sustainable growth and convergence.

3.1. Structural reforms are needed to boost potential growth and productivity growth in the euro area and to improve the business climate in some Member States

A representative of a public authority noted that in the Economic and Monetary Union, monetary policy is centralised but important parts of economic policy remain national. All of the EU's Member States are responsible for fixing the problems within their economies. Structural reform is a very important concept in this context, which includes a number of aspects. The issue of productivity also needs to be looked into further, as do the environment and Europe's social safety net, which are areas in which Europe leads the world.

Another public authority representative stated that the question of structural reforms is a very important one, but responsibility for such structural reforms rests with the EU's Member States. The causes of the stagnation of investment in Europe are in great part structural; notably, there are many obstacles on the supply side, including the operating margins of many EU enterprises and taxation that impedes business investment. Structural reforms are therefore essential for stimulating investment growth in Europe, because such measures have the capacity to improve the business climate in a sustainable manner and would increase the resilience and adaptability of Member States.

In such a context, Member States need to take measures that improve the allocation of resources, increase productivity and competitiveness and strengthen resilience. Reforms should not only aim at labour market flexibility but also at the proper functioning of product markets; they have to address competition as well as regulatory challenges; they have to support innovation and enhance institutional quality. Also, the vigorous implementation of the Banking Union, including bail-in and bank resolution, is important, >>>

>>> while judiciary systems should support the workout of problem loans. Macro-prudential instruments should be used to contain unsustainable lending to the private sector.

The realisation of these measures is often fiercely resisted by vested interests – predominantly few actors that might lose out from reforms. Product market reforms seem to be among the most contested, although their positive impact on GDP and employment at limited or no budgetary cost is well documented.

A third public authority representative pointed out that he has been finance minister for two and a half years, which is a very long time compared with certain predecessors. When the country specific recommendations are sent out every year by the European Commission, they always recommend making structural reforms, because countries spent too much money in the past and now do not have enough for investment in the future. Health systems and pension systems remain unreformed; countries other than Greece face problems with their pension systems. As such, there needs to be structural reforms in the Member States, but also structural reform at the EU level; this recommendation is also made in the Five Presidents' Report.

3.2. Increasing incentives for Member States to stick to the rules and engage in reforms

A public authority representative stated that incentives to comply with common rules and with a stronger monitoring of national fiscal policies should be set up. Europe needs to move towards mechanisms that provide strong incentives to comply with the rules and implement structural reforms. On the basis of the current treaties, room for manoeuvre is limited. One reform would mean stricter conditionality for payments from the EU budget and structural funds. Another proposal is a system of benchmarking for economic policies and outcomes to facilitate comparison among Member States and stimulate reform efforts.

Another question is whether benefits, or sanctions, are necessary: e.g. if a Member State wants money from the funds, it would have to prove that it has engaged in structural reforms. These contracts cannot be changed on the EU level, because 27 Member States would need to agree to amend them. However, some benefits can be put in place to encourage structural reforms: all governments and all members of the ECB know that for finance ministers, current rates of interest provide benefits, but they are not an advantage for the whole market. When interest rates rise, Member States that have made no structural reforms will indeed have problems with financing their budgets. However, there is now a window of opportunity to begin structural reforms, both of Member States and of the EU. But although improved economic governance may facilitate reforms, it cannot remove all responsibility from Member States.

3.3. Do we need transfers to promote economic convergence?

The Chair observed that since the euro crisis, excessive macroeconomic imbalances and divergences have largely disappeared within the monetary union, not least because of some ESM programmes. It can be asked whether transfers are necessary to promote convergence; transfers from richer to poorer countries are provided by the EU budget, and have been since the beginning of the EU. Poorer countries can obtain up to 3% of their GDP. If the EU budget did not exist, the question would be different for the euro area. However, with the EU budget, there is a great deal of money flowing between countries, and the Chair does not see any reason to add to this.

Despite this, a small fiscal capacity, in the form of a stabilisation fund or an insurance scheme, could strengthen risk-sharing and tackle dramatic asymmetric shocks in the euro area without raising permanent transfers or debt mutualisation. In addition, risk-sharing through financial markets can be promoted through completing the Banking Union, by setting up a backstop for the Single Resolution Fund, and a common deposit insurance once legacy issues have been sorted out and general de-risking has progressed. The Capital Markets Union would be another way to ensure greater financial integration, and thus more economic private risk sharing.

A public authority representative stated that the transfers and cohesion funds are not part of the EMU, but have to be considered as part of the whole picture. In Italy, the European Union has the support of less than 50% of the population, despite receiving €32 billion per year. Some might be of the opinion that this is not enough, but this does not indicate that Europe 'has no heart' or does not demonstrate its solidarity.

As such, Europe is 'in the middle', between giving all responsibilities to the European Union and keeping all responsibilities with the Member States. It is not a good time to create an EU government that can decide all of these questions on its own. Europe has done what it can in terms of monetary policy, with the actions of the European Central Bank, and the single market has been created and the CMU is being built. However, all of the EU's Member States >>>

>>> maintain a large amount of responsibility, and are responsible for fixing the problems within their economies.

The Chair added that transfers are the same in every country. The EU has to make transfers, but this does not solve the problems of Member States that are on a lower economic level and receive more money from the richer countries. Europe has cohesion funds and structural funds, and it is very important to employ these funds, because doing so helps to bring the Member States, and the economic development of these states, closer together. Europe is also back on a path of growth, unemployment is decreasing, and growth per capita is similar to that in the United States, so it is not the case that there is a crisis in Europe. The EU has some problems to be solved, but they are solvable by implementing national structural reforms.

4. DEEPENING THE ECONOMIC AND MONETARY UNION NEEDS A SOLID FOUNDATION BUILT ON MUTUAL TRUST AND CONFIDENCE

4.1. It is difficult to make progress in deepening the EMU so long as existing rules have not yet been met by all Member States

A public authority representative stated that individual states have responsibility for managing their countries' different structural reforms, but on the European level, it is important for them to keep the rules that have already been created. There are many different agreements, but in the negotiations between the different euro area countries, the speaker sees that not all of these agreements are fulfilled. The average level of debt to GDP in the euro area is around 90%, despite it having been agreed that the level should be 60%. There are good ideas about what should be done next on the European level, but it can be difficult to make progress when existing agreements have not yet been met in all parts of the Union. During the Estonian presidency, this issue will be emphasised.

4.2. Complying with existing rules and procedures should be the short term priority for improving the EMU

A representative of a public authority thought that there are already enough rules, but these rules need to be adhered to. The speaker recalled that they were 'astonished' to hear the President of the European Commission, when asked why France is allowed to have a higher deficit, reply, 'Because it is France'.

Another public authority representative stated that for a number of Member States, the deepening of the EMU is very much dependent on how they can jointly demonstrate their ability to follow the rules based approach. This should not be a 'blindfolded', automatic following of the rules; there is considerable flexibility within the Stability and Growth Pact. However, Member States all too often try to bend the rules.

A third public authority representative agreed that there should be no treaty change. People are tired of treaty changes, and rightly so; it is more important to apply the treaties that already exist. If the EU complies with its rules, it will have fewer problems. In politics and the economy, it takes some time to achieve results; levels of debt to GDP cannot be reduced from 90% to 60% immediately. Belgium's debt stood at 135% of GDP in the 1990s, and it took them nearly 20 years to decrease this to 100%, whereas a country can double its debt in a couple of years. As such, there is a need to be very careful and cautious.

In addition, from 2008 to 2013, Luxembourg's debt rose from 7% to 23%, and it took a great deal of effort to stabilise debt levels over the course of the last three years. It is very difficult to even stabilise debt, because once a country is spending more than it earns, its deficit continues to grow. Everyone has to take responsibility for this, including Member States, and the tools exist to address it: this can be called structural reform, or lowering expenditure at a public level. There are many methods, which Member States can adjust, and which will be their responsibility.

4.3. Increasing financial stability by implementing and enforcing the rules more vigorously

It is important to remember that the debt criterion sits alongside the deficit threshold in Europe's fiscal governance rules. The high debt levels have to be taken seriously, as the low interest era will not last forever, and Europe's ageing population will put additional pressures on long-term fiscal sustainability. The Commission has to fulfil its task in overseeing how the debt reduction target is met and whether this is persistent. This would contribute significantly to strengthening financial stability within the EU. However, Europe must avoid trying to promote the deepening of EMU on false pretences, as deepening itself will not be enough. There has to be a clear political will to follow the rules based approach and to implement the structural reforms, which are inevitable in a better integrated EMU.

With a view to increasing economic resilience and supporting sustainable growth, new institutions have been established and procedures strengthened. While there might be a need for institutional >>>

>>> fine tuning, the set-up seems sufficient in principle, but the implementation and enforcement of rules and procedures are not. Thus, first of all each and every actor has to stick to the agreed rules, not least in order to avoid negative spill-overs to others. Especially Member States in breach of the requirements of the central instruments for coordination, e.g. Stability- and Growth Pact, the Fiscal Compact and the Macroeconomic Imbalances Procedure, or those hesitant to implement the Banking Union, have to do their homework. In addition, the European Commission has to implement and enforce the rules vigorously and even-handedly – including imposing sanctions if foreseen by the rules – to get incentives right.

4.4. Delivering what has been decided

A public authority representative stated that the European Union should also prioritise finishing the work undertaken, including the Banking Union. In general, Europe needs to speed up: it takes too long to make decisions. There have been discussions regarding a common level base for corporation tax for five or six years, but it is a very important question for all Member States, and a decision needs to be accelerated. Secondly, since Jonathan Hill left the European Commission, not as much has been heard about the CMU being a good idea, and work on it has stalled somewhat. The EU should begin by finishing the business that remains to be done.

Procedures such as those to limit tax base erosion and profit shifting (BEPS) have been started, and the speaker regards this as a good idea, but this needs to be implemented. Cooperation also needs to be enhanced and strengthened: it is not possible that all 27 countries will proceed at a similar pace in all economic areas but much can be done on a cooperative basis in 10 or 12 countries. This is also a question that relates to the presidencies over the next one and a half years.

4.5. The European Union should concentrate on 'big points'

The public authority representative continued by stating that the European Union should concentrate on 'big points', rather than details, although it is also necessary for rules to be detailed. The first big point is immigration and security, and what the European Union is doing about this, because insecurity such as this impedes growth. The second issue is that of climate: all the countries of the EU have signed the Paris Agreement, and there needs to be a focus on what the European Union is doing to meet these climate goals. Another important issue is digitalisation, which is a process that is still ongoing, and there has to be consideration of how the European Union will compete as a single market against the world's big players.

Europe needs to identify the rules that it has, stick to them, finish its unfinished business, and concentrate on the critical issues that it needs to elucidate. It will be necessary to find solution together, because small countries cannot solve this problem by themselves.

4.6. A 'stepwise' process

A representative of a public authority stated that the deepening of the EMU has to be a 'stepwise' process; much managing of expectations will be involved. Europe definitely must avoid trying to promote the deepening of the EMU on false pretences, as the deepening in itself will not have the desired effect. There has to be a clear political will to follow a rules based approach and to implement the structural reforms that are inevitable in a more integrated EMU. The word 'Economic' in 'Economic and Monetary Union' does not just refer to budgetary policy coordination, it means also a functioning financial sector, including the Banking Union and capital markets.

Another public authority representative added that there are probably five major issues that need to be prioritised. This will then create a good programme for the next three and a half years: finishing unfinished business, creating growth and employment, dealing with the 'big points', and beginning a programme of enhanced cooperation among the countries that want to be involved. Convergence has just begun; enhanced cooperation could create a new perspective on this, because different Member States have different situations, and economies can be brought closer together on a speedier basis. Making a decision with 27 Member States is difficult; it is even difficult to make decisions within the Eurogroup, which consists of 19 countries with a common currency. That the 'outs' can make decisions that will affect the 'ins' does not work.

The Chair observed that there appears to be a broad consensus about what should be done: sticking to what has been agreed, finishing unfinished business, and using enhanced cooperation

4.7. Risk sharing and risk reduction should go hand in hand

A representative of a public authority stated that there is the possibility of doing more together in Europe. Addressing these issues requires a step by step approach, and those countries that are doing well or better, or are fulfilling the Maastricht criteria, clearly have some sense of additional >>>

>>> solidarity. However, the speaker's country is only prepared to engage in this cooperation if this includes both risk sharing and risk reduction. This is an expression that is used frequently in relation to the European Insurance Deposit Scheme, but runs 'like a red line' through the whole issue of cooperation in the EU.

If other countries are reducing their deficit and taking the appropriate measures, then in parallel, solidarity mechanisms can be developed; these should not be permanent, but limited in duration. These should help to cover some risks, such as different economic cycles between different countries or specific shocks in a single country, and demonstrating solidarity and having a stabilisation mechanism. However, most people are not ready for continuous transfers to countries in which no progress is taking place. The speaker's nation would not exclude the possibility of an insurance system for unemployment situations or the stabilisation fund from discussion, but this can be discussed only if everybody takes responsibility and acts to reduce risk.

4.8. The white paper on the future of Europe published by the EU Commission is a good opportunity to discuss proposals to enhance EU economic policy governance and deepen the EMU.

A representative of a public authority observed that one of the main topics over the next half of 2017 will be the European Commission's initiative on the five scenarios (see annex). The speaker believes that it will take time to make decisions at the level of the Ecofin Council. This raises the question of how to proceed, and how ambitious to be. There will be very interesting discussions over the next half of the year during the Estonian Presidency of the EU Council.

Another public authority representative noted that Member States have always been in the same situation: they announce many things, but do not deliver results, and the latter is what is important. The same applies to the European Union: there are not five scenarios, but four, because doing nothing is no alternative.

A third public authority representative agreed with this. The five scenarios need to be discussed, but Europe needs to 'do its homework' first, and apply the rules. Continuing 'business as usual' – i.e. not applying all the rules – is not an option. The second scenario is being happy with the single market, which is clearly moving backwards, and this is therefore also not a solution. The third scenario is more enhanced cooperation, to enable those who want to do more to do more.

Scenario four is that whatever Europe does together at the present time, it should do more efficiently; this is not a concept that anyone can oppose, but a principle that should be applied to all of the other scenarios. The fifth scenario is the most ambitious: Europe doing much more together, changing the treaties in order to do so. The speaker does not think that this is a credible solution, as Europe has been built step by step, and forcing very ambitious change is going to lead to a loss of support. This is an issue of sequencing and timeline, and nobody should underestimate the impact that Brexit is going to have, as it relates to all of the strengths and weaknesses of Europe. It is to be hoped that the EU 27 will stick together to achieve a good result that does not punish the UK or disrupt the rest of Europe: there are contracts, obligations, and other aspects that will continue beyond 2019, and markets need to be given predictability and certainty if economies are to grow.

4.9. Europe needs to address the Non-Performing Loans issue

Answering a question from the audience, a public authority representative stated that there is no bank crisis; there is a crisis of profitability, and banks that do not have high enough profitability will not be shock resistant for the next crisis. Secondly, NPLs are not coming out of nowhere; in Italy, for example, NPLs have been built up over many years. Thirdly, there are clear EU rules to solve the problems: there is a directive for winding down failing banks, which was used for two banks in Austria. This was done very successfully, but it was a very complicated procedure, and is even more complicated in Italy.

Europe will need to work hard to address the issue of NPLs. When it began the process of convergence, the situation of the various Member States was very different, and the ECB has been helpful in this respect, as have the European Commission and ESM. Countries like Spain and Ireland that had problems following the crisis did a 'perfect job', and are now back on track. This is important: doing nothing will mean a return to the crisis, and it is not clear that governments in countries such as Portugal will stick to these rules. One country can affect all of the EU's other countries; the spill over effects are very significant. As such, the speaker is glad that firewalls are now in place, because they make Europe much better prepared for a crisis than it was in 2008 or 2009.

There are also the questions of the banking systems within the member states, and of structural reforms. The issue is not only the pension system, the health system or the care system, but also how markets can be opened. Countries will need to reform their labour markets and their banking sectors; >>>

>>> some countries have done this, others are doing this, and some have not started to do this. Different countries are in different situations, but all over Europe, NPL levels are too high. ●

ANNEX

White paper on the Future of Europe: avenues for unity for the EU at 27

This White Paper published on 1 March 2017 is the European Commission 's response to the Rome Summit which took place on 25 March 2017 to mark the 60th anniversary of the EU. The document sets out five scenarios, each offering a glimpse into the potential state of the Union by 2025 depending on the choices Europe will make. The scenarios cover a range of possibilities and are illustrative in nature. They are neither mutually exclusive, nor exhaustive.

- **Scenario 1: Carrying On** - The EU27 focuses on delivering its positive reform agenda in the spirit of the Commission's New Start for Europe from 2014 and of the Bratislava Declaration agreed by all 27 member states in 2016. By 2025 this could mean:
  - Europeans can drive automated and connected cars but can encounter problems when crossing borders as some legal and technical obstacles persist.
  - Europeans mostly travel across borders without having to stop for checks. Reinforced security controls mean having to arrive at airports and train stations well in advance of departure.

- **Scenario 2: Nothing but the Single Market** – The EU27 is gradually re-centred on the single market as the 27 Member States are not able to find common ground on an increasing number of policy areas. By 2025 this could mean:
  - Crossing borders for business or tourism becomes difficult due to regular checks. Finding a job abroad is harder and the transfer of pension rights to another country not guaranteed. Those falling ill abroad face expensive medical bills.
  - Europeans are reluctant to use connected cars due to the absence of EU-wide rules and technical standards.

- **Scenario 3: Those Who Want More Do More** – The EU27 proceeds as today but allows willing Member States to do more together in specific areas such as defence, internal security or social matters. One or several "coalitions of the willing" emerge. By 2025 this could mean that:
  - 15 member states set up a police and magistrates corps to tackle cross-border criminal activities. Security information is immediately exchanged as national databases are fully interconnected.
  - Connected cars are used widely in 12 Member States which have agreed to harmonise their liability rules and technical standards.

- **Scenario 4: Doing Less More Efficiently** - The EU27 focuses on delivering more and faster in selected policy areas, while doing less where it is perceived not to have an added value. Attention and limited resources are focused on selected policy areas. By 2025 this could mean
  - A European Telecoms Authority will have the power to free up frequencies for cross-border communication services, such as the ones used by connected cars. It will also protect the rights of mobile and Internet users wherever they are in the EU.
  - A new European Counter-terrorism Agency helps to deter and prevent serious attacks through a systematic tracking and flagging of suspects.

- **Scenario 5: Doing Much More Together** – Member States decide to share more power, resources and decision-making across the board. Decisions are agreed faster at European level and rapidly enforced. By 2025 this could mean:
  - Europeans who want to complain about a proposed EU-funded wind turbine project in their local area cannot reach the responsible authority as they are told to contact the competent European authorities.
  - Connected cars drive seamlessly across Europe as clear EU-wide rules exist. Drivers can rely on an EU agency to enforce the rules.

The ECB's asset purchase program and future prospects

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1. THE ACCOMMODATIVE MONETARY POLICY OF THE EUROSYSTEM: EFFECTS AND SIDE EFFECTS

The ECB has engaged in a very bold expansionary monetary policy, particularly since the beginning of 2015. The Chair asked what the current balance of the positives and negatives is as regards the 'ultra-accommodative' monetary policy of the ECB.

A central banker replied that the positive aspects are much bigger than the side effects. The ECB is currently providing €2,500 billion of central bank liquidity, about two-thirds of which is generated through the extended Asset Purchase Programme (APP). From April 2017, net asset purchases are intended to continue at a monthly pace of €60 billion until the end of December 2017 or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim. This is a very intensive operation but it has been successful.

1.1. Non-standard measures support GDP growth

A central banker stated that GDP is growing. There are even upward revisions in the forecasts now, and this is very important. The danger of deflation no longer exists, so this is an area where monetary policy measures have been successful. The situation is that unemployment has started to decline. This is a number that is not well known in Europe: since 2013, four million new jobs have been created in Europe. This is something of which there should be awareness. The recovery in investment also continues to benefit from very favourable financing conditions. There have been positive effects. Of course, this is not only due to monetary policy, because it is known that monetary policy cannot be the 'only game in town'. There have been certain structural reforms, and it would be wrong to say that nothing has been done. There are also worldwide, positive developments in the world economy. The signs of a stronger global recovery and increasing global trade suggest that >>>

>>> foreign demand should increasingly add to the overall resilience of the economic expansion in the euro area. Taking everything together, however, this has proved to be a success.

The central banker argued that the background paper prepared by Eurofi for this discussion concentrates more or less only on the negative perspectives. Of course, a long period of ultra-low interest rates implies risks: for instance, low interest rates may induce households and businesses to invest in riskier assets. Low interest rates are also challenging for banks and insurance companies, as their profitability might suffer. As monetary policy makers, the members of the ECB Governing Council are concerned about these risks and monitor them closely. However, the central banker wanted to balance the picture.

An official stated that the important role that central banks have played during the global financial crisis should be recognised. Central banks saved the world from another Great Depression, and this has to be noted and commended. The positive aspects are beginning to be realised now, although they have been somewhat slow to appear. Ben Bernanke had stated that the problem with QE is that it works in practice but it does not work in theory; it is working now in practice. Vítor Constâncio had just reminded this audience of some good growth indicators. There are also some collateral effects when too much of this 'strong medicine' is used for too long, in terms of the financial health of the industry.

1.2. The downside of the current situation is the negative rates

A banker stated that the downside of the current situation is the negative rates. Over time, it will increasingly hurt bank profitability and thus the credit channel. The problem is how to get out from negative rates, given that, to some extent, Europe got into a situation of negative rates in the hope of not getting into QE, and both negative rates and QE occurred. The question in the current environment is due to the uncertainty about when and how to exit. At some stage, the discussion will arise in debate and in the newspapers, and that is what is going to be most difficult. It should be remembered that the Fed exited twice from QE and entered twice, so it had three QEs.

One issue is to do it properly, but the other challenge that the ECB has is sequencing: whether getting out from negative rates or from QE should come first. It could be argued that, if negative rates can be escaped from first, the impact on long-term rates will be in the same direction, so more QE should take place, which could be a paradox arising from trying to exit by doing more. This debate may be taking place in the Governing Council and, hopefully, a lot of discussion and thinking is going to happen, but it is certainly not clear to the industry how things will happen.

In comparison to the US, where the banking system is now addressing a situation of a yield curve that is much steeper, the prospects in Europe of exiting from all this with a yield curve that will be flatter may be even more worrying. The monetary policy should not be regarded only in the interests of banks, because it is in the interests of the economy as a whole, and they also have to remember that the current monetary policy has reduced the cost of risk to levels which are very low. This is very positive for the banking industry and for the financial system as a whole. There is a more stable environment, but the challenges will come ahead.

1.3. The adoption of unconventional monetary policies in major advanced economies has had a far-reaching fallout in term premia and exchange rates everywhere, accentuating the global financial cycle

An official underlined one particular element that has not been mentioned, which is the spill-over effects of these policies, particularly in emerging markets. These policies tend to increase local financial exuberance and to boost local credit markets. Perhaps the effect of QE has not worked very rapidly in advanced economies, but it did work in emerging markets through spill-overs, rising asset prices and the appreciation of exchange rates. That made life more complicated for policymakers trying to manage their own financial and business cycles. This has to be thought through. There is perhaps a coordination policy problem here, and of the solutions to mitigate excessive cross-border financial spill-overs might be to use macro prudential policies. Much work has been done at the BIS but also at the IMF on macro prudential and spill-overs, so this also has to be taken into account. Overall, however, what is being done is working, and the bold actions of central banks should be commended. These policies have helped to mitigate the direct and indirect effects of the crisis. Achieving a smooth coordination will perhaps be the most difficult part.

2. PRECAUTIONS NEED TO BE TAKEN REGARDING THE EXIT OF THE ECB'S QUANTITATIVE EASING

The Chair moved to the second issue: thinking about monetary policy in the Eurozone for all Member States. They asked whether ending ultra-loose monetary policies, or QE, is a feasible target given the different economic circumstances >>>

>>> across the Member States, and whether there are precautions that might need to be taken in that environment, given the high levels of debt in some countries.

2.1. Deleveraging process, financial fragmentation and communication challenges

A banker stated that Europe could learn from the US experience. Looking at how QE was implemented, there were many concerns in the beginning. In fact, the US starting exiting QE maybe too hastily with the taper tantrum and had to improve its ways of communicating to markets, but overall the on-going exit process in the US seems to have been managed in a fairly good manner. Markets have been shaken to an extent, but that is unavoidable. There remain challenges ahead, but now they are talking about reducing the balance sheet, so maybe this needs to be looked at as a less dramatic issue. One thing is timing, and there is a need to be careful in this space: in Europe, there were some experiences that arose from exiting a little too early, or being a little too late in doing certain things.

Another issue is what the transmission mechanism is. The QE in the US has in particular facilitated the deleveraging of the private sector in particular, more than the public sector. This deleveraging has taken six years to take place, however, and in Europe there have only been two years of QE. Looking at long-term interest rates compared to the rate of growth of the economy, it is only over the last two years that there has really been a rate of growth in the economy that is higher than the interest rate. The deleveraging process is 'snowballing', so one has to be sufficiently patient.

In addition to this, the banking system is not functioning very well in Europe; there is still much fragmentation. There has been an impact from the regulatory changes that have taken place recently, and the redenomination risk is still present. These are elements that have to be taken into consideration when calibrating the exit, and not wanting to do things too quickly. Fragmentation, in particular, remains an important element to take into account. Withdrawing liquidity in a situation where liquidity is abundant but is not circulating well enough in the system – which, in the current environment, could be considered a paradox –could produce quite some negative reactions.

An official stated that fragmentation is more benign now, compared to several years ago. If there are independent fiscal authorities, it is natural to have some degree of differentiation in terms of sovereign-risk premium. This does not necessarily mean that there is a loss of effectiveness in policy.

There has also been discussion about the prolonged usage of APPs and QE, and withdrawal from that needs to be very carefully communicated. This always revolves around communication, in terms of where the neutral rate is, and what inflation expectations and targets are aimed for. This has been done quite skilfully by, for instance, the first central bank that has been normalising now. In this process, those other institutions that are in different phases of the cycle will also be capable of making very good use of the communication strategy, to ensure that the process is carried out very smoothly.

2.2. Taking into account the evolution of the economic situation

The Chair asked whether markets and these countries would cope when policy is no longer as accommodative as it is today, when the ECB feels comfortable that inflation is self-sustained and that they are at their objective of close to, but below, 2%.

A central banker replied that the mandate of the ECB is price stability, and the question of debt levels is therefore only relevant insofar as it is relevant for price stability. This does not enter into the discussion directly, and nor should it; it is obvious that every exit is a very difficult operation. It is dangerous to be premature, but on the other hand, Europe does not want to be 'behind the curve'.

A very clear policy decision for 2017 was made by the ECB Governing Council in December 2016. The programme of asset-buying will go on until the end of this year, with certain reduced volumes. Beginning from 1 April, €60 billion will be bought per month, instead of €80 billion. It is also important that these are realistic numbers, so there will be enough material to buy. For this year, then, there has been a clear decision.

Then, starting in the summer, there will need to be an examination of how the economic situation is evolving and how stable developments are obtained. There is a need to look at what risks are still there.

There is one element of disagreement between two members of the panel: the speaker does not perceive there to be redemonination risk. The markets do not question the existence of the euro. The euro is 'here to stay', although there are a lot of other risks around, and these will need to be monitored. A banker agreed that in Europe, people are used to saying that there is no redenomination risk but, when going outside Europe, the question still exists. In Beijing a month ago, a leader stated that, within five years, the euro area will be gone, or at least one or two countries will have left it. They were then asked whether this was true. Of >>>

>>> course, people in Europe 'have to preach', but people outside Europe are less confident, and are looking at election results very closely. This is a redenomination risk that cannot be hidden; it is still there. Monetary policy should not compensate for this, but it should take this into account. In this very delicate environment, this is just one of the other elements. The markets are waiting for signals, because they have been told for years by Nobel prize winners that the euro area cannot work because it is not in line with optimal currency areas.

A central banker noted that this is nothing new. In the Anglo-Saxon world, some people have been saying this since the creation of the euro, for different reasons. Some of them might be scientific reasons, and others might be self-interested reasons. It is interesting – and this can be observed empirically – that at one time, the markets were influenced by a redenomination risk, but this is not the case now. The voice of the markets is a positive one.

3. TO ENCOURAGE ECONOMIC RECOVERY AND INCREASE POTENTIAL ECONOMIC GROWTH, STRUCTURAL REFORMS ARE INDISPENSABLE

3.1. Monetary policy, even in extreme forms, was never intended to be a substitute for structural reforms

The Chair asked about the role of monetary policy, and whether monetary policy is sufficient to revive growth, consumption and investment in the real economy, focusing on Europe.

An official stated that if there was one 'silver bullet' for problems, it should be used, but the answer is a little more complicated. Central banks have done a great deal, and that needs to be appreciated: they have helped to avoid another depression. By making sure that the social fabric stuck together, they have helped to resist protectionism and populism, although these elements have eventually returned, as in many other crises.

Central banks were not supposed to do everything. Monetary policy, even in extreme forms, was never intended to be a substitute for structural reforms or for growth-enhancing reforms, and was also never intended to be the only macro economic policy in use. Essentially, it became the 'only game in town' due to political-economy problems, such as gridlocks in parliaments and in decision-making processes. After a first coordinated G20 initiative, the world evolved into a 'tragedy of the commons', wherein they could not employ the whole array of policies that were at hand.

There is a need for understanding that blame should not necessarily be attached to policymakers. Reforms are complicated and necessary and should make good use of the time that monetary policy can buy to engineer structural reforms. However, structural reforms are not easy: they create winners and losers, and they is always a time inconsistency problem between the benefits and the costs. It is, therefore, always very complex to make sure that everyone is convinced of what the right levels of inflation, debt and taxes are, and that this is consistent with the type of social welfare benefits that a society desires. Unanimity is very difficult. The role for monetary policy in a crisis is to do the utmost, but also to create the conditions for societies to engineer structural reforms.

For that, a little more growth is required, and this is being achieved in Europe, so things are moving in the right direction. There need to be skilful politicians and some fairness in burden-sharing, and a little bit of luck is also required. If that is beginning to happen, hopefully Europe will also reflect on what types of structural reform are needed. These will likely have to do with the growth model and sustainable environment policies that will change technologies, and also, particularly in advanced economies, more social inclusion and fairness. These would be good things for social, political, economic and financial equilibrium. If monetary policy could be the first leg of this, hopefully this will be followed by a period of fair and profound structural reforms in Europe.

3.2. Monetary policy cannot be the only game in town

A central banker stated, for the sake of future generations, potential economic growth in the euro area should be boosted. Unfortunately, this is nothing monetary policy can deliver. This requires policies that set the right incentives for investment. To push forward economic recovery and raise potential economic growth, structural reforms are indispensable. The sooner the structural reforms are implemented, the stronger and more sustainable the recovery will be.

3.3. Mutual respect between independent central banks and democratic governments is essential

A central banker stated that the world that everyone is living in is one of, on the one hand, independent central banks – and there are very good reasons for their independence – and, on the other hand, democratically elected governments. There needs to be mutual respect between these; the independence of central banks should be fully recognised but, on the other hand, central banks should also not try to be perceived as over influencing democratic governments. What can be provided is >>>

>>> economic expertise, and expertise may also be offered in fields that go beyond monetary policy.

For a central bank to apply pressure to a democratically elected government, however, would be inadequate. There has to be a dialogue, but one based on mutual respect. In some countries, unfortunately, there is a growing tendency to have a negative discussion on the independence of central banks, and care is required in relation to this. People need to be clear about the purpose of a central bank in a democratic society. The ECB has found the appropriate role; it pursues a dialogue with the political institutions, but as an independent player, and that is how it should be.

A banker stated that in 2011, the central bank tried to push certain governments to make reforms, and this had a mixed result. Malta has made a lot of reforms with the same monetary policy as Italy, which has made fewer reforms, and other countries, which have done differently. Central banks should not rely on monetary policy as an instrument to influence governments.

An attendee asked whether there is not some complacency in this perspective whenb affirming that there is no redenomination risk and no fragmentation, when TARGET2 balances are back to what they were in 2012. She is all for saying that the euro is 'here to stay', but as an international investor, although the ECB has been telling a 'nice story' that this just reflects the ECB or its asset-purchasing operations, there is a question as to why the money is not circulating. It gets stuck in Germany, despite all of this liquidity. She asked whether, if there were a properly functioning banking system, Europe would see these large balances, and whether the ECB is taking into account the existence of this fragmentation and perception of risk in the conduct of its policy and in its thinking about the exit strategy.

A central banker stated that there is a certain element of fragmentation, but it is much smaller now. It must not be forgotten that Europe now has a banking union, so huge progress has been made. This afternoon, there will be a discussion at the Ecofin meeting about non-performing loans. This is a discussion based on exactly the same definitions of non-performing loans, which did not exist three or four years ago. That means that they have better information and better instruments to deal with this. It would take a long time to talk about TARGET2, but there have been studies by the Bundesbank and the ECB that show that this has nothing to do directly with fragmentation; it is more to do with certain technicalities of the APP. ●

Global markets and cross-border investment

Thomas Lodder - *Global Head of Regulatory Policy, Barclays Bank*
David Wright - *President, EUROFI*

DAVID WRIGHT

David Wright announced that he and Tom Lodder would discuss global markets and cross border investment. Broad, deep and harmonised capital markets are a positive force. They connect the providers of capital with its users; direct savings towards investments; help economic actors manage their risks; and ultimately power our economies. Fragmented, disjointed and sometimes conflicting regulatory policy benefits no one but global markets can only be maintained if we continue to work towards global standards with regulators and resolution authorities working in an atmosphere of trust.

He asked how Tom Lodder sees the current world: whether he perceives disruptions to cross border financial activities; whether he feels the effects of the alleged rising protectionism; what concerns he has regarding fragmentation, and how he perceives its impacts across the European economy.

TOM LODDER

Tom Lodder responded that he sees numerous threats to global markets and cross border flows, and the geopolitical tensions overspill into markets. In that context, he appreciates Sharon Bowles's comment to 'Take the politics out of markets'; it is ambitious, but aspirational.

In regulatory terms, Europe is moving from a shared post crisis agenda into one where there is much less alignment from a regulatory and political perspective, in terms of outcomes. This sets the stage for markets to become the arena for figuring out competitive advantage, which provokes a concern, and it is happening at a time when markets are particularly fragile. It is unclear why this is, and what is the cause of reduced liquidity in certain markets, but Barclays certainly sees the impact of increasing capital levels on its ability to service certain markets, jurisdictions, clients and products. Global banks are rationalising >>>

>>> what they do in an attempt to deal with this new environment.

These banks are also subject to considerable pressure on the regulatory side, because such pressure fragments their operating models and potentially their booking models. There are regional issues as well as pre existing national requirements in terms of structural arrangements. There are banks supporting global markets in a way that has substantially changed, which means that the markets themselves are potentially more fragile. The sentiment that banks should ring fence or consolidate capital or liquidity within national boundaries works against the need for global harmonised markets, which provokes a concern.

The upcoming regulatory agenda in Europe is a primary concern for Barclays. Barclays are currently looking at issues such as the ability to maintain waivers from solo capital and liquidity requirements under the CRR, and an appropriate balance between home and host authorities in terms of capital, liquidity and resolution. They have concerns about things like the Intermediate Holding Company (IHC) proposal in CRR which would require non EU banking firms to establish a holding company in Europe potentially including existing branches. There are other issues, as well. At a more granular level, one issue is the calibration of regulatory reforms, which needs to be done carefully. This is why the banking industry is cautious about its approach and advocates the appropriate changes collectively, as an industry, because they do not really know what the product by product impact of regulatory measures like the Fundamental Review of the Trading Book (FRTB) and net stable funding ratio (NSFR) will be. The testing and methodologies are still incomplete. BCBS is working in the background on improving the methodologies and calibration, so it is a work in progress; In other words, It is an area where caution is urged in relation to the ultimate outcome in Europe because there are potentially significant impacts for certain sectors of the market.

Beyond this a range of market specific reforms also give Barclays cause for concern. There are indeed significant structural issues for them in certain markets, and much uncertainty. For example, the upcoming derivative trading obligation under MiFID2, without an appropriately early equivalence decision for US trading venues, creates a material problem for a significant portion of the global swap markets, which are supported by European banks, subject to these requirements. In the same vein, MiFID and equity trading venue requirements and the equivalence determinations attached to them cause much undesirable uncertainty.

DAVID WRIGHT

David Wright stated that in theory there is a slowdown in global regulation,. Svein Andresen will say that the agenda is moving towards implementation, so at the global level one would expect some of the problems currently pointed at to be dealt with. He asked whether, looked at from London, countries are trying to 'play the competitive game' with regulation, and whether the US is trying to undercut capital for Barclays' subsidiary in the US.

TOM LODDER

Tom Lodder responded that the US is manifestly (through US IHC requirements) more defensive in its approach to resolvability, which is not the scenario that he wanted to prevail in terms of home host cooperation globally. The US model is to some degree contrary to the sharing and caring approach that Barclays would like, but the incentives behind it can be understood in terms of the ability to have an effective cross border resolution of a foreign bank.

Whilst Barclays would like to see global standards with the politics removed, no one disputes that they are moving in the right direction towards finalisation of those global standards. There are inherent political debates going on at present, which cannot be ignored. It appears that the various parties are ready to make a compromise on output floors at the end of Basel IV: Europe is having to go a considerably long way to reach this compromise, from 0% to mid 70%, whereas the US is coming down to 75% from a level that is closer to 100% in some cases. Political compromise needs to be made to achieve the right end result, and the European Union support of those international standards is admirable. That is ultimately the way to achieve harmonisation. The important thing is that it cannot be at any cost for European banks. In particular, we have to be very cautious about introducing standards like NSFR in Europe, if they are then not followed up in the US. There is an inherently important political angle to that. Consistent implementation of global standards is essential.

DAVID WRIGHT

David Wright stated that there is a problem with the level of implementation. Despite the best efforts of various stakeholders, there is no enforceability of global standards. If even handed implementation is desired at the global level then the global standard setters need to be strengthened and given enforceability powers. However, few people want to support that, and certainly not in the US. >>>

>>> TOM LODDER

Tom Lodder agrees, noting that there always needs to be a degree of sensitivity to the specific case in hand, and this becomes more difficult when extended to national or regional exceptions.

DAVID WRIGHT

David Wright explained that there is a slowdown of rule making at the global level with uneven implementation, compounded by the evident political risks. One, which was not mentioned, is the undermining of the World Trade Organization (WTO). If that happens, there will be more heightened political risk. He asked whether Barclays are worried about that.

TOM LODDER

Tom Lodder responded that this is a developing situation. Barclays have become more expert in trade and WTO issues since Brexit has arisen as a concern. Changes at a WTO level will initially impact clients. The WTO is also important in terms of financial services. Barclays have seen where the WTO's strictures can create issues: a financial services agreement between Europe and the UK would potentially be easier to achieve without those strictures, but one can see the advantage of having that overlay.

DAVID WRIGHT

David Wright asked Tom Lodder to outline some measures that would improve the attractiveness of Europe for inward investment.

TOM LODDER

Tom Lodder responded that following the Brexit result, people have started to look at the UK and consider whether it is where they want long term investment. The Brexit result taught Barclays much about what their clients, customers and the wider economy value in terms of inward investment. Political and legal certainty, and tax and regulation are on the list. Not all of these can be relied upon, in terms of making the UK and Europe attractive.

Harmonisation and the CMU is the right goal in terms of attracting wider investment. Fewer barriers to competition will also attract investment. Barclays are looking at the regional or national issues that may cause concern.

DAVID WRIGHT

David Wright noted that he has recently seen Philipp Hildebrand of BlackRock say, in the Financial Times, that he is rather bullish about the European economy. Putting aside the issue of Brexit, he asked whether Barclays saw some 'green shoots' in the European economy.

TOM LODDER

Tom Lodder responded that there is the potential for 'green shoots'. Barclays certainly believe that the increased certainty that will result as the political process is worked through will improve this environment. ●

Leveraging savings to develop cross-border investment in the EU

Pervenche Berès - *MEP, ECON Committee, European Parliament*
Ambroise Fayolle - *Vice-President, European Investment Bank*
Roberto Gualtieri - *MEP and Chair, ECON Committee, European Parliament*
Klaas Knot - *President, De Nederlandsche Bank*
Dimitar Radev - *Governor, National Bank of Bulgaria*

1. CROSS-BORDER CAPITAL FLOWS IN THE EU: RECENT EVOLUTION AND STAKES

1.1. What is at stake?

The Chair stated that financial integration promises many benefits, such as the potential of diversification, risk sharing and a more efficient allocation of capital. A monetary union has been established so that the disappearance of the exchange risk within member countries can enable savings from all the monetary union countries to be used to finance the most effective investments within the monetary area.

The financial crisis has shown that capital mobility was not without a dark side: during the decade from 2000 to 2010, the Eurozone's capital mobility funded primarily inefficient investments - budget deficits in Greece, Italy and Portugal, real estate bubbles in Spain and Ireland – and contributed to massive current account deficits. Capital inflows that were not used productively amplified existing vulnerabilities in the monetary union. The current account deficits were increased as the wages and prices generated by the capital inflows eroded competitiveness and productivity gains.

The 2011-2012 sovereign debt crisis halted the circulation of capital flows between eurozone countries and the European Union, which led to large financing problems for banks and sovereigns and an amplification of the economic downturn. The 'great retrenchment' of cross-border capital flows has only been partly reversed. They still remain well below their pre-crisis levels.

Introducing the debate, the Chair recalled two figures from the Eurofi prep note; the first was that the euro area benefits from a savings surplus of more than €200 billion a year, or 2% of GDP. One of the questions for discussion was what should be done with this money, knowing that, in 2008, Europe had €2 billion cross-border capital flows while >>>

>>> nine years later, the figure is just €1.26 billion. Something has gone wrong, and there needs to be a discussion on how it can be fixed.

There are five proposals to be discussed: firstly, reinforcing the Investment Plan for Europe, possibly with the assistance of the European Fund for Strategic Investments (EFSI); secondly, whether there is a need for a European product, such as a savings, retirement or investment product; thirdly, whether there should be pan EU banks; fourthly, increasing cross-border equity flow; and fifthly, whether it would help solve the non-performing loans (NPL) question to go back to the cross border investment. The Chair asked whether the new EFSI would help solve this problem.

1.2. A completion of the single financial market and a reinforcement of the Juncker Plan are necessary to restore cross-border investments

1.2.1. The European Investment Bank (EIB) is contributing to restore cross-border investments within the EU

An official stated that this topic is something that is well known in terms of the consequences of the crisis, especially deleveraging and the impact of the correction of current account imbalances, as well as more fundamental problems related to underdeveloped equity markets in Europe. Interestingly, however, in a recent poll, the EIB asked 12,000 non-financial companies throughout Europe what the major and minor obstacles to investment are. The first was uncertainty about the future; the second, surprisingly, was the lack of availability of staff with the right skills, which is an issue that is not directly linked to the day's discussion, but is very important; and the third was business and labour market regulations, followed by the availability of finance. This is considered by 40% of European companies to be a major obstacle to investment.

There is also considerable dispersion across countries. In particular, one group of countries causes concern, namely those countries where companies do not have very many internal resources and have difficulty accessing external resources, or funding outside the company. These companies are mostly in Southern and Eastern Europe and this emphasises the importance of what the Juncker Plan is trying to implement. In terms of investment, Europe has now mobilised 58% of the total €315 billion target that was set by the Plan. The investments approved under the EFSI are in all the 28 countries, and around 400,000 SMEs have been financed; The EIB has provided support notably to projects in energy, transports, research, digital, social infrastructure or environment and resource efficiency. The European Investment Fund (EIF) has significantly increased its volume of operations in support of SMEs and mid-caps. At EIF, a co-investment equity platform with 30 national commercial banks and institutions from 19 countries in Europe has been created. This is something that will help these institutions to invest in projects that will be brought by fund managers to the EIF in other countries in Europe. These kinds of projects will help in the future to develop cross-border investment. There is also an idea for the next initiative, which can be delivered later, related to ELTIF.

A policymaker stated that Europe needs to do all of the things that the Chair listed. This is a very ambitious programme, and there is also a need to be pragmatic at the same time, because of the need to not only design perfect solutions, but to implement practical and successful solutions. To address the problem, there are cross border capital flows far below the pre-crisis level. Europe will need to return to these levels, but also address volatility issues, because the pre-crisis model was not perfect. That is why well regulated financial integration is needed. To be pragmatic, there is a need to start with banking, because Europe is clearly a bank-based economy. Unless Europe builds a true banking union, it will never solve this problem or achieve a practical and successful solution.

1.2.2. The completion of the Banking Union and the implementation of the Capital Markets Union (CMU) should increase the efficient allocation of capital within the EU

According to this policy maker, Europe needs to move forward in these two areas. Some of the issues to be addressed are politically very controversial, but are nevertheless required. These include the permanent backstop of the Single Resolution Fund (SRF) that would increase the credibility of the EU crisis management framework and the European Deposit Insurance Scheme (EDIS), which would underpin trust in the euro and achieve a uniform system whereby the same confidence in bank deposits as in money applies throughout the whole euro area. The banking package proposed by the EU Commission in November 2016, of which work has already begun, is balanced; an EU agreement on the combination of risk reduction and a better design of incentives in order to boost growth needs to be achieved. There is still much to do but, if EU Institutions do it well, they will make a significant contribution towards building up a well-regulated and integrated banking system, which is essential to developing cross-border flows. And this should also facilitate the completion of the Banking Union.

There is also the CMU side, and here, equity is the key word; equity financing in Europe needs >>>

>>> to be improved. The current mid term review of the CMU might help. 16 out of 37 actions have been taken so far, which have been useful, but some measures were only recently approved, so the prospectus that is completed will develop its effects gradually. Clearly, however, more should be done, especially to address the problem, and a fiscal treatment of the famous debt equity bias is essential.

1.2.3. In addition, market failures need to be properly addressed

Third, Europe needs to address market failures; if it does not, it will achieve nothing. Here, the Juncker Plan is fundamental, and is doing well. However, it will have to be improved in terms of its capacity to merge a grant component with a guarantee component. If this can be achieved, Europe will be able to provide additionality, address market failures and have investment across the whole EU area. If this grant component is combined and developed with the idea of a European savings and investment fund, trying to channel savings, together with a macroeconomic policy that is more growth-oriented and which is also capable of addressing imbalances, this combination might end up addressing this saving and investment gap by making a strong and effective contribution to growth and jobs.

The Chair noted that uncertainty had been listed as a concern, and this was shared by other panellists. The second concern was staff skills. The Chair wondered how to address this question, because this has nothing to do with the Banking Union or with CMU, so it is not being discussed around the table. In countries like Greece, this is not a minor issue, so it should be asked whether those represented around the table could do something about it. She added that on the Banking Union, everybody agrees on what the loopholes are and that they need to be fixed.

2. ADDRESSING UNDERLYING ISSUES OF CROSS-BORDER INVESTMENT IN THE EU

A central banker stated that, in general, the background from the perspective of cohesion countries, including Bulgaria, is generally the same. Capital mobility helped boost investment growth in these countries in the pre-crisis period. At the same time, large capital inflows contributed to some vulnerabilities and imbalances: for example, in the real-estate market and in Bulgaria's external position. Trends are also generally the same; for example, capital inflows in cohesion countries collapsed from their peak in 2007, from about 27% of GDP to around 5% of GDP after 2012. This background is well known.

The reduction in capital inflows to cohesion countries was not necessarily a bad thing. There are some observers who refer to this process as 'normalisation'. Research shows that the negative impact on the economy of the post crisis correction of the imbalances was less dependent on the size of the flows, and more about the structure or type of capital inflows. For example, in cases where capital inflows were intermediated with the banking system, the adjustment was more painful, usually coinciding with the banking turmoil. An example of this is a substantial drop in real GDP. In cases where capital inflows were in the form of foreign direct investment (FDI), an orderly adjustment was possible, since these inflows were contracted in a smoother manner compared to other types of capital inflows. As the experience of Bulgaria shows, this secured the orderly adjustment of the current account deficit at a low cost for the economy.

Secondly, uncertainty and risk aversion from the perspective of cohesion countries are major factors. Unfortunately, many current developments, including with regard to the future of EU integration, seem to add to this uncertainty rather than to address it. There remains notably a potential conflict between the prospects of "multiple speed" developments and advancing real convergence between the euro area and the rest of the EU. The EU needs to move promptly on this issue, in order to address uncertainties. An important dimension of this uncertainty is that the post-crisis saving-and-investment mismatch is not only within the EU but also within cohesion countries, which limits their investment opportunities; for example, the current account surplus in Bulgaria reached 4.2% in 2016.

Thirdly, national authorities have the responsibility to tackle their reform agendas, with a focus on financial stability, fiscal soundness and structural reforms. Those measures are a pre- requisite to attract effective and productive cross- border investments in these countries. The background note prepared by Eurofi rightly refers, for example, to how capital mobility has been used to finance budget deficits and inefficient investments in some member countries; so the question is whether more of this is needed. Of course, there are some positive examples, but not many. The Bulgarian Deputy Minister of Finance and people from the Ministry of Finance will present Bulgaria as a positive example. Bulgaria was running a broadly balanced budget for 10 years in a row until 2008, and is now back on the path of fiscal consolidation, balancing its budget for 2016 and keeping the debt-to-GDP ratio well below 30%.

To conclude, there is a need to focus on not only the size of capital flows but, more importantly, their effective and productive use. There is a need to adequately address uncertainties; otherwise, >>>

>>> ongoing and new initiatives will have mixed results. Finally, Europe needs to effectively enforce rules in the banking sector as well as in the fiscal area, which involves the responsibilities of both the EU and the national authorities.

3. TOWARDS MORE SUSTAINABLE CAPITAL MOBILITY WITHIN THE EURO AREA

3.1. In view of the accumulation of large macro-economic imbalances in some Eurozone countries between 2000 and 2007, financial integration in the euro area proved unstable in the context of a financial crisis

A central banker stated that from a macroeconomic perspective, regarding the question of intra-EMU capital flows, Eurofi is discussing the right topic. Private risk sharing is much more important for the smooth functioning of the EMU than public risk-sharing. Looking, for instance, at successful monetary unions like the United States, private risk-sharing takes on four or five times the role of public risk-sharing in relation to smoothing out asymmetric shocks across the various states. The Banking Union and the Capital Markets Union are the two central policy initiatives to foster private risk sharing in Europe and to catalyse financial integration in Europe.

Secondly, since there are significant differences in levels of GDP per capita and in living standards across the different member states of the euro area, there is nothing wrong with having consistent current-account patterns that show a surplus in the more advanced countries and a current-account deficit in the countries that are engaged in a process of catch-up or of convergence towards the richer countries. Where theory and practice started to deviate was the hubris of free capital mobility: for too long it has been believed that if there is free capital mobility, capital will always automatically flow to these investment opportunities that are the most productive and that have the most value-added to raising productivity, creating new assets and thereby fostering the convergence process.

Looking back on the crisis, this did not happen. Capital inflows were not used for investment that would benefit productivity; rather, they went into real estate. The growth of the less productive, non-tradable sector pushed up wages in this non-tradable sector. There was then arbitrage within these economies, so wages in the tradable sector also went up, and that combined to erode competitiveness and productivity gains. At some stage, this became unsustainable and a sharp reversal of cross-border flows followed, leading to large scale financing problems for banks and sovereigns. Capital flows led to an amplification of the economic downturn. At this point, public authorities stepped in. As of today, there are instruments like fixed rate full allotment and longer-term refinancing operations in the toolbox of European central banks, still effective in having taken over some of the private capital flows. This, of course, cannot be a sustainable policy indefinitely.

3.2. Since the crisis, European policy makers have been taking many measures meant to alleviate the dark side of financial integration

The speaker added that since the crisis, first of all, the Macroeconomic Imbalance Procedure (MIP) has been created, which is a very important procedure. Unfortunately, there are still some issues with compliance with the procedure, which is a phenomenon that is being seen more broadly with European procedures. In and of itself, however, it is a procedure that is pointing out the right issues. Second, Europe has strengthened prudential policies; on the macro side, these are countercyclical capital buffers and loan-to-value ratios. There is also strengthened micro prudential banking supervision at the European level, with the coming into being of the SSM. One can have many debates about NPLs and about 'too little, too late', but at least the issue is now under consideration, and there seems to be a consistent approach emerging from within the SSM about how to tackle NPLs. That is also good news.

The Chair added that regarding the MIP, this is not only a question of compliance, but it is also a tool that the Parliament has been urging forward 100% and which the Commission is not using as it should.

3.3. Increasing the share of equity and Foreign Direct Investment (FDI) flows in the composition of cross-border flows is of paramount importance. This requires changes to the taxation framework and increasing the efficiency and consistency of insolvency frameworks across the EU

Finally, according to this central banker, a lot of the volatility of these cross-border flows during booms and busts also came from the structure of capital flows, and the fact that these were heavily skewed towards debt financing instead of equity financing. One thing that is within the remit of policymakers to change is the debt-equity bias in fiscal frameworks. It is clear that debt flows go much more quickly into reverse when adverse shocks hit, and amplify business-cycle fluctuations. Therefore, it is of crucial importance that the share of equity and FDI in cross-border flows is increased.

Increasing equity financing requires the changes to the taxation framework and increasing >>>

>>> the efficiency and consistency of insolvency frameworks across the EU. On taxation, the Chair stated that there is the project to address the debt equity bias. Indeed the tax deductibility of interest payments in most corporate income tax systems coupled with no such measure for equity financing creates economic distortions and exacerbates leverage. Addressing the preferential tax treatment of debt over equity would encourage more equity investments and create a stronger equity base in companies. The recent legislative proposal of the EU Commission on the debt equity bias is an encouraging step forward.

A central banker stated that the question is about the soundness of ongoing and new initiatives that are under consideration; and the specific measures to address market failure. This has not yet been achieved, so more work is needed in this direction; there has been too much focus on political considerations. With regard to taxation, this is an issue that needs to be resolved in the context of the CMU discussions.

Another central banker stated that much of the CMU concerns issues that are not directly within the remit of the people who are talking about it. Taxation is one of these; insolvency law is another area where finance ministers are a little uncomfortable accepting that it is their problem to deal with. However, it is indeed their responsibility. It is not only the responsibility of justice ministries to make the CMU successful.

3.4. Implementing and enforcing the rules more vigorously is of the essence

A central banker fully agreed with the point relating to compliance with the MIP. The procedure is the right one; unfortunately, fewer than 5% of recommendations are being followed. Some 40% of recommendations get some follow-up, but not the follow-up that was intended, and more than 50% of recommendations have no follow-up whatsoever. Europe needs to cease this practice of presenting big plans, but then having no implementation and no tools to hold policymakers accountable when they do not implement their promises.

An official stated that the new Juncker plan is already a priority for the EIB. As an investment bank, they are not financing the education budget, but they can help by making sure that the universities and the schools improve in terms of efficiency; not only energy efficiency, but also digitalisation. They need to demonstrate to Europe's citizens that European institutions are there to help them, and that is something that they will try to strengthen in EFSI, as well.

A policymaker stated that the European Parliament looks forward to the Commission's studies on tax incentives for venture capital and business angels, for instance, coming up in June, and the broader issue of the Common Consolidated Corporate Tax Base (CCCTB). There is indeed a tax dimension in CMU, which requires serious work. In particular, the preferential tax treatment of debt from the deductibility of interest payments causes equity to be less desirable, impeding efficient capital market financing. Addressing this tax bias would encourage more equity investments and create a stronger equity base in companies. Also, there are obvious benefits in terms of financial stability, as companies with a stronger capital base would be less vulnerable to shocks.

NPLs are also a crucial component, and Europe needs a comprehensive solution that does not end up destroying value; an appropriate solution is necessary for the flow, as well as a solution for the stock. There was a discussion on this at Ecofin that afternoon.

Finally, MIP is fundamental. MIP also means addressing symmetry, including in the current-account surplus and the capacity to be combined in a way that gives sense to the concept of a euro-area fiscal stance. MIP and the correct implementation of Europe's other fiscal rules is a very complex issue and a fundamental one, and should be addressed in this broader framework with a focus on aiming at and overcoming this saving and investment gap, while fully using all of Europe's new micro/macro prudential tools. Europe needs to avoid returning to the past, where capital went in the wrong place, and to recover and create a truly single, integrated financial market. ●

Implications of Brexit for the EU economy

David Wright - *President, EUROFI*
Andreas Dombret - *Member of the Executive Board, Deutsche Bundesbank*
Odile Renaud-Basso - *Director General of Treasury, Ministry of Economy and Finance, France*
Shriti Vadera - *Chairman, Santander UK*

1. POTENTIAL IMPACT AND IMPLICATIONS OF BREXIT FOR THE EU

An official noted that one should be modest when evaluating the impact of Brexit. Before the British referendum, there were many very negative assumptions and forecasts about what the impact of a 'Leave' vote would be, but in the very short term, there has been no real impact. The UK economy is doing well, and the resistance of financial markets has been very good. However, Brexit will ultimately have an impact on growth, probably more so in the UK than in Europe; the current forecasts are a loss in UK GDP growth of around 1%, and a quarter of that in the EU.

Another official stated that a financial centre the size of London is clearly important for the European economy. If Brexit hampers European banks and corporates from accessing London based financial services, this will affect funding conditions for Europe as a whole. For the German banking sector for example, the United Kingdom is the most important financial market in Europe, and second only to the United States in the world. The total exposure of German banks against UK domiciled debtors is around €320 billion, constituting a fifth of what is being lent across borders by German banks, which is very significant.

Taking into account all economic sectors, Germany has total claims against the United Kingdom of more than €1 trillion, the bulk of which is accounted for by financial derivatives and short term deposits held with UK banks. Conversely, Germany has liabilities against the United Kingdom of €1.2 trillion from the same sources, and all of this will be impacted by any change in the EU-UK relationship. Traditional banking services (e.g. loans, deposits...) should be relatively easy to substitute for, but complex banking services conducted in the City (e.g. derivatives clearing) will be much more complicated to replace because such risks are more difficult to transfer. >>>

>>> An industry representative stated that, while it is important to focus on the challenges posed by Brexit, it should also be recognised that it presents an opportunity for Europe to create a much deeper capital market, particularly if the Capital Markets Union (CMU) can be accelerated. The UK will have to accept that there are going to be changes, and there will be movement of jobs from the UK and into all of the major European capitals.

An official added that, however, Brexit is not good news: it will take up a great deal of time and negotiation, and will be the focus of a large amount of attention, as has been demonstrated by the discussions that have taken place thus far.

2. PRIORITIES AND POSSIBLE OUTCOME OF THE EU – UK NEGOTIATIONS

2.1. Priorities and appropriate conditions for the EU-UK negotiations in the financial area

An official considered that although it is unlikely that Brexit will be a positive change, all involved should do their best to limit the negative impacts. Europe and the UK are about to enter into a period of negotiation; on both sides, there has been a good start. The degree of convergence and solidarity observed among EU Member States, which have been very disciplined about not entering into bilateral negotiations before Article 50 has been launched, is very positive. There is a shared view among the EU's 27 member states about the objectives and the consequences of Brexit. Both sides now understand that the UK will no longer be in the single market anymore. Europe needs to find an arrangement with the UK that will preserve the unity and integrity of the EU, and its capacity to decide in an autonomous way, the official believed, while also maintaining a very close relationship with the UK.

Another official emphasized the importance of maintaining a close cooperation and close ties between the British and European economies, and of preserving a level playing field with a single rulebook. The Bundesbank has always worked very closely with the Bank of England PRA, and will continue to do so following Brexit in order to mitigate risks. The official expected that the Single Supervisory Mechanism will remain applicable, as well. The four freedoms of the European Union are however not divisible, and no third country should receive a better deal than any single EU Member State.

The two biggest mistakes that could be made regarding the Brexit negotiations the official emphasized would be for the EU27 to consider penalising the UK for its decision to leave, and for the UK to believe that it can 'cherry pick' and force the EU27 into a position that they cannot agree to. The negotiations should be conducted in a pragmatic and constructive manner.

The first official agreed that ensuring a level playing field between the different players is essential. If there are different regulations and full market access, a competiveness gap will open up.

Another concern is financial stability, the official emphasized: the EU needs to have the ability to ensure its own financial stability, which is strongly related to government and national sovereignty. Very fundamental financial functions located in the UK will be outside the EU, and therefore outside the scope of the EU's regulation and supervision. Some agreement will need to be struck regarding supervision, but the first step is deciding how regulation and convergence are to be dealt with. The current equivalence regime used in different EU legislations is a potential tool, but this will need to be reviewed, enlarged and refined to be effective in the context of the UK.

An industry representative stated that it is not necessary to discuss every issue related to financial services during the negotiations. Capital markets are the most important – about 80% of EU27 capital market activity takes place in, and is conducted through, London – but retail insurance, retail banking, and some aspects of commercial banking are less important. London is one of only two universal, global financial ecosystems in the world, and provides a depth of liquidity and a cost of capital that must not be jeopardised, particularly in the context of a crucial turning point in the European economy. Fragmentation will lead to costs, both for financial firms and for the real economy. There is also a need to prevent perverse impacts of increasing costs for investment banks at a time when they are struggling to meet their hurdle rates of return because it would be a shame if the gains of Brexit were realised by New York, rather than Europe.

2.2. Outcome that should be aimed for

An industry representative considered that the goal that needs to be worked towards is a free trade agreement, possibly narrower for financial services. The speaker however noted that achieving this would be quite unprecedented in trade history. It indeed takes seven years on average to negotiate a trade agreement, a length of time that will be compounded by the current focus on political priorities at the expense of economic priorities. What is needed is a solution that balances political, economic and market considerations but that is not happening at the moment. A challenge moreover is that politicians usually prefer to wait >>>

>>> to act until the negative impacts become clearer if there is a cost associated with acting; the Brexit negotiation process is therefore 'putting politics in a race against time', which is not a comfortable position.

The advantage though is the starting point in this case, since there is total convergence between the UK and the EU regulations, the industry speaker claimed. Regulation is key: it is imperative that any deal is based on mutual recognition, and contains a deep and formalised regulatory cooperation agreement. This agreement will need to reassure the EU regarding its ability to supervise and have oversight over systemically significant service providers, as well as reassuring the UK that it can manage the risks of a systemically important sector in its own economy. The speaker noted that the industry is comfortable with this concept, as they are used to having multiple supervisors and regulators. Any Brexit deal will need to be based on international rules and regulations, and uphold the importance of the international organisations, the industry representative added. It is important to remember the role that regulatory arbitrage played in the financial crisis and that should be avoided.

The present level of integration between the UK and Europe is such that a de merger of markets on the scale envisioned is also unprecedented. The outstanding notional value of euro interest rate swaps cleared in London is €77 trillion for example; splitting this would potentially lead to deep instabilities. In the area of insurance, London writes €12 to €15 billion worth of corporate specialist reinsurance and insurance policies for EU27 clients, and London's international investment banks have a balance sheet of €2 trillion. These are very high amounts. Without an agreement, there would be a need to "safely disentangle and rebuild" activities in EU27 with a sufficient depth of liquidity and of risk capital, with adequate infrastructure, supervisory capability and governance, while retaining the ability to service clients. The choice, therefore, is between an unprecedented, complex, and politically fraught agreement, or an unprecedented, complex, and expensive de merger; which is a choice between two 'seemingly-impossible outcomes' and between the positively impossible and the negatively impossible.

An official emphasized that the UK's decision to leave the EU will inevitably bring fragmentation over time. The easy solution would have been for the UK to move towards an EEA type arrangement. This would mean the country becoming a rule taker, but that is the only way to ensure that the same regulations and rulebook are followed over time. However, since this is not an option, it will be very difficult for the UK to leave the EU and at the same time commit to following all EU regulations, which would involve abiding by the European Commission's rules and the possible decisions of the European Court of Justice. This is possible in theory but very difficult politically.

The official emphasized that the UK becoming a third country will inevitably change the EU-UK relationship, and there is no precedent for this kind of redefinition; although the EU has a free trade agreement with many countries, these agreements are not of the same nature as the agreement that will need to be struck with the UK. The UK and the EU are starting from the same basis, with identical regulations and organisation, but the UK wants to take back its sovereignty, which means that the UK and the EU may move in different directions. Introducing some degree of sovereignty regarding regulation necessarily leads to fragmentation. This will need to be addressed and adjusted to, which will require all involved to be 'very imaginative'.

Another issue is that it will also be difficult for the EU to maintain systemic infrastructure in a third country with potentially different regulation and supervision. Although an agreement might be reached regarding supervision, this will give rise to important issues of sovereignty, with political authorities wanting assurance that they can ensure financial stability in their area. The financial crisis has made it clear that financial stability is ultimately a national responsibility, and therefore it is very difficult to have one's financial stability depend on other authorities.

3. THE NEED FOR A TRANSITION PERIOD AND ITS FEASIBILITY

An industry representative emphasised that two types of transition are necessary: the first is related to the fact that there may not be a new deal on the day of exit regarding the terms of the relationship, and that a bridging period will therefore be necessary. Secondly, after the terms of exit are known, financial industry players will need to deal with operational issues, including licences, regulatory approvals, IT systems, and repapering clients; this will take a long time, and it is therefore essential that this should begin early in the process. The most positive signal that the industry representative has seen is acceptance, at least in the EU, that it is natural for major items of legislation to come with a transition and implementation period. The UK Government has accepted this too, the speaker believed.

An official stressed that it is difficult to define the transition period while not knowing what the direction of the agreement will be. It seems therefore logical to take the attitude that >>>

>>> the transition period can only be discussed once there is more clarity about the future of the EU UK relationship. As the dynamic of the negotiations is not known, it is very important that all parties should prepare for the possibility that negotiations may be unsuccessful, even if this is not the desired outcome.

The industry speaker replied that it would not be helpful to announce that there is going to be a transitional period very close to the date of Brexit since as one approaches the cliff-edge, disruption becomes more likely. ●

Emerging risks in global and EU financial markets

José Viñals - *Chairman, Standard Chartered Bank*
Andrei Magasiner - *Corporate Treasurer, Bank of America*
Francesco Mazzaferro - *Head of the Secretariat, European Systemic Risk Board*
Luiz Awazu Pereira da Silva - *Deputy General Manager, Bank for International Settlements*
Stacey Schreft - *Deputy Director, Office of Financial Research*

1. AVERTING THE RISK OF GLOBAL FRAGMENTATION

1.1. The global economy in an uncertain environment

The Chair stated that the session deals with emerging risks in global and European financial markets, and that this may be a very relevant discussion, because of the complexity of the current times. Decision making in the context of so much uncertainty, including geopolitical uncertainty, economic uncertainty, and regulatory uncertainty, is not easy. Growth numbers from 2016 indicate that the year saw the lowest global growth since the global financial crisis. However, in the short term, growth is increasing in the United States. European growth is solid; no 'hard landing' is envisaged in China, and emerging markets in general are expected to perform better, so forecasts for global growth this year and next are increasingly positive. However, on a deeper level, a number of issues are still not right. Total factor productivity growth still remains very low, lower than in the pre crisis period, and a lot of debt remains, both on the public and the private side.

Many banks still struggle to adapt their business models to the new post crisis economic, regulatory and political realities. Most importantly, there are many concerns about whether the world is going to enter a phase of de globalisation, both of trade and finance, which would be very risky for a global economy. Despite this, however, financial markets are generally doing very well.

A representative of the public sector agreed that that phenomenon is 'a bit paradoxical'. Better indicators are being seen in the areas of activity, inflation pick up, core, and equity prices. However, there is a disconnect between this optimism and the very high level of political uncertainty. Political risk has been mispriced. >>>

>>> 1.2. Threats to trade, financial integration and international cooperation are increasing

According to this speaker, this disconnect includes issues like the complexity of Brexit, but most importantly, the potential consequences of a rise in protectionism and populism, and the trade tensions that might result. This is occurring in a difficult context, wherein there has been some rejection of trade and financial integration, and international cooperation. All of these have been very successful in creating growth in the global economy. Many emerging markets have tried protectionism and populism before, but it has never led to a positive outcome.

This speaker added that trade tensions could lead to ruptures to global value chains, for instance impacting large global corporations and retailers. This could have consequences for consumption and then investment eventually halting the recovery that is beginning to occur. There would be sudden stops of foreign direct investment and some deterioration of trade flows, which would affect financial stability, both globally and locally. There is a need to not be complacent about the current positive indicators.

In the area of financial sector risk, there is a different type of complacency: people tend to forget crises too quickly, and to think that removing regulation might boost creditor markets. Prudence remains necessary; good progress was made following the crisis on many aspects of the regulatory framework – capital, liquidity, and leverage – and these elements need to be implemented with a reasonable, positive mindset. Many studies from many international institutions for example the BIS have shown that stronger and better capitalised banks are the ones that benefit credit markets. There is a need to finalise regulatory reforms, and ensure that a robust, healthy financial sector is the best contributor to the real economy.

2. ADAPTING THE BUSINESS MODELS OF BANKS IN THE CURRENT UNCERTAIN ECONOMIC AND REGULATORY ENVIRONMENT IS CHALLENGING

A leader of the industry considered that their institution has spent the last few years implementing new regulation, and has learned a lot as a result. It welcomes the regulation much of which has been valuable. For example, the advent of stress testing, scenario planning and resolution planning have been significant positive developments and are important tools for treasurers. Also the increase in business involvement in properly managing risks, and escalation up to the board and back down through the organisation, has been incredibly positive.

The view taken by this speaker is that there is a need to bring the process of regulatory change to a conclusion, but it appears that it will continue. This is a challenge as the speaker's institution works for its shareholders, investors, staff, and customers. In doing so, it needs to build optimisation routines, and optimising returns for banks in the present environment, with all of the complexity that has been created by regulation, is difficult... Overall, good progress has been made in the area of regulation, but work on supporting the business strategy remains to be done, as well as being able to support that business strategy with optimisation models that prove that the decisions that are made are the right decisions for stakeholders. They would like to reach the end of the regulatory change process.

Although it is still quite early, it appears, according to him that the current global forces are trending away from consistency and towards divergence. This speaker noted that they are operating in around 40 countries, and it is difficult to keep up to date with 40 varying regulatory regimes at the same time. Although banks are told to simplify their business models and structures, the regulators, central banks, and regulation creates increased complexity and cost in the system, which ultimately also affects returns and makes optimisation exercises more difficult.

3. US FINANCIAL STABILITY ISSUES

A representative of a public authority explained that risks to the US are in the moderate or medium range, and has identified four broad categories. These are risks from low long term interest rates, and the risk taking behaviour that this encourages; risks that emanate from other countries and transmit to the US, particularly political and financial stresses originating in Europe; risks that exist in financial institutions, especially growing cyber security risks and the stability implications of these, which stem from the interconnectedness of financial firms; and finally data gaps. Without good data, it is hard to fully assess the risks that exist.

In relation to the risks from low long term interest rates, this representative of the public sector stated that when the Federal Reserve began its tightening phase, it was stricking the extent to which the media, press, and business analysts were talking as if the era of low interest rates had come to an end, and there was no longer any need to worry about these risks. At the present time, the Federal Funds Rate stands at 0.75% to 1%, and even with three tightenings over the course of 2017, it would only stand at 1.5% to 1.75%. That would be a historically low rate for any point in time, and certainly for this point in the business cycle. US long >>>

>>> term rates also remain very low, and the term premium on the 10 year treasury is 'almost non existent'. Although it is assumed that this will change as tightening continues, this official did not perceive much of an increase in that term premium during the last tightening cycle, and does not expect that it will necessarily increase this time, either.

As financial systems have become more globally interconnected, which will inevitably continue in the future, every time that political or financial stress occurs somewhere in the world, people seek safety through US treasuries. This has pushed down interest rates at the long end in the US, and the same thing has happened in this instance. This has benefited the US as the US did not need to take its policy rates into a negative range but it has also encouraged risk taking activity.

Although there has been discussion of the potential market reaction to a reduction in the asset holdings on the Federal Reserve's balance sheet, the Federal Reserve has only been following the steps it outlined when it first started tightening. It has been very clear that it was going to raise the policy rate first and taper the balance sheet later, and that it probably will taper by no longer reinvesting the earnings and instead leting maturing bonds roll off the balance sheet gradually. From public data on the distribution by maturity of the Federal Reserve's holdings, it is clear that not a lot will mature in the near term. Tightening will be a very gradual process, and the speaker does not expect it to have enough of an impact to offset the global pressures that encourage a 'flight into treasuries'.

4. THE STRUCTURAL VULNERABILITIES IN SEVERAL BANKING SYSTEMS OF THE EU

The Chair noted that for many years, the European Union has succeeded in stabilising the economy and growing further, and has made significant steps towards banking union, but there remain a number of 'hotspots' for financial stability in the EU.

A representative of the public sector stated that Mahmood Pradhan's statement the previous day had contained a lot of the points that they wanted to make. There is not much space for policy response in Europe in the event that things get worse, although this varies from country to country. Although Europe has returned to growth, the problem is ultimately not cyclical, although the cycle has made things worse. Some of the problems that Europe is confronted with are deeply structural, including the profitability of the banking sector in a situation where Europe is bank based. There are problems with banks' business models, to which bankers do not know how to respond. Issues of asset quality will take a long time to solve; stock problems of this magnitude cannot be addressed very easily. Stakeholders, private and public, should act sooner rather than later.

The speaker noted that if Eurofi had been meeting in August 1913, a year before the beginning of the First World War, participants would have thought they were still living in the Belle Époque, when the world was completely globalised. De globalisation took only a few months, and regimes that had existed for centuries were destroyed in the course of months. The lesson of this is that disruption exists historically, which is a fact that, to a certain extent, has been forgotten. Although European integration has led some to believe that history is linear, and things will always go in the direction of closer cooperation worldwide, in actuality history does not have a direction, and uncertainty is endemic.

The damage to trade integration is real, but the problem goes deeper: the sense of mutual trust among people and social groups is coming into question in our polities, which is something that no financial institution can really address. The decision makers in the room will need to consider how they can have dialogue with a society that is changing.

The Chair observed that this speaker had spoken about asset quality problems – the pockets of non performing loans that exist within some EU banking systems – and structural issues related to banks' struggles to regain profitability. However, one issue that is being widely debated is the excess capacity of the banking systems in the EU, which presents a formidable problem. This problem is similar to those that many economies faced in the 1970s and 1980s, related to traditional sectors like shipping and steel, which led to very significant industrial restructuring processes, high public expenditure, and large numbers of people losing their jobs. The Chair asked whether there is a plan to deal with the structural issues in the European banking system, particularly regarding excess capacity and the need to restructure, consolidate, and exit institutions.

The public authority representative replied that there is not a single plan for whether certain banks do or do not have a future, but there are rules and operational institutions. It is clear that banks that are continuatively not able to raise capital will need to be resolved at some stage. Banking is not the stable source of employment that it used to be until the 1990s; the number of banks will need to be reduced.

5. WILL A SUDDEN SURGE IN YIELD TO BE A MAJOR RISK?

A public authority representative stated that they are not expecting much of an increase in >>>

>>> interest rates, but nevertheless, this is a risk. The search for yield in the US has led to elevated equity and commercial real estate prices, and a high – and rapidly growing – stock of US non financial corporate debt. Their institution has concerns about the risks that banks and insurers have taken on, and how mass investors might react to a surge in yields. Although there would be benefits from such a surge, including to retirees, their institution has been warning for some time about the duration risk that some institutions have taken on.

An industry representative added that it is hard to imagine rates increasing at a fast pace or to long run historical average levels without meaningful inflation. At the present time, a large number of structural factors are leading to low levels of inflation, including technology. Technology is having a major impact on jobs in the corporate sector: the entry level jobs that from the last few decades are disappearing. While structural shifts in energy and technology, e.g. robotics, will lead to significant job growth, it will likely be in different sectors and with different skill requirements. There is a lot more pressure on productivity in the economy in the sectors that used to support growth than is widely recognised which will likely persist until new sectors absorb and replace, which could cause rates to remain structurally low for some time.

Much attention is being paid to the last crisis, and what caused it. Through models, stress testing and infrastructure since the crisis, there is now very good capability to understand what will happen if rates, or property prices, increase or decrease. The industry representative feels that more focus should be paid to identifying the risks and understanding the shifts that would result in these variables changing.

Another panel member from the public sector added that it is necessary to manage expectations regarding markets in a very skilful manner; central banks have been doing this. However, monetary policy was never intended to be a substitute for productivity, or for growth enhancing policy, and these two processes need to occur simultaneously. Communication strategies need to be appropriate, which is happening in the US during their process of normalisation, but at the same time, conditions need to be created to enable the productivity and growth that will support an increase in activity.

6. EMERGING ECONOMIES NEED TO ADAPT TO A LESS SUPPORTIVE EXTERNAL ENVIRONMENT

The Chair noted that there had not yet been much discussion of emerging markets. These could be significantly affected by headwinds coming from advanced economies; however, emerging markets have represented between 60% and 65% of global growth in the last few years, and have been a source of strength for the global economy.

A public authority representative stated that emerging markets will need to learn to operate in the new context, and will need to address some of their structural issues, including governance problems; a lot of them are doing so. Previously, because of the abundance of liquidity, many jurisdictions exhibited a tendency to get over indebted and benefit from very large inflows of easy money coming from advanced economies. This will need to be reversed in a way that does not create financial stress, or financial crisis. Emerging markets know from past crises how to deal with open economies, with what is called the 'impossible trinity'. Now, they will need to learn how to disengage from this period of unconventional monetary policy and very easy money.

CONCLUSION

Summarising, the Chair stated that five themes had arisen from the panel session; the first is uncertainty. There has been an emphasis on political uncertainty, including geopolitical risk, but also the risk that politics might compromise the open, free trade and finance environment that has prevailed in the past. A potential de globalisation of free trade and finance would be a negative shock, and should be avoided; the ability of policy to address negative shocks is now much more limited than in the past, and political problems will need to be solved via political means.

The second theme is complacency, and if markets are too complacent, there may be a need to face the risk of market corrections.

The third theme is that many of the problems Europe faces are deeply embedded, requiring work that goes well beyond monetary policy, and achieving stronger growth will require a large number of structural reforms including on the financial side. Regarding the structural reforms in the banking area there will need to be coordination between the private sector, which ultimately takes the decisions, and the public sector, which needs to put together a 'road map'; at present, there is not a clear road map in Europe.

The goal also needs to be a better global policy mix that allows for an exit, in a reasonable manner, from the very low interest rate environment.

The fourth issue is banks, which remain central to the concerns that exist. Many are experimenting with, or experiencing, very difficult transitions in their business models. There is now a three >>>

>>> tier banking landscape: the first tier is the American banks that adapted best after the crisis, and were the first ones to accommodate their business models. The second is European banks, some of which are struggling, especially those located in very low growth economies, and the third is emerging market banks, which have continued to do better but still face some challenges.

The final issue is regulatory uncertainties. When the Chair was working in the public sector, they had thought that this issue was over emphasised, but they have changed his mind, particularly in the light of the changes brought in by the new administration in the US, which have introduced wholesale regulatory uncertainty. It is important that cooperation at the global level between different countries, which has been critical in making the financial system a safer place, is not undermined. There is a risk of endangering multilateralism, which would be a significant public bad news for the global economy, and the Chair expressed the hope that Basel continues to play its role of international coordination. ●

Priorities for progressing towards a single banking market

Sylvie Goulard - *MEP, ECON Committee, European Parliament*
Per Callesen - *Governor, Danmarks Nationalbank*
Antonio Carrascosa - *Board Member, Director of Resolution Planning and Decisions, SRB*
Andrea Enria - *Chairperson, European Banking Authority*
Erkki Liikanen - *Governor, Bank of Finland*
Xavier Musca - *Deputy Chief Executive Officer, Crédit Agricole S.A.*

Preamble: The benefits of a single banking market

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

Better EU financial integration should also enhance competition and broaden the access of customers to credit and new financial products. In addition, better integration would lead to enhanced risk diversification. Thus, EU banks would benefit from eliminating legislative differences and harmonizing supervisory practices. Moreover a single banking market would improve private risk sharing – that is if banking markets are integrated in such a way as to help companies and households cushion domestic bank shocks.

A representative of a public authority stated that the issue of risk sharing is critical; there must be a clear separation between financial markets and public authorities. One of the main aims of a single European financial market is for financial markets to share a larger amount of risk, as happens in the United States. As such, this speaker does not understand why some politicians are against creating a single market of financial services; this would promote risk sharing in the European area and make political leaders' positions easier, whereas if these developments do not occur, risk remains the responsibility of their country's taxpayers. A true single market with strong European authorities and clear legislation makes it possible to have Europe wide institutions that operate across >>>

>>> borders, and can also share risks. If this is not permitted, the taxpayers in their member states remain responsible.

Another public authority representative added that if Europe wants to increase public risk sharing instruments and share taxpayers' money (i.e. temporary fiscal transfers), doing so will remain difficult for a very long time, and can only be envisaged on a case by case basis. However, if the goal is to develop private risk sharing mechanisms – i.e. an attractive EU banking and financial environment including efficient insolvency legislation and practices – there will be true risk sharing, and this is easily feasible. In this perspective, the breaking of the sovereign bank loop will notably be required to improve the integration of the EU banking market, and more will need to be done to diversify banks' holdings of sovereign debt, in order to have a truly single system.

The public authority representative added that they envision Europe reaching the point of being a true single market, with more cross border banking than presently exists. They hope that Europe can create a solid banking system whereby banks are decoupled from their national sovereigns, but also one in which banks fail and are resolved on a regular basis, because that is the proof that a competitive market exists. This representative commented that they wish that Denmark was part of this grouping, including the SSM and Europe, but achieving political consent for this may take some time.

Reversing fragmentation would be an additional expected benefit from the single market potential. This "de-fragmentation" would contribute to breaking the 'vicious circle' between banks and sovereigns, and improve the resolution of banks, which would therefore reduce the risk of taxpayers' money being involved in bail outs. These are the reasons why the priority is to make the Banking Union effective and to keep the development of supervisory practices in the Banking Union well connected with the EU-wide convergence agenda.

Introductory statement

The Chair stated that they are glad to be able to moderate a panel on this subject: fragmentation remains an important issue in relation to the financing of Europe's economy. Whenever the Chair takes the floor at Eurofi, they always attempt to give the audience a sense of where public opinion stands, and is always struck by the fact that many of Europe's citizens do not believe that European institutions have done much to frame banking activity and make it useful to the real economy. When the Chair is not at Eurofi, they are defending the necessity of having a sound finance sector, but this is an important issue; in some countries, it is felt that what Europe has done has not been appropriate.

Europe tackles issues step by step; the first step in this context has been the de Larosière report. First the authorities were created, then the SSM, and then the resolution layer was added. The CMU project is also related to how the relationship between banking intermediation and markets is conceived, but an element might be missing from this. This is the broad, strategic vision of the direction that Europe wants to go in, and the Chair would encourage participants to take a perspective that allows them to reflect, and maybe to go back and consider what has been done.

Participants were also encouraged to look at the future from a medium and long term perspective: not what is going to happen, and what is in the European Commission's pipeline, but what kind of strategy they want to develop. Enough people will focus on the flaws and the difficulties, but the Chair would invite panel members to be positive and make proposals, looking at the future as something that they share and in which they will want to do things in common. Even if Brexit means that a part of Europe is leaving, the rest of the EU 27 aim to stay together.

From a neutral, legal perspective, Brexit changes a lot. The Chair stated that they remember when they were one of the rapporteurs on the SSM and the Resolution Board; it was clear that the tendency to make a distinction between the 'ins' and the 'outs' of the euro area was very strong. Now, all 27 EU member states are legally committed to join the euro, apart from Denmark, and Denmark is very close to the euro, as the krone is linked to it.

1. MUCH HAS BEEN ACHIEVED

A representative of a public authority noted that, 10 years ago, Malta was fully in the process of preparing itself to join the euro; it adopted it on 1 January 2008. Turbulence occurred in August 2008, and uncertainty remained even once the ECB and the Federal Reserve had provided liquidity to the banks. In September, following an informal Ecofin meeting and evening dinner, Jean Claude Trichet informed everyone present that a meeting would take place at midnight; this had been when Lehman Brothers had been in difficulties. It has since become clear that Jean Claude Trichet called Tim Geithner early on the Monday morning, and had asked him whether the Federal Reserve had 'lost their minds', having let Lehman Brothers fail and risking a global panic. Tim Geithner's attitude had been that they had not done so on purpose, but had come >>>

>>> up against the limits of their authority and the fears of British regulators.

In the summer of 2012, a summit took place, wherein European leaders demonstrated enormous commitment and a long term vision in the decision to create the banking union, including the SSM, the SRM, and Deposit Insurance. The European Commission, the Parliament and the Council worked with extreme intensity and effectiveness to conclude these projects. Also in 2012, Mario Draghi gave a famous speech during the London Olympic Games; the 'Whatever it takes' speech'.

It now needs to be asked what has been achieved since 2012. Firstly, the banks are better capitalised. In 2012, many banks' real capital stood at about 2% of their balance sheet, but now, these amounts are three, four or five times higher. Banks have more liquidity, which is a major change.

Secondly, everybody agrees in principle that no bank should be too big to fail, and while it is possible that not enough has been done in this respect, a lot has been done. Major steps have indeed been taken at unprecedented speed over the past years to establish the Banking Union. After a comprehensive assessment of all significant credit institutions in the Banking Union, the Single Supervisory mechanism was fully established in 2014 and the Single Resolution Mechanism has become operational in 2016.

Thirdly, macroprudential schemes are now functioning in all countries. This is not enough, but it represents a lot of progress.

2. MAKING THE BANKING UNION A REALITY

2.1. Fragmentation is still an issue and the cross border banking activities have not been restored

An industry representative stated that since 2008, two developments have stood out: the first is the dislocation in the European market. From an examination of the figures, it is obvious that the flows from European banks to foreign entities outside their own country have declined quite markedly. Cross border operations in the banking sector have declined, and are still declining. Without the ECB acting as they did, Europe would have suffered even more, as occurred in 2011. At this time, there were huge spreads in interest rates between the different countries, and SMEs in Spain, Italy, Germany and France were suffering from very large differentials in interest rates. This has been reduced thanks to the ECB's intervention, but has only been achieved by extreme measures. There is still a question of fragmentation; the issue is how to resolve it.

A representative of a public authority added, regarding fragmentation, that there are clear signals that in around 2011 to 2012, there was a significant deterioration in all the indicators of integration, price and quantities: i.e. cross border flows and interest rate differentials. To some extent, following banking union, these reduced in their price dimension, but cross border flows are still not present. There has been a significant retrenchment, and cross border banking has not yet returned.

2.2. EU cross- border groups do not operate in a single market

2.2.1. The lack of single-jurisdiction status

An industry representative stated that the lack of single-jurisdiction status – or the multiple national jurisdictions – penalises banks operating across the Eurozone and impedes greater risk diversification. Cross border banks can face additional liquidity and capital charges on their subsidiaries located in the euro area. These additional prudential requirements imposed by national authorities ring-fence national markets and are very detrimental. They fail to recognise the new EU financial architecture and fail to recall the mistakes made during the 2008 crisis: opacity, complexity and fragmented supervision worsened the crisis.

2.2.2. The example of the NSFR

The industry representative continued, taking the example of the calibration of the NSFR. The first question is whether Europe should translate the NSFR into its legislation if the United States do not. The second question that has puzzled this speaker is the proposal to translate NSFR into European legislation not on a consolidated level, but on a solo basis. This indicates that Europe does not believe that cross border banks are able to transfer liquidity from one country to another in less than a year, and therefore sends the message that although Europe claims to be in a Banking Union, it is not in practice. The industry representative also asked why a solo basis approach is being imposed on EU regulation that has in principle to be done at the consolidated level: MREL or Pillar 2 requirements.

2.2.3. Additional capital charges for systemically important banks regarding their cross-border Eurozone exposures

The industry representative added that another symptom is the treatment of additional capital charges for systemically important banks related to cross-border euro area exposures, which are still considered as international exposures from a regulatory perspective and which hinder >>>

>>> cross border consolidation. Although Europe claims that it wants cross border activities and pan European banks, politicians' minds are not made up; they say they want these things, but do not deliver them in the regulation and in the legislation, because national governments want to pre position loss absorbing buffers in their countries.

From past experience, the industry representative believes that some supervisors and regulators will respond to his statements by claiming that they are exaggerating, as the possibility exists to grant waivers on a case by case basis. The speaker would like this logic to be inverted: it should be assumed that no solo requirements applies within the Banking Union for consolidated banking groups unless there was a compelling reason otherwise, with the burden of proof on supervisory authorities' side. As a G SIB, the speaker's institution is penalised because of its presence in different Eurozone countries, which the industry representative does not understand: JP Morgan is not penalised due to its presence in both New York and Los Angeles. To achieve a true Banking Union, there does not need to be any legal change, or transfer of sovereignty or money between countries, but it does require a clear and voluntary approach to be taken by all the authorities present. They are sure that this willingness will materialise.

2.2.4. Internal MREL in the euro area: an obstacle to cross-border banking

According to a public decision maker, internal MREL arises from two different topics. In the case of the Eurozone, as there is a single resolution authority, decisions on resolution do not need to be coordinated by individual member states. However, there are other reasons to set the internal MREL, such as whether something is related to the resolvability of the entity and the existence of subsidiaries. If a particular bank only had branches in Europe, then given the existence of a single resolution authority, there would be no need to set internal MREL. The problem is that this bank also has subsidiaries, and there is a need to comply with the requirements of upstream losses and downstream capital in the event that there is a problem with an entity. There is also a need to comply with the 'no creditor worse off' principle, so that the creditors of the parent cannot be worse off as a result of resolution than in liquidation. This is not only a problem of authority, but a more complex problem.

The industry representative replied that these are good arguments, but ultimately, Europe needs to decide whether it wants cross border banking or not. They understand the technical reasons why their institution has a Pillar 2 on its subsidiary in Italy and on its activities in France, but there comes a point at which Europe has to take a step forward, trusting other countries and relying on the authorities that have been set in order to resolve the problems.

Regarding the NSFR, there are a lot of good arguments, but what is underlying these arguments is the desire of national authorities to maintain their role. As a banker, this industry representative wants the Eurozone to be considered as a single constituency; otherwise, it is not clear why so many efforts to move towards a single monetary union and banking market were made, if companies will not be able to realise the benefits of doing so.

The Chair added that one simple point that is worth emphasising: what is often presented as national interest might actually be the interest of a small group of people in European countries, fighting against the general interest of the population at large.

2.2.5. Subsidiaries or Branches: does one size fit all?

A representative of a public authority stated that they will take the points made by the industry representative on board. They added that there needs to be more simplicity within the euro area: they are from a country that has seen 'branchification', because two banks have had subsidiaries systemically imposed on them and have been operating in Finland. Now, they are moving subsidiaries into branches, and their headquarters are outside the euro area, but they are systemically important inside the euro area. As such, this issue should be able to be solved within the euro area, where the same supervisory and resolution mechanisms exist, but entities that have headquarters and branches outside the euro area complicate this issue.

Another public authority representative stated that the main impediment to applying the same rules that exist for subsidiaries to branches is the complexity of legal structures, which need to be fixed. Simplification is a growing issue: there are a lot of complexities in the system. If banks were very well capitalised, with a resolution system that they trust and implement, then regulators do not need to run the business of banks to the same extent as they do today, with lots of detailed rules and red tape. Europe has not reached this stage yet, but part of regulators' vision for the future is to move in that direction.

2.2.6. Pillar 2 capital add-ons are still used by national supervisors, notably to address macro prudential risks, which contributes to financial fragmentation

A public authority representative stated that they are very sympathetic to many of the arguments that the representative from the industry made. >>>

>>> Macro prudential tools is an area that is of concern; they believe that, when the de Larosière report proposed macroprudential policies and tools, this was on the basis that these policies need to be different in different locations, but they could be done at the European level. There could be a common European system in which the tools and levers to be pulled in the event of a build up of risks in a certain region of the economy are defined.

But , in reality, having 28 macroprudential authorities has meant that several types of risk, such as the build up of a bubble in the real estate market, would be tackled using very different tools, including higher risk weights or floors to Loss Given Defaults (LGDs) in internal models and requests for loan to value ratios. To some extent, this also generates a problem with the functioning of the single market, even in such an area as the comparability of ratios across countries. Europe needs to now come up with some streamlining that is more 'European' minded'.

The Chair noted that the revision of the ESAs will come soon, which will be a good opportunity to act on this.

3. THE CAUSES OF FRAGMENTATION

3.1. At the beginning of the crisis, Europe has chosen to go the national route, which has generated segmentation

A public authority representative stated that the main drivers of fragmentation have been the decisions that have been taken in the European Union; they are particularly thinking of two instances. The first took place in 2008, when the financial crisis represented a systemic crisis for the whole of the European Union. At the time, there was a proposal from the Dutch finance ministry to set up a common European bail out fund, but this proposal was rejected, as the prevailing thinking was to deal with this on a national level. There has been a clear decision to take a national approach to dealing with the crisis.

The second moment was when the European Financial Stability Fund began to intervene during the sovereign debt crisis. It was decided not to have an intervention to support the restructure of the banks at the European level, but to give the money to the member states and to have national initiatives to restructure the banks. The consequence of this was that the restructuring occurred mainly on a domestic basis.

There is now a third stage: Europe now must deal with the cleaning up of the banks' balance sheets, and with legacy assets and the NPL issue. The public authority representative has tried to put forward a proposal to take a European approach to these challenges, but it is their understanding that this will be difficult; national solutions will probably be opted for. At every stage at which the legacy of the crisis has had to be addressed, Europe has chosen to go the national route, which has generated segmentation.

Mutualisation of losses has never been proposed. An interesting paper has been produced by Daniel Gros, which compares the way in which the banking crisis has been resolved in Puerto Rico and Nevada in the US, and in Greece and Ireland in the EU. These are very similar in terms of size and the types of problems they faced; however, in the US, the FDIC entered the banks, identified the losses, and then sold the liabilities and the good assets to banks from other states, which was exactly the private risk sharing that is required in a resolution. Customers did not even notice that this had happened. In the European Union, however, this was done entirely at a national level, and it is therefore unsurprising that the EU is exiting the crisis with in a more segmented environment than it started with.

Another public authority representative stated that they, and others, struggled to prevent what happened during the crisis before it took place. Since this time, this person has been very impressed by the institutional changes that have taken place, particularly in relation to two issues. At the time of the crisis, frank discussions took place between honest people about whether or not risk diversification was a good thing; the argument against was that, with a lot of risk diversification, there would also be a risk of contagion. This demonstrates the extent to which the thinking was on a national level, in terms of supervision and resolution. Other people, including the speaker, argued against this perspective, and now, they do not hear many people question the need for more diversification.

The second issue is that Europe pretended to have a resolution system, called 'constructive ambiguity'. However, this was neither constructive nor ambiguous: there was only one way to resolve a bank, and that was via a bailout, as banks could not be allowed to go bankrupt. This creates too many distortions in markets, and Europe did not have at the time the equipment that it has today, with ordinary resolution and bail in tools.

3.2. Problems related to legacy assets are increasing, because the right measures were not taken on time

A representative of a public authority stated that there is also an issue with market fragmentation and the different attitude of authorities. >>>

>>> In Europe, some authorities tackled the problem of the banking crisis in 2008; others did so in 2012, and others are trying to do so now, or in the coming years. Problems related to legacy assets are increasing, and this is probably because the right measures were not taken on time.

4. SHORT TERM PRIORITIES

4.1. Completing the Banking Union and simplifying the EU macroprudential regulatory framework

A representative of a public authority stated that there remain steps to take; the first is to complete banking union, and the European Deposit Insurance Scheme (EDIS) will be critical to this. A common EU backstop for the Single Resolution Fund (SRF) also be secured if Europe wants to reap the economic, financial and political benefits of a Banking Union. This means de risking in parallel, so that all parties are on the same level. NPLs also need to be reduced to make sure that everyone is on the same footing. The legislation that was accepted at the time also needs to be reviewed: much of it is extremely complicated, with too many options and possibilities for national discretion. If there is to be a truly European financial market, this requires everybody to work to the same rules. Europe should also simplify its macro prudential regulation, and the EU Commission should make proposals in this respect.

If this can be achieved, it will mean the creation of the Deposit Insurance Scheme in the long term, the reduction of NPLs, and the simplification of legislation that will create incentives and possibilities for the true single European financial markets. This also requires European banks and financial institutions that operate across borders. Although this is the short term agenda, there is no need to be shy in describing how much Europe has achieved over the course of the past nine or 10 years. When the speaker was in Brussels in the 1990s, the largest move towards a single market came into effect in 1993: the Delors programme, which dated back to 1986. The issue of Banking Union is the second biggest step that the EU has ever taken, but it needs to be seen through to completion.

4.2. The quicker Europe can address the NPL challenge, the better

An industry representative stated that resolving the issue of NPLs is crucial in order to restore a well functioning monetary union and single market. The proposals made by a previous speaker would be steps in the right direction, but the main issue is that of timing. NPLs is a legacy issue in a lot of countries, and the quicker Europe can address this, the better. Europe is at a point at which its economy may rebound, and this seems like a good opportunity to solve this problem as quickly as possible. Doing it at the national level may not be the ideal solution, but is the more rapid solution, and the industry representative commented that they have no 'vested interest' in this. They hope that the national authorities involved in the process – the European Commission, the ECB, and the resolution authority – will find the necessary flexibility to deal with this issue.

Part of the problem also arises from the division of labour, which has been too high between the different levels and authorities (SSM, SRB, EU Commission, and National Authorities). Rules, and in particular the bail-in rules, have been applied too rigidly and are somewhat rigid themselves. Political impetus, trying to bring all these authorities together and put pressure on them to solve this issue as quickly as possible, would be welcomed.

A representative of a public authority noted that they had previously believed that the biggest remaining issue in banking is NPLs, but having listened to the previous day's discussion on the "Priorities for relaunching the eurozone and the EU-27 projects", they have become convinced that finalising and implementing a resolution system may be even more important. Without a comprehensive resolution system, Europe will remain fragmented; there will be a very strong link between national governments and banks, and there will not be any risk sharing because, if Europe has a system that relies on bail outs, there can be no risk sharing other than that shared by the domestic taxpayer. This will not lead Europe in the direction of elevation. A lot of progress has been made: Europe has created legislation, and communicated that a solid system is in place, but there is reluctance to implement this in full. The public authority representative noted that they are not talking about specific cases, but the way that people talk about the BRRD is of concern.

Regarding the question of NPLs, there are a lot of issues, but one of the most important is that of insolvency regimes and how efficient these are. If the administration problem with NPLs was contained to the banks, benefits might arise from selling the bad loans to an asset management company, if they had a greater capacity to deal with these issues than the banks themselves. It could be asked whether the banks should continue to be banks if they are not capable of managing NPLs: bank lending is a normal feature of doing banking business, and banks should be capable of managing this.

However, if the problem is the judiciary system and its efficiency, selling off these loans will not >>>

>>> necessarily be very helpful, for two reasons. The first is that the asset management companies will obviously price these loans at a very low rate; otherwise, they cannot recoup their outlays. The second reason is that, even if banks were to sell off their NPLs, if it is clear that the judiciary system is inefficient, this is a broader issue than just the legacy: questions arise of who will provide lending from within the country, out of the country and from cross border banks if access to collateral is extremely difficult or slow. These insolvency regimes are a significant part of the issue.

4.3. The implementation of the EU harmonised resolution framework would reduce the level of fragmentation

A public authority representative stated that if the topic is market fragmentation and NPLs, the regulatory framework already exists to tackle all these topics within the BRRD and the SRM regulation. The challenge now is to comply with these regulations, and to implement the measures included within them. A previous speaker mentioned the problem with NPLs; Europe now has a resolution tool, the asset segregation tool, which it can use for the purposes of resolution if necessary. The best way to combat market fragmentation is to decouple the sovereign banking loop: i.e. not to use public money in the bail out of banks. In reality, there are cases for resolution that do not employ the measures and tools included in the BRRD. Europe has a way of avoiding the use of public money and delinking the banking and sovereign loop. However some authorities prefer to use different instruments and public money.

A very large problem at the present time is that of the credibility of the regulations, the frameworks, and the resolution framework that was approved three or four years ago. Europe needs to bear in mind the consequences of a reversion to the banking and sovereign loop.

The Chair commented that they sometimes wonder whether Europe actually accepted the bail-in agreement: the debate in some member states shows that the decision has been taken to move 'from bail out to bail-in'. Taxpayers do not want their money to be used anymore, but some people want their minister to intervene nevertheless, if there is a problem.

4.4. Europe needs to demonstrate that the single banking market can be delivered for the EU as a whole

A public authority representative noted that, in the event of a crisis, it is the national taxpayer or national policy choices that are relevant, which gives strong incentives to national authorities to try to maintain the capital and liquidity available in their jurisdiction, rather than to allow these to flow freely within the single market. It is therefore necessary for Europe to deal with this issue; the first interventions, which have put the emphasis on the resolution side, have been the correct approach. There is a need to fix the link through recovery and resolution planning and create a credible method for failing firms to exit the market. Once credible means exist of dealing with a cross border group in a crisis, there should exist an incentive to begin retrenching the prudential measures that now require European states to lock capital and liquidity into individual jurisdictions. This is a high priority, because Europe needs to demonstrate that the single market can deliver for the EU as a whole.

Both in the resolution and in the supervision area, the speaker has seen a number of people indicate that they wish to maintain even pre positioning of a loss absorbing capacity in individual entities and Pillar 2 requirements on individual entities, sometimes even within the euro area, which is 'puzzling' from a long term perspective. There is also a need to reconsider the way in which Europe takes decisions; for instance, the speaker's board has engaged in a lot of mediation, and some discussions regarding the breach of union law, but these issues are ultimately decided by all of the national authorities taking a final decision.

All of the mediation cases that the public authority representative has dealt with have been positive, but given the way that the legal framework is set up, the host authorities can always take their own decision. This means that, in mediation, sometimes there is an agreement to crystallise segmentation or to let everybody take the actions that they think are required in their own jurisdictions. With these decisions, Europe should try to have more decision making take place on the European level, rather than allowing this to be only in the remit of the national authorities, although the EBA should not necessarily decide; there could be an independent panel, for instance. Joint decisions should work more for the single market, but this has not yet been achieved.

The Chair added that European decision making processes need to include a national level, but not everyone should be locked into a national perspective.

4.5. Recognizing risk diversification in the EU banking regulatory framework

An industry representative stated that when an entity acts as an insurer when present in different >>>

>>> countries, it has lower capital requirements, as a result of the benefits of diversification. When it acts as a banker when present in different countries, it is penalised, because it is believed that it will be more difficult to resolve, and therefore more capital is required of it. The industry representative would like some progress to be made in this area.

Regarding the issue of 'transition' versus 'steady state', one public authority representative agrees that resolution legislation is generally well done. This will be ideal for the steady state, when there is a well functioning supervisory mechanism and resolution regime, but transition is not easy; it represents a significant change, and very often in European legislation, there is have a transition period and a steady state. Although authorities should act swiftly, there need to be special national efforts to put all the banks and international institutions on the same footing, to progress ahead with European integration. ●

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Prospects of global financial regulation following the US elections

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Alexander Wilmot-Sitwell - *President EMEA, Bank of America Merrill Lynch*

1. THE OUTLOOK FOR GLOBAL FINANCIAL REGULATION FOLLOWING THE US ELECTIONS IS UNCERTAIN

1.1. The priorities of the FSB for 2017

A public authority representative stated that their organisation is reaching the end of the policy work to address the fault lines of the crisis and are seeing progress in implementation in many of the finalised areas. Their attention increasingly turns to evenness and assessments of the effects of the reforms. Meanwhile, they are focused on a number of other emerging risks and vulnerabilities, some of which the G20 has asked them to address.

The speaker's organisation's priorities for 2017 are: to conclude Basel III; finish their work on the CCP; and to have the recommendations issued on asset management activities operationalised. There is business to do to complete guidance on internal TLAC, and the speaker's organisation is looking into regulatory and supervisory issues that merit the authorities' attention in fintech. The policy work of covering large areas is drawing to a close.

1.2. The difficulties in pre judging what the new US Administration will do

A public authority representative pointed out that their organisation has not yet seen, in their work processes, the issue of the US retrenching from international cooperative activities. The US administration had the opportunity to signal if it wanted a break from all of that at the recent Baden Baden G20 ministers' and governors' meeting. Whilst the US made it clear that they have differences from previous commitments regarding trade and climate related issues, all of the elements that relate to financial reforms remain in place and were not contested.

The US remains in the process of putting in place its review under the new executive order, and it >>>

>>> would be wrong to speculate on the output of that. Much of the focus is on a number of US specific issues, and global regulatory reforms are not the primary focus of that review. Caution is advised on speculation over what may happen now.

A representative of another public authority responded that they have participated in two international gatherings since the new administration took office, in Cape Town and Baden Baden. In both cases the US told Europe to take time, take precautionary positions and not to prejudge what the new administration will do.

The new administration has been extremely cautious but is clearly backtracking from the position of the Obama Administration. However, they made it clear that they wanted to leave room for their authorities to decide on the course of action, once settled. At the same time, they insisted that they would maintain the regulatory dialogue that was meant to take place last week. It took place and was very engaged and productive but It is too early to draw definitive conclusions about any positions that the new US administration will take at international fora.

The moderator questioned whether there ought to be concern that in the last G20 discussion, the US was unable to accept any terms formulated against protectionism. He asked whether it was a passing phenomenon or a serious retrenchment from global multilateral institutions. He reminded the audience that the WTO dispute settlement process is a vital piece of the global multilateral system.

A public authority representative emphasised that the US delegates made it clear that the changes they have requested to various documents were precautionary. However, the representative confirmed that they are concerned, have questions, and think it would be disastrous for the US to retrench.

However, when an individual has access to power, they tend to realise that issues are more complicated than they thought; Donald Trump could currently be learning that. The biggest power in the world may think that multilateralism is not in their best interests, but it offers other advantages. There are positive externalities in that, to which the US may be awakening.

An industry representative agreed with other panellists that it is too early to say what the new US administration is going to do. The media speculation will be misguided, exaggerated and flawed. They will not do away with all regulation. More harmonisation with level playing fields for global businesses is better because it makes the lives of regulators easier. A single set of rules is easier to establish, implement and manage.

The representative was also pleased to hear that the WTO rules are useful because the UK, alarmingly, may need to fall back on WTO rules for its future existence.

1.3. Global business needs global rules

At the 2009 G20 summit, following the global financial crisis, governments agreed to support a vision of greater regulatory harmonisation and co-operation across the world's financial sector. Eight years later, most of the regulation intended to prevent similar financial turmoil occurring again is now either in place or close to implementation. These positive initiatives have undoubtedly helped financial stability, notwithstanding that there could have been greater efficiencies in their delivery. A banking representative stated that unfortunately one theme that comes through in everything that has been discussed is potentially the greatest missed opportunity in the post financial crisis world: the failure of global harmonisation of rules and regulation. Global businesses require globalised standardisation of rules. Not having them increases complexity, lack of consistency and the costs of doing business. The extent to which those rules continue to fail to harmonise will only exaggerate that missed opportunity.

The comments about America against the UK and Europe are alarming thoughts in terms of achieving an appropriate degree of convergence and harmonisation, and that applies to Basel. It is critical that, as much as possible, the EU should ensure international consistency and adoption of those rules. Failure to do so risks significant unintended consequences.

Ultimately, global rules make the financial system safer, and they underpin the level playing field that is needed for free trade, competition and growth. Financial stability has been created and it is critical that that should be maintained. The concern about a race to the bottom is real, but is unlikely to pose a great risk. It is the responsibility of everyone to ensure that the achievements made over the last decade are reinforced, maintained and preserved.

1.4. Consistent implementation of global rules is crucial

The moderator explained that they did not want to rely solely on the WTO, but stated that it being a multilateral institution is useful in itself. It has the precious jewel of a disputes settlement >>>

>>> system, which has provided a vital safety valve during periods of economic stress. The WTO can take a great deal of credit for the lack of overt and deliberately protectionist measures. A rules based system like that has an important role to play.

The moderator had tried, whilst previously working for a public authority, to tighten the decision making and make it more obligatory. The representative had not seen, nor did he expect to see, support from the US. The representative noted that the FSB have no legal powers to enforce. If the EU does not apply the Basel rules as intended, there is little the FSB can do, which is a major problem in global financial markets.

A public authority representative stated that the solution is unknown. The pressure comes from where the shoe is felt to be pinching. The institutions operating internationally feel the pressure of a lack of harmonisation of rules. However, the market needs to be realistic and to distinguish where harmonised rules are absolutely needed. A piece of infrastructure that operates across borders clearly needs international governance and clear rules that everybody commits to observing.

In other areas the market needs to accept that it begins with a correct understanding of the principles that all should abide by in regulating the system and/or achieving levels of resilience in that system. In banking and other areas, the traditions of corporations have lasted longer, gone further and achieved more. In other spheres, it is still developing. There is the capacity for other regulators in the conduct, market oversight and other areas to progress, and it is hoped that that will happen over time.

A representative of another public authority stated that peer pressure is important. The representative recalled when adopting Basel III that there was a Regulatory Consistency Assessment Programme (RCAP) by the Basel Committee with which the European Union was found materially non compliant. That prompted a healthy reaction from the European Parliament to say that it is fine, that it is important to have global standard setters, and they have been elected to make rules in that jurisdiction. It is never good to deviate from the rules because it means that the case was not approved in the first place. Sometimes it is necessary in pursuit of common standards, but the structures of financial markets in general, and banking sectors in particular, are very different.

It is difficult to have common sets of rules that make sense everywhere. It is possible, but requires good will and also that everybody should understand that standard setting is not an offensive arm in terms of trying to boost the competitiveness of one's players against the others.

A representative of a public authority agreed that it is important that the work be implemented, and done so consistently. It would be a travesty to step back from what has been achieved. The speaker remains optimistic that that it will remain in place and that its value will be recognised increasingly strongly over time.

An industry representative suggested that the inconsistencies could be resolved by an international treaty, but that is unlikely to happen. Instead, everybody should support the global standard setters by giving them as much authority as possible within the different political systems. A representative of the banking industry is not convinced that that will happen.

1.5. Europe knows what they want

A public authority representative stated that the EU's position is clear. It is crucial that the degree of international commitment should remain strong, particularly for the biggest players. The EU has seen how instrumental G20 standards and the Basel Committee have been in fighting the crisis and recovering, and these standards are only good to the extent that they are widely and faithfully implemented across the world.

They are also important because there are the sole basis for what Europe calls 'equivalence' and others call 'difference' or 'substituted compliance'. It provides a benchmark upon which Europe decides whether they can trust a foreign jurisdiction to manage part of, sometimes important, risks. The same goes for foreign jurisdictions vis à vis Europe. Without global standards, there would likely be no meaningful equivalence or substituted compliance policy. It is essential for the industry to work in an environment that is not too fragmented. There are enough sources of fragmentation; individuals ought to avoid adding more.

A national public authority representative noted that although Europe knows what they want, they do not yet know what America wants. It would be unrealistic to expect any decisive breakthrough before next fall. Europe needs time for friendly and difficult discussions aimed at transatlantic clarification.

Europe has three clear wishes: first, to stabilise banking rules; second, to progress decisively with non banks; and third, to preserve the existing international rules. Everyone should agree >>>

>>> with the first wish. The need is urgent and also requires the completion of Basel III, if possible. It would mean two conditions: first the agreement should be without a significant increase of overall capital requirements (this is clearly written in all the G20 communiqués); and second, Europe wants to keep a system that is models based on risk sensitivity. The purpose of the completion of Basel III is to reduce the unwarranted variations of the models based result; but should not to introduce a standards based approach. They have to accept an output floor, but it must remain a backstop and must not be the general rule. Amongst the stabilisation of banking rules, the November banking package from the Commission is globally thought to be appropriate, so should be implemented as quickly as possible.

The second wish, on progressing decisively on non banks, is mainly for the FSB. There are two priorities: first is asset management. Rules are needed for asset management (especially on liquidity) that differ from the banking sector. Second, there are CCPs, which clearly belong to Europe's FSB priorities in quarters to come.

Regarding the third wish, on preserving existing international rules, everyone no doubt agrees for two reasons: first, that although better and more could be done, international and domestic regulators have delivered an impressive and fairly consistent job; and second, that the US going backwards on international standards would be bad news regarding their implementation, due to the level playing field and the probability of the next financial crisis in the US.

It would be wrong to conclude from such a situation that Europe should begin to dismantle their existing regulations. The common good as Europeans is to have financial stability first, so long as it does not hamper growth. Financial stability regulations in Europe have not hampered growth by any measure; at present there are no credit constraints in Europe. There is significant growth in credit volumes and low interest rates, so financial stability must come first.

2. MAKING BASEL RULES WORK FOR EUROPE IS VERY CHALLENGING

2.1. Wait and see the US decision

An industry representative advised giving the US the benefit of the doubt on trade issues, but feels it needs to be monitored closely. One issue on which there is no agreement yet is completion of Basel III. The representative asked how to find agreement and whether the debate is going in the right direction or whether there are major concerns over competitive and implementation issues.

A banking representative agreed with the wait and see approach. Basel III has already been largely implemented. The question is currently whether to go further and renew those standards. The representative emphasises that the full Basel IV package would be a complete change from what has been done until now.

The representative agreed with other panellists that they ought not to speculate on the US implementing those changes, but felt that it would be perhaps even more speculative to anticipate that they will implement all of the changes. The wiser thing is to wait and not implement in Europe until the US clearly states what they intend to do. The world is in front of a new US administration who openly says that compliance with Basel is not their first priority. America is the first priority for America. The UK is the first priority for the UK. Europe's top priority should be Europe.

The representative also supports not stepping back. However, Europe should not continue going forward in the same way as they have because there is no certainty from the other side that any new Basel package will be implemented.

There are differing banking systems, especially as far as mortgages are concerned. Delinquency rates on European residential mortgages have small variability, at around 1% in France while it is 5% in the US. Putting a same floor on the standard method for those types of loans, with so many different types of lending practices, is not harmonisation. The industry needs to aim for consistent impact from the regulation, but not necessarily the same regulation applied to differing underlying systems.
In the context of nascent recovery in Europe, creating jobs is also important. The European economy needs to be taken care of. Recovery is there, but it is fragile and needs care. Thus the balance between the two policy objectives financial stability and supporting the economy, must clearly be on the side of the economy and jobs.

A recent EC paper published by DG ECFIN stresses that the Basel IV package would hamper the European recovery. Stability is needed. The rules of the banking business have recently changed almost every year, which does not help to manage a business or help lending. It obliges the creation of much homework, permanently, in order to adjust to new regulations. For that reason the Basel IV package ought to interrupted and postponed which means another overhaul of the current rules in credit, operational and market risk. Postponing that would allow for better recovery in Europe. >>>

>>> 2.2. Finding an agreement in the Basel Committee that works for all jurisdictions is not an easy task

A public authority representative stated that a key dilemma Europe faces is how to achieve consistency in implementation across the world whilst ensuring that the agreement reflects certain unique characteristics of regional financial markets and institutions in their particular diversity.

The agenda of the Commission is clearly stability and implementation. Globally, the rules adopted in implementing financial standards are good. Unintended detrimental effects should be repaired, but very logically. Stability is key. In order to encourage market participants to take strategic decisions and invest long term, the rules cannot continue to change and a signal should be given that they should not change, in principle.

That does not mean that Basel should not be completed. The mandate given to the Basel Committee to reduce excessive variability is appropriate: currently, the same hypothetical bank with the same risks is dealt with completely differently in one jurisdiction than in another, and that simply cannot be. The problem is that it is not what the Basel Committee delivered. The first proposal of the Basel Committee for finalisation pretty much came back to a standardised approach, which effectively means treating different risk the same way. That removes what is at the heart of a number of the reforms that have been made which try to incentivise market players to better manage their risks. Moving back to a standardised approach with any high level floor makes a risky bank balance sheet being treated the same as a non-risky bank thus removing this incentive and this remains the biggest problem.

During the current negotiations on the finalisation of Basel III, the importance of the issue from a European perspective has often been illustrated by reference to residential mortgages. Compared to many other jurisdictions, banks in Europe hold a large amount of low risk mortgages on their balance sheets, which can attract relatively low risk weights in particular if internal models are used, and they often are, to determine the risk weights. In principle, the low risk weights are justified by the low underlying risks.

As the current discussions are driven by concerns about unjustifiably low risk weights that may result from internal models and proposals revolve around putting in place constraints around the use of such models, there is a high risk that these constraints will prevent banks with low risk mortgages from reflecting this low risk in the capital charges they apply. Such an outcome would clearly be undesirable, as it would limit the risk sensitivity of the framework, creating the wrong incentives and resulting in increased capital requirements, all of which to a larger extent for European banks than for many others. In other words they would miss the initial target for the whole exercise that was to treat similar risks in the same way across jurisdictions, and would instead end up treating similarly very different risks across jurisdictions. A key objective from a European perspective is thus to ensure that the Basel framework remains risk sensitive enough to accommodate that key concern.

Furthermore, any backtrack for international standards, in any jurisdiction, is the basis for deferrals. If a jurisdiction for which the EU has recognised equivalence were to backtrack significantly in that field, that determination of equivalence would have to be reassessed. Of course, there is value in having everybody implement the same standards in terms of level playing fields, but standards are implemented in Europe because they are good for financial stability.

Finally, European banking specificities should further be taken into account by the Basel Committee where that is not yet sufficiently the case.

CONCLUSION

The moderator thanked the panel for their contributions. They summarised that the FSB and international institutions have done a remarkable job over the period, since 2009. Everybody needs to support implementation of what has been agreed, and not the unravelling or complete overhaul of what has taken the world into a much better place. ●

Fostering investment in the Maghreb region: challenges and opportunities

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Objective of the session

Fostering private investment is an important issue for EU Member States. There is indeed a need to strengthen the economies of the Mediterranean countries, which should contribute notably to more social and political stability in this region and more controlled economic migration.

The objective of this session was to take stock of the measures and solutions for facilitating investments put in place in some of these countries and discuss the challenges and opportunities for the EU financial industry to support sustainable growth in this Maghreb region.

1. FACILITATING PRIVATE INVESTMENTS AND ACCESS TO FINANCE IN TUNISIA

Since 2011, Tunisia has undergone a political transition that is advancing positively, albeit slowly. Nevertheless, this has affected its economic situation. The economic situation in Tunisia has altered somewhat in recent years, for cyclical reasons, related to the transition that the country has undergone but also for structural reasons linked to particular economic malfunction.

For some time, Tunisia has witnessed a recovery in economic activity in certain sectors, and has begun work on a development policy for Tunisia. This will allow the country to get back on the path of growth and, in the medium term, to grasp more serious growth opportunities. This will be with the goal of meeting the various challenges that Tunisia faces, particularly unemployment. The country has a high unemployment rate, especially among young people and particularly university graduates. These challenges are also due to regional disparities in the country which experiences higher growth levels in the costal regions. All of these topics are incorporated in Tunisia's development policies, and successfully addressing them will only be the result of an investment-focused effort, particularly >>>

>>> private investment. This means that private investment, domestic and foreign in particular, must be the cornerstone of Tunisia's development.

This is the reason why Tunisia is engaged in a significant programme of structural reforms to improve the investment environment. Having diagnosed the situation, the Tunisian government has realised that there are relevant medium-term factors that it needs to work on. One very important factor is security: Tunisia has been through a number of events, with acts of terrorism being the most significant, and these have hampered the investment environment. Addressing this issue is therefore crucial for investment. The polls show that restoring security and political stability is a determining factor in the current environment, as has been seen this morning, during the first session.

Social stability is also a determining factor for investment; social stability has been somewhat undermined during this period through increasingly large social demands, but the situation continues to stabilise and, lately, Tunisia has done more specific work on the country's legal and regulatory framework. The framework that is now in place has been improving. Tunisia has adopted a new law on public/private partnership, because it has realised that the state, especially with its present day budget constraints, cannot meet all the demands it faces in terms of infrastructure and public utilities, especially in more remote areas. The private sector must therefore come to the state's aid, and as such, Tunisia has put in place the right framework for projects involving public/private partnerships.

Tunisia has also introduced a new competition law, and above all a new investment code which simplifies the general investment framework. In addition, Tunisia has worked on sectoral policies, because it has also realised that it must identify key, high value added sectors that will draw the economy towards more strategic projects. Work has begun on simplifying administrative procedures, because all the polls show that the process of implementing investment is 'tied up in red tape'.

Financing is also an important factor. Tunisia has worked on restructuring its banking sector, and, in particular, state-owned banks. The state has quite a large presence in the banking sector: 40% of banking assets are currently owned by the Tunisian state. The country has worked on restructuring these banks in order to open them up to private investors, initially institutional investors, and then worked on how to implement this. Work has begun on identifying sources of finance outside the banking sector, the financial markets, and, particularly, on improving diversification. A whole series of actions and discussions were carried out.

Today, Tunisia has a five year development plan into which all of these elements have been incorporated. The government intends to gradually move its implementation forward with infrastructure projects, and public/private partnership to take advantage of the the investment environment. This is a medium term undertaking, requiring great effort; the process has begun, and the first signs of an increase in investment levels have been the result. Tunisia is determined to move forward in this direction, and is convinced that the only source of growth – the only way to improve the country's macroeconomic indicators and the prosperity it is seeking for its economy – is via investment and, particularly, private investment.

2. PROMOTING INDUSTRIAL DEVELOPMENT: THE EXAMPLE OF MOROCCO

Morocco has a strategic vision in relation to both investment in the private sector, and industrialisation in general. The country has set up a new development model, which evolved as a result of the international financial crisis; it was affected by this crisis, mainly through the channel of foreign demand for Morocco. This foreign demand declined during the global financial crisis, and more specifically due to the persistent weak growth in the Eurozone.

In view of these factors, Morocco adopted a new growth model that sought to address these key challenges from three main angles: how to position the Moroccan product in the global value chains, what factors this new growth should be based on, and what new trade opportunities exist for the Moroccan products as a result of the persistent crisis in the Eurozone.

To answer these three questions, with a view to the positioning of Moroccan products, the government began work by focusing on a number of high value-added sectors, and did an enormous amount of work on these. Initially, four areas were identified: the automotive industry, the aeronautical industry, electronics and offshoring. These four sectors were subjected to sectoral strategies that address all the difficulties and all of the demands of investors wishing to invest in these sectors, whether relating to regulatory issues, bureaucracy, financial, or property-related issues. All of the conditions that would allow the private sector to come and invest in these sectors were identified.

In relation to the second question, Morocco identified two basic comparative advantages: >>>

>>> its geostrategic position and a skilled, cheap workforce. With regard to its strategic positioning, the country created a large number of logistics bases, notably large ports. With regard to labour, Morocco created universities offering training dedicated to the needs of each sector. With regard to the opening up and diversification of our markets, the country launched a far-reaching process in a quest for new partnerships, whether in India or in China, pursuing a 'win win strategy'. After this 'emerging' strategy was adopted, Morocco made progress through an industrialization acceleration plan, which was launched in 2014 and which seeks to develop not only horizontal, but also vertical integration. An example of this would be a very important international investor going into partnership with local industry to promote the distribution of Morocco's industrial fabric.

The following results have been seen: the automotive industry is currently experiencing high growth in Morocco, and has effectively become the leading export industry. Car production now exceeds 345,000 vehicles, compared with only 18,000 vehicles produced in 2003. Morocco has thus become the second vehicle manufacturer in Africa, after South Africa. The Renault brand is produced in Morocco, and the country is also working towards having Peugeot start operations there in 2019, with a planned capacity of 200,000 vehicles and 200,000 engines. Automotive industry exports increased by 17% per annum between 2008 and 2016; today, they are worth 55 billion dirhams, and represent the largest export sector. This sector has generated skilled workers, rising by 13% per annum in the period 2008-2015.

The aeronautical sector has benefited from the same strategy. This sector has welcomed the arrival of Airbus, Boeing and Bombardier, the world leaders in the field. In Morocco, the aeronautical sector achieved revenues of 9.2 billion dirhams in 2016 compared with 3.4 billion in 2008 i.e. annual growth of 12.5%. This dynamic also generated skilled workers, with the number rising by 11% per annum during this period. The industrial acceleration plan provides for an increase in industrial production in Morocco to 23% of GDP by 2020. Today, the figure stands at around 16%. The same approach was adopted for phosphates and other sectors. In Morocco, the phosphate industry is very well developed, and mostly produces phosphate derivatives, rather than the raw commodity.

The same approach has been taken with the Green Morocco Plan, which seeks to empower agriculture against bad weather. For example, in 2016, the country experienced a very severe drought, the worst drought in the last thirty years; cereal production declined by 70% in 2016, but value-added agriculture only declined by 10%. The same reduction in 2007 had resulted in a 24% decline in value-added agriculture, and in 1997, value-added agriculture went down by 45%. This demonstrates how important the Green Morocco plan is; it allows the country not only to modernise this sector, but also to empower it and make it less dependent on the weather.

Finally, the Kingdom of Morocco has launched a new strategy aimed at reducing the country's dependence on oil. It is developing renewable energy, particularly solar energy, on a major scale. It predicts that by 2020, 42% of the country's energy needs will be met by renewable energy, and estimates that this figure will be 52% by 2030. The first phase of the largest solar complex in the world – the Noor power plant in Ouarzazate – was launched in 2016. Today, Morocco is launching other phases of this programme. This industrial strategy is primarily based on the consolidation of the country's macroeconomic framework, very important work on the business climate, and, of course, on the political stability enjoyed by the Kingdom of Morocco.

3. OPENING THE BANKING SECTOR TO MORE COMPETITION AND DEVELOPING FINANCIAL MARKETS: THE ALGERIAN EXPERIENCE

Each Maghreb country has its own characteristics and model, but they all face the same challenge: that of growth and development. Each country offers almost equal opportunities, but nonetheless presents some differences. The banking system in Algeria is experiencing gradual diversification and development. It has greatly diversified since Algeria called on the help of a panel of primarily international banks. A few years ago, it was dominated by six state owned banks that historically had their own specialities in the central system. Algeria has proceeded to deregulate these banks, to make them universal banks, and called for foreign capital. Today, there are now 20 banking institutions in Algeria, including six state owned banks and 14 private international banks; 10 financial institutions, including a private equity firm; and 23 insurance companies.

Algeria's financial markets must develop, especially with the planned opening up of the capital of certain banks and industrial groups. The government has scheduled the privatisation of a state-owned bank, and possibly two state-owned banks which are considered less strategic but which are well established in retail banking, for all customer segments, especially SMEs/SMIs; this is a vehicle that has been selected by the government >>>

>>> to diversify the economy. There is leasing and private equity, but currently shareholding structures reveal a preponderance of foreign capital. Foreign capital dominates, with ownership of 56% of banking shares.

Algeria has geographic diversity: 11 out of the 29 active funds are concentrated in the MENA region. European shareholders have holdings in four banks, including two financial institutions. Algeria contains a bank whose parent company is located in the United States; as such, the financial markets are diversifying and developing. However, there is a dichotomy between the two sectors: the public sector is smaller but owns more assets, representing close to 83% of assets. This is why the government today is able to put a certain number of banks up for sale, gradually, to allow these banks to become universal and especially to create mixed capital, whether belonging to Europeans or other nationalities. At the present time, Algeria's proximity to Europe makes Algeria more attractive to European capital.

Algeria has a number of characteristics. It is an oil producing country; it has suffered as a result of the oil crisis, which has been going on for the last three years, but it has developed the capacity to be extraordinarily resilient, in that in the period 2001-2014, before the onset of the crisis, it previously accumulated significant domestic and foreign savings. These savings have allowed it not only to develop resilience, but also to maintain a growth rate of 3.7% in 2016, estimated to be 4% in 2017. Algeria also has exchange reserves of $114 billion, and insignificant borrowings, of the order of 2% of GDP; this gives the country a lot of 'room for manoeuvre'. During this period of improvement, of all of the partners who invested in Algeria, either under the 51/49% rule or as part of direct foreign investment, those who came before 2009 were financed by Algerian banks, since indebtedness was not allowed at that time. This financing capacity still exists.

To overcome Algeria's dependence on hydrocarbons, the country launched a new economic growth model with a view, mainly, to diversify business activity. The sectors targeted in this diversification are mainly agriculture, industry, tourism and renewable energy. For the last 10 years, Algeria has invested massively in industry, and today Algeria is self sufficient in cement, iron and steel and plans to set up car assembly lines. Five or six automotive brands that have been approved in the Algerian market are planning to assemble their cars in Algeria, and this will bring additional sub contracting into the economy. During the economic crisis, the banking sector remained very resilient.

4. THERE IS A NEED TO STRENGTHEN THESE MAGHREB COUNTRIES, AS WELL AS MENA COUNTRIES IN GENERAL, AS THESE ARE THE GATEWAY OF SUB SAHARAN MIGRATION

It has been Malta that has brought the issue of boosting private investment in North Africa to the fore within ECOFIN. Malta believes this is an important issue, which is why it has included this session in Eurofi's programme, and has also asked the five finance ministers of the Maghreb to join with European counterparts in a five plus five meeting on the fringe of the conference. This had already applied to foreign affairs, but now has been extended to the Ministries of Finance.

Over the three days of the Eurofi conference, there has been discussion of how to improve NPLs, the euro, the Capital and Markets Union and the Banking Union, and related topics. Sometimes, disruptive politics – such as Brexit and the election of Donald Trump – acts as a distraction, but this is the result of people being more bothered by terrorism and migration than, for instance, NPLs. These fears, or problems, need to be addressed: refugees are a result of war, and there are humanitarian conventions on how to treat them, but economic migration is a different issue. It is a result of significant income differences between the north and the south, and will continue until these differences are at least narrowed, if not closed.

Malta is more sensitive than other countries to what is happening in Libya, the Maghreb, and other places. They believe that, although the German initiative that hosted the G20 to talk about the compact with Africa was a good initiative, more should be done in the Mediterranean. The EIB is contributing to support the economic and social development of the Mediterranean partner countries under the Facility for Euro-Mediterranean Investment and Partnership (FEMIP), and the World Bank also mobilizes ressourcesin the region. The EBRD also has an extended mandate to work in North Africa.

North African countries are not the same as Central or Eastern European countries: there are similarities, but also a lot of dissimilarities. There is a need to strengthen these Maghreb countries, as well as MENA countries in general, as these are the gateway of sub-Saharan migration. Young people need to be offered hope, as, in many of these countries, youth unemployment stands at between 20% and 40%. When working in the European Union with ECOFIN, there is a need to ensure that the problem of migration is dealt with at its source, rather than trying to send large numbers of people back to their home countries. The speaker noted that they are very interested in this topic, and >>>

>>> is very glad of the cooperation of the North African countries that have come to Malta.

Some of the problems related to lack of investment in North Africa are the same as those faced by the European Union, such as political instability. The Maghreb has other issues to a greater extent, such as corruption or lack of credit, but Malta wanted to draw the attention of the European Union to the fact that it is the closest to Africa of all the Member States, and for the EU to think seriously about this issue and coordinate its efforts. This has to be a cooperative effort, and with three large development banks and the EU itself involved, Malta wants these bodies to coordinate their efforts, monitor the issue more closely, and see progress being made.

5. CONCLUDING REMARKS

The central issue in the debate has been the creation of employment for young people; this preoccupies not only countries south of the Mediterranean, but those north of the Mediterranean as well, and the five plus five.

One conclusion that can be drawn from the discussions is that employment will only be created by the private sector; there is general agreement that that is going to be the driver. A lot of the enterprises in Northern Africa are not showing the same dynamism that the World Bank sees elsewhere in terms of job creation: there are larger enterprises that are reasonably comfortable and relatively highly capital intensive, and younger enterprises that grow to be small and medium sized enterprises, but do not then replace other market participants, create jobs beyond a certain level, or grow beyond a certain size. This is not true to the same extent across all countries, but it is one of the issues that the World Bank is seeing.

This links to the banking sector, because the banking sector is often lending more to the larger enterprises that are well known and that have large collateral. In some cases, these are state owned enterprises, and it is therefore harder to get financing for small and medium sized enterprises and for young entrepreneurs. This is an area that development banks like the World Bank, the EBRD and the EIB work on and look at, and is one of the areas that they are discussing with the region's governments, investing in these areas to create more employment.

A second area is the overall business environment. Promoting a good business environment in the Maghreb is vital to respond to the high level of unemployment, especially among the region's young people and women. This is a delicate area, which needs to be carefully thought through: the goal is to have both political stability and the changes that need to be made to attract more investment. All of the governments involved have their own pace and their own history, and are all thinking through this issue. It requires a lot of investment, technical assistance, and a good dialogue and engagement with each of these governments, so that they come to a conclusion about what is necessary and what they should be doing next, and as they do so, they realise the benefits.

A third element is the education sector, and the linkages between the private sector and the education sector, which need to be strengthened. Often, the education sector bypasses the needs of the private sector, or employers' needs change so quickly that the skills taught in schools and universities are no longer relevant. One of the phenomena that the World Bank sees in Northern Africa is that many of the unemployed are highly skilled or highly educated, but are not finding jobs. Bringing together and twinning the sectors that are producing with the education sector is very important. There has also been discussion of how the experiences of Eastern European nations and countries that are seeking to accede to the European Union, such as the Western Balkans, can be used to inform the dialogue further, and the ways in which Northern Africa can come closer to the plus five on the Southern Europe side and work together.

The Chair concluded the session by stating that they are sure that there are goods and services that they would like to buy from Tunisia, Algeria, Morocco, or Malta that they do not know about. There is on-going momentum in the Maghreb region, notably to improve the business environment and develop the banking sector, which should help create more open, thriving economies .Connecting economies via information technology and e commerce is a very powerful driver, and small companies in these countries could have access to not just the European market, but a global market, at an extremely low cost. The more connectivity there is between economies, linked to the capital markets, those who are doing good business can easily move and invest, not only domestically but internationally, and this represents an extremely powerful model and a wonderful opportunity for the Maghreb and other emerging countries. ●

Malta 2017

POLLS

Results

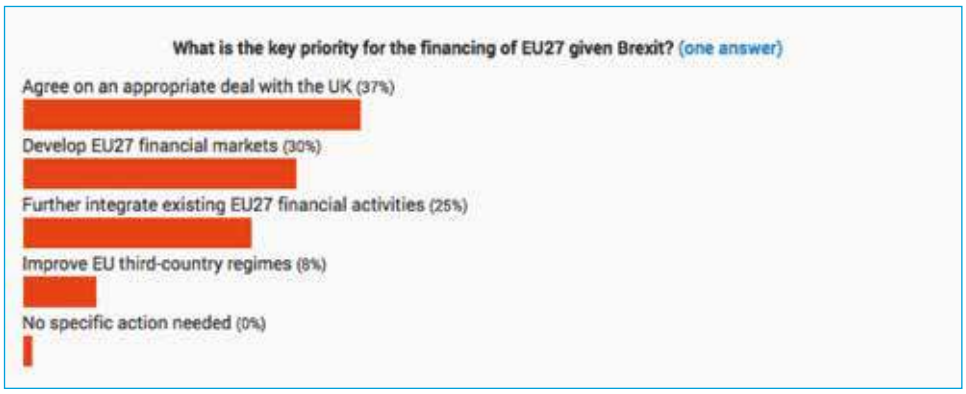
Malta 2017

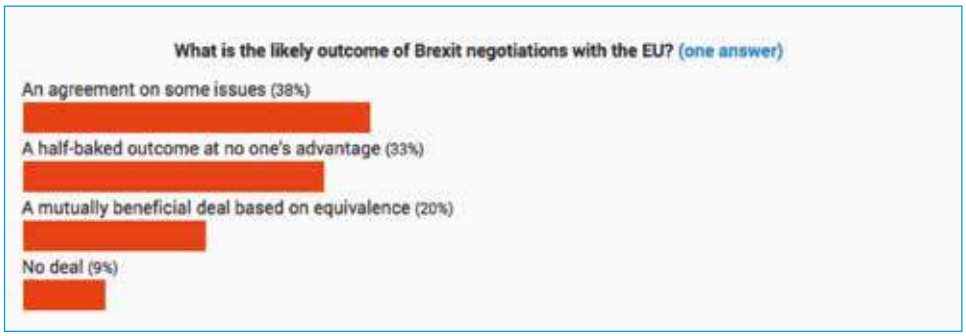
POLLS

Results

Polls were conducted during the Malta Seminar on 5 subjects: Brexit impacts, EU27 prospects, Banking Union, CMU acceleration, Vulnerabilities

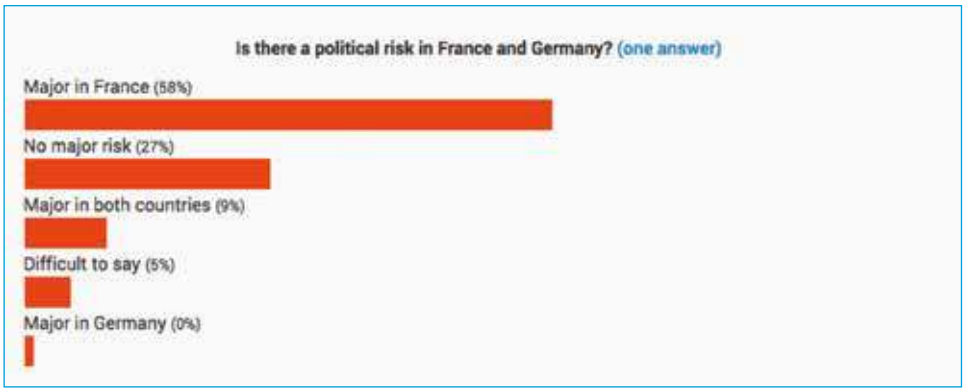
Brexit impacts



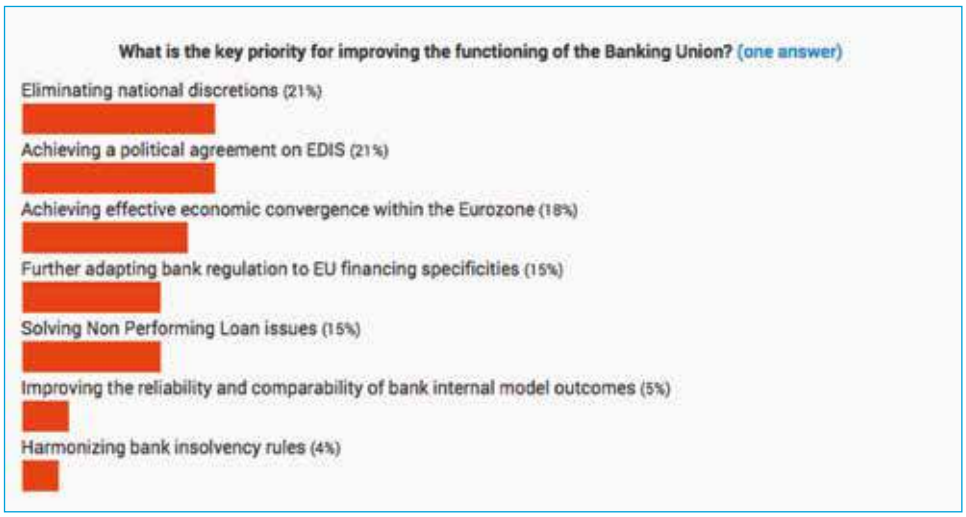


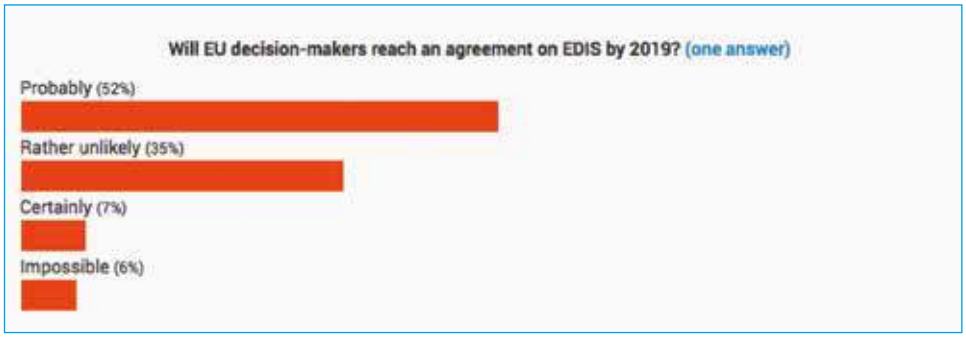
Polls were conducted on the Eurofi App

EU27 prospects



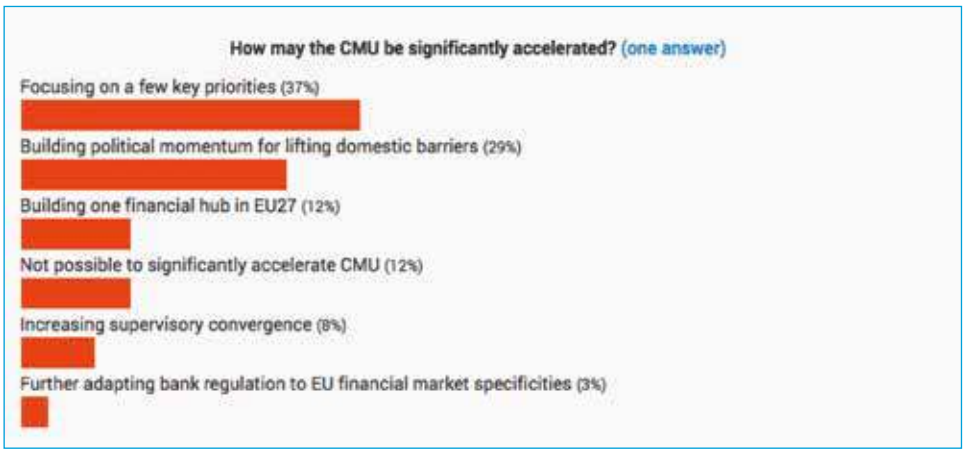
Banking Union

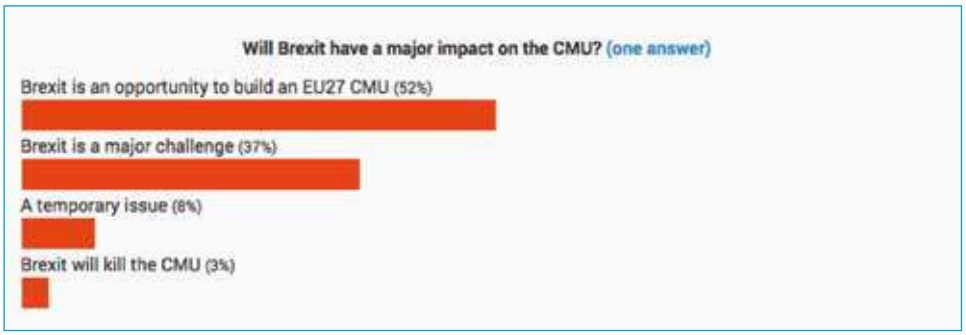




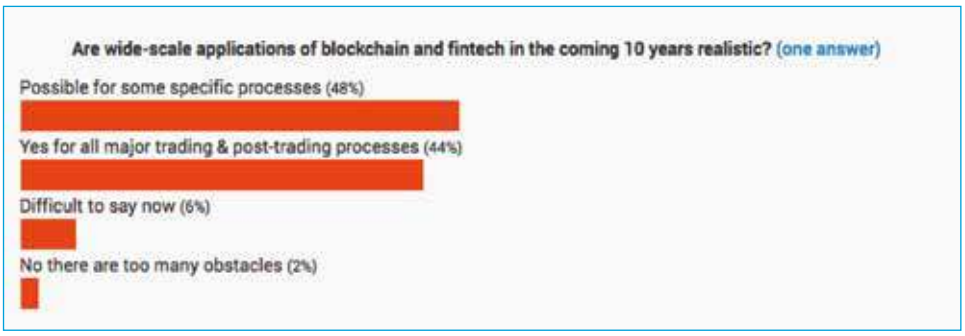
Polls were conducted on the Eurofi App

CMU acceleration





CMU acceleration



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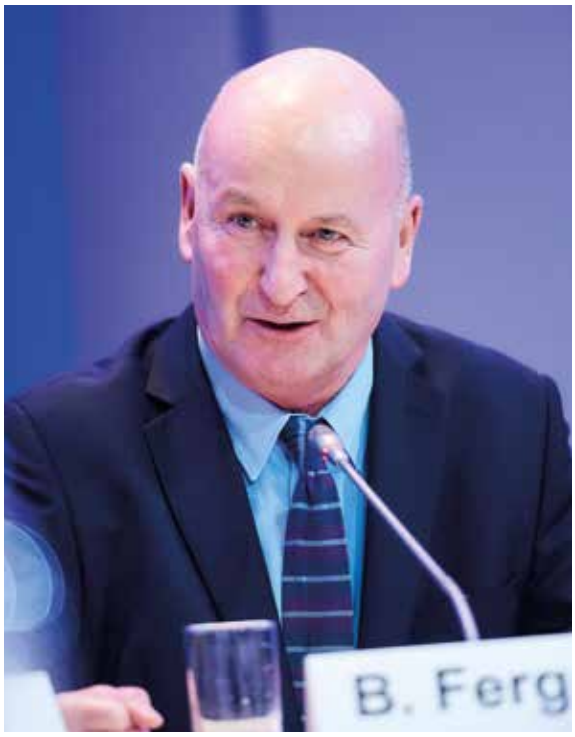
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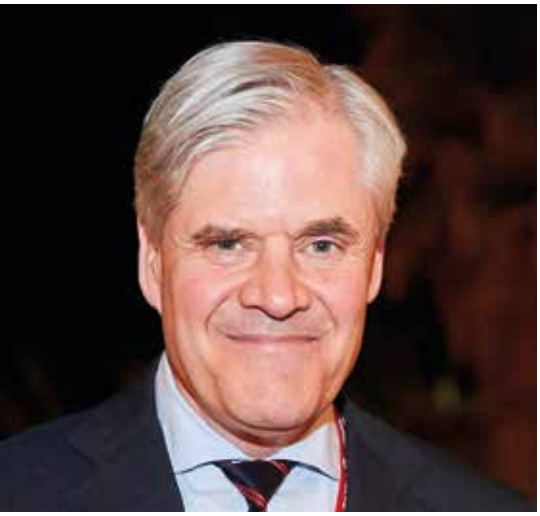


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Chair : David Wright - President, EUROFI ;

Public authorities : Vincenzo La Via - Director General of the Treasury and Chairman, Financial Services Committee, Ministry of Economy and Finance, Italy ; **Peter Praet** - Member of the Executive Board, European Central Bank ; **Odile Renaud-Basso** - Director General of Treasury, Ministry of Economy and Finance, France ;

Industry representative : Xavier Musca - Deputy Chief Executive Officer, Crédit Agricole S.A.

Chair : Klaus Regling - Managing Director, European Stability Mechanism

Public authorities : Pierre Gramegna - Minister of Finance, Luxembourg ; **Hans Jörg Schelling** - Federal Minister of Finance, Austria ; **Sven Sester** - Minister of Finance, Estonia

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Chair : Mahmood Pradhan - Deputy Director, European Department, International Monetary Fund

Public authorities : Ewald Nowotny - Governor, Oesterreichische Nationalbank ; **Luiz Awazu Pereira da Silva** - Deputy General Manager, Bank for International Settlements

Industry representative : Lorenzo Bini Smaghi - Chairman, Société Générale

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Chair : David Wright - President, EUROFI

Public authorities : Andreas Dombret - Member of the Executive Board, Deutsche Bundesbank ; **Odile Renaud-Basso** - Director General of Treasury, Ministry of Economy and Finance, France

Industry representative : Shriti Vadera - Chairman, Santander UK

Chair : David Wright - President, EUROFI ;

Public authorities : Levin Holle - Director General, Financial Markets Policy, Federal Ministry of Finance, Germany ; **Cyril Roux** - Deputy Governor, Central Bank of Ireland ;

Industry representatives : Stéphane Boujnah - Chief Executive Officer, Euronext N.V. ; **Joe Cassidy** - Partner, KPMG ; **Sylvie Matherat** - Chief Regulatory Officer, Member of the Management Board, Deutsche Bank ; **Antonio Simoes** - Chief Executive Oficer, HSBC Bank plc ;

Expert : Sharon Bowles - Member, House of Lords ; **Christian Noyer** - Honorary Governor, Banque de France.

Chair : Benjamin Angel - Director, Treasury and Financial Operations, DG Economic and Financial Affairs, European Commission ;

Public authorities : Carmine Di Noia - Commissioner, Commissione Nazionale per le Società e la Borsa ; **Fausto Parente** - Executive Director, European Insurance and Occupational Pensions Authority ;

Industry representatives : Sophie Barbier - Director of the European Affairs Department, Caisse des Dépôts Group ; **Michael Hennig** - Deputy Head of Institutional Sales and Relationship DC, Fidelity International ; **Xavier Larnaudie-Eiffel** - Deputy General Manager, CNP Assurances ; **Fernando Navarrete** - Chief Financial Officer, Instituto de Crédito Oficial ;

Expert : Jean-Jacques Bonnaud - Independent Director, EUROFI.

Chair : Pervenche Berès - MEP, ECON Committee, European Parliament

Public authorities : Ambroise Fayolle - Vice-President, European Investment Bank ; **Roberto Gualtieri** - MEP and Chair, ECON Committee, European Parliament ; **Klaas Knot** - President, De Nederlandsche Bank ; **Dimitar Radev** - Governor, National Bank of Bulgaria

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Discussants : Thomas Lodder - Global head of Regulatory Policy, Barclys Bank ; **David Wright** - President, EUROFI

KEY VULNERABILITIES IN THE EU FINANCIAL SYSTEM

Chair : Mahmood Pradhan - Deputy Director, European Department, International Monetary Fund ;

Public authorities : Benjamin Angel - Director, Treasury and Financial Operations, DG Economic and Financial Affairs, European Commission ; **Philipp Hartmann** - Deputy Director General Research, European Central Bank ; **Steven Maijoor** - Chair, European Securities and Markets Authority ;

Industry representatives : José Manuel González-Páramo - Executive Board Member, Banco Bilbao Vizcaya Argentaria ; **Michel Madelain** - Vice Chairman, Moody's Investors Service.

Chair : Ugo Bassi - Director, Financial Markets Directorate, European Commission ;

Public authorities : Andrew Gracie - Executive Director, Resolution, Bank of England ; **Ivan Odonnat** - Deputy Director General for Financial Stability and Operations, Banque de France ; **Verena Ross** - Executive Director, European Securities and Markets Authority ; **Kay Swinburne** - MEP, Committee on Economic and Monetary Affairs, European Parliament ;

Industry representatives : Ulrich Karl - Director CCP, Global Markets, HSBC Bank plc ; **Sandra O'Connor** - Chief Regulatory Affairs Officer, JP Morgan Chase & Co ; **Larry Thompson** - Vice Chairman, The Depository Trust & Clearing Corporation ; **Tim Grange** - Director of Regulatory Policy, ICE Clear Europe.

Chair : Francesco Mazzaferro - Head of the ESRB Secretariat, European Systemic Risk Board ;

Public authorities : Paul P. Andrews - Secretary General, International Organization of Securities Commissions ; **Benoît de Juvigny** - Secretary General, Autorité des Marchés Financiers ; **Marianne Scicluna** - Director General, Malta Financial Services Authority ;

Industry representatives : Joanna Cound - EMEA Head of Government Relations and Public Policy, BlackRock ; **Dennis Gepp** - Senior Vice President, Managing Director and Chief Investment Officer, Cash, Federated Investors (UK) LLP ; **Michael Rüdiger** - Chief Executive Officer, DekaBank Deutsche Girozentrale.

Chair : Corso Bavagnoli - Assistant Secretary, Financial Department of the French Treasury, Ministry of Economy and Finance, France ;

Public authorities : Pervenche Berès - MEP, Committee on Economic and Monetary Affairs, European Parliament ; **Carlos da Silva Costa** - Governor, Banco de Portugal ; **Sharon Donnery** - Deputy Governor, Central Banking, Central Bank of Ireland ; **Andrea Enria** - Chairperson, European Banking Authority ; **Maria Velentza** - Director, Markets and Cases, DG Competition, European Commission ;

Industry representatives : Gabriele Guggiola - Director, PwC Italy ; **Bernard de Longevialle** - Managing Director, EMEA Financial Services Lead Analytical Manager, S&P Global Ratings ; **Aurelio Maccario** - Head of Group Regulatory Affairs, UniCredit S.p.A.

NEW TECHNOLOGY AND CLIMATE-RELATED TRENDS

Chair : Gertrude Tumpel-Gugerell - Supervisory Board Member, Commerzbank ;

Public authorities : Vasily Pozdyshev - Deputy Governor, Bank of Russia ; **Antoine Saintoyant** - Deputy Assistant Secretary, French Treasury ; **Pēteris Zilgalvis** - Head of Unit, Startups and Innovation; Co-Chair, Task Force on Financial Technology, European Commission ;

Industry representatives : John Dye - Executive Vice President, General Counsel and Secretary, Western Union ; **Florence Lustman** - Chief Financial Officer, La Banque Postale ; **Santiago Fernández de Lis** - Head of Financial Systems and Regulation, Banco Bilbao Vizcaya Argentaria ;

Expert : Jean Allix - Special Advisor, The European Consumers' Organisation.

Chair : Marc Bayle - Director General, Market Infrastructure and Payments, European Central Bank ;

Public authorities : Bob Ferguson - Head of Department for Project Innovate, Financial Conduct Authority ; **Eric Pan** - Director, Office of International Affairs, U.S. Commodity Futures Trading Commission ; **Verena Ross** - Executive Director, European Securities and Markets Authority ; **Pēteris Zilgalvis** - Head of Unit, Startups and Innovation & Co-Chair, Task Force on Financial Technology, European Commission ;

Industry representatives : Tom Casteleyn - Head of Product Management for Custody, Cash and Foreign Exchange, BNY Mellon ; **Larry Thompson** - Vice Chairman, The Depository Trust & Clearing Corporation.

Chair : Jonathan Taylor - Vice-President, European Investment Bank ;

Public authorities : Daniel Calleja Crespo - Director General, DG Environment, European Commission ; **Gerassimos Thomas** - Deputy Director-General for Energy & Steering Board Chairman of EFSI, European Commission ;

Industry representatives : Stewart James - Managing Director, Deputy Head of Group Government Affairs, HSBC ; **Abyd Karmali** - Managing Director, Climate Finance, Bank of America Merrill Lynch ; **Michael Leinwand** - Chief Investment Officer, Zurich Group Germany ; **Mark Lewis** - Managing Director, Research, Barclays Bank ; **Isabelle Mateos y Lago** - Chief Multi-Asset Strategist, BlackRock Investment Institute ;

Expert : Christian Thimann - Group Head of Regulation, Sustainability and Insurance Foresight, AXA Group.

BANKING AND INSURANCE REGULATION

Chair : Sylvie Goulard - MEP, ECON Committee, European Parliament ;

Public authorities : Per Callesen - Governor, Danmarks Nationalbank ; **Antonio Carrascosa** - Board Member, Director of Resolution Planning and Decisions, SRB ; **Andrea Enria** - Chairperson, European Banking Authority ; **Erkki Liikanen** - Governor, Bank of Finland ;

Industry representative : Xavier Musca - Deputy Chief Executive Officer, Crédit Agricole S.A.

Chair : Adam Farkas - Executive Director, European Banking Authority ;

Public authorities : Paul Hilbers - Director Financial Stability, De Nederlandsche Bank ; **Korbinian Ibel** - Director General, Micro-Prudential Supervision IV, European Central Bank ; **Luigi Federico Signorini** - Deputy Governor and Member of the Governing Board, Banca d'Italia ;

Industry representatives : José Manuel González-Páramo - Executive Board Member, Banco Bilbao Vizcaya Argentaria ; **Alain Laurin** - Associate Managing Director, Moody's Investors Service Limited ; **Karl-Peter Schackmann-Fallis** - Executive Member of the Board, Deutscher Sparkassen- und Giroverband ; **James Chew** - Global Head of Regulatory Policy, HSBC Bank plc.

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Public authorities : Andreas Dombret - Member of the Executive Board, Deutsche Bundesbank ; **Edouard Fernandez-Bollo** - Secretary General, Autorité de Contrôle Prudentiel et de Résolution ; **Martin Merlin** - Director, Regulation and Prudential Supervision of Financial Institutions, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission ; **Marinela Petrova** - Deputy Minister, Member of the Economic and Financial Committee, Ministry of Finance, Bulgaria ; **Märten Ross** - Deputy Secretary General for Financial Policy and External Relations, Ministry of Finance, Estonia ; **Isabelle Vaillant** - Director of Regulation, European Banking Authority ;

Industry representatives : Philippe Bordenave - Chief Operating Officer, BNP Paribas ; **Johannes-Jörg Riegler** - President, VOEB and Chairman of the Management Board, BayernLB, Association of German Public Banks ; **Diederik van Wassenaer** - Head of Global Regulatory and International Affairs, ING Group.

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Public authorities : Laurent Clerc - Director Financial Stability, Banque de France ; **Andreas Dombret** - Member of the Executive Board, Deutsche Bundesbank ; **Oliver Prato** - Head of Basel III implementation, Basel Committee on Banking Supervision ;

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CMU IMPLEMENTATION

Chair : Steven Maijoor - Chair, European Securities and Markets Authority ;

Public authorities : Corso Bavagnoli - Assistant Secretary, Financial Department of the French Treasury, Ministry of Economy and Finance, France ; **Olivier Guersent** - Director General, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission ; **Levin Holle** - Director General, Financial Markets Policy, Federal Ministry of Finance, Germany ;

Industry representatives : Alexander Batchvarov - Head of International Structured Finance Research, BofA Merrill Lynch Global Research ; **Michael Cole-Fontayn** - Chairman EMEA, BNY Mellon ; **Alexandra Hachmeister** - Chief Regulatory Officer, Deutsche Börse Group.

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Expert : Guillaume Prache - Managing Director, Better Finance - The European federation of Investors and Financial Services Users.

Chair : Nicoletta Giusto - Director of the International Relations Office, Commissione Nazionale per le Società e la Borsa ;

Public authorities : Ugo Bassi - Director, Financial Markets Directorate, European Commission - DG FISMA ; **Jochen Metzger** - Director General Payments and Settlement Systems, Deutsche Bundesbank ; **Sébastien Raspiller** - Deputy Assistant Secretary, Financial Markets Division, Ministry of Economy and Finance, France ; **Paul Tang** - MEP, Committee on Economic and Monetary Affairs, European Parliament;

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Chair : Joe Bannister - Chairman, Board of Governors, Malta Financial Services Authority ;

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Expert : Niels Lemmers - Managing Director, European Investors' Association.

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Chair : José Viñals - Chairman, Standard Chartered Bank ;

Public authorities : Francesco Mazzaferro - Head of the ESRB Secretariat, European Systemic Risk Board ; **Luiz Awazu Pereira da Silva** - Deputy General Manager, Bank for International Settlements ; **Stacey Schreft** - Deputy Director, Office of Financial Research ;

Industry representative : Andrei Magasiner - Corporate Treasurer, Bank of America.

Chair : David Wright - President, EUROFI

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Industry representatives : Philippe Bordenave- Chief Operating Officer, BNP Paribas ; **Alexander Wilmot-Sitwell** - President Europe, the Middle East and Africa, Bank of America Merrill Lynch.

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Public authorities : Lamia Boujnah Zribi - Minister of Finance, Tunisia ; **Mohamed Loukal** - Governor, National Bank of Algeria ; **Edward Scicluna** - Minister for Finance, Malta ; **Jan Walliser** - Vice President, World Bank; **Faouzia Zaaboul** - Director, Minister of Economy and Finance, Kingdom of Morocco.

SPEECHES

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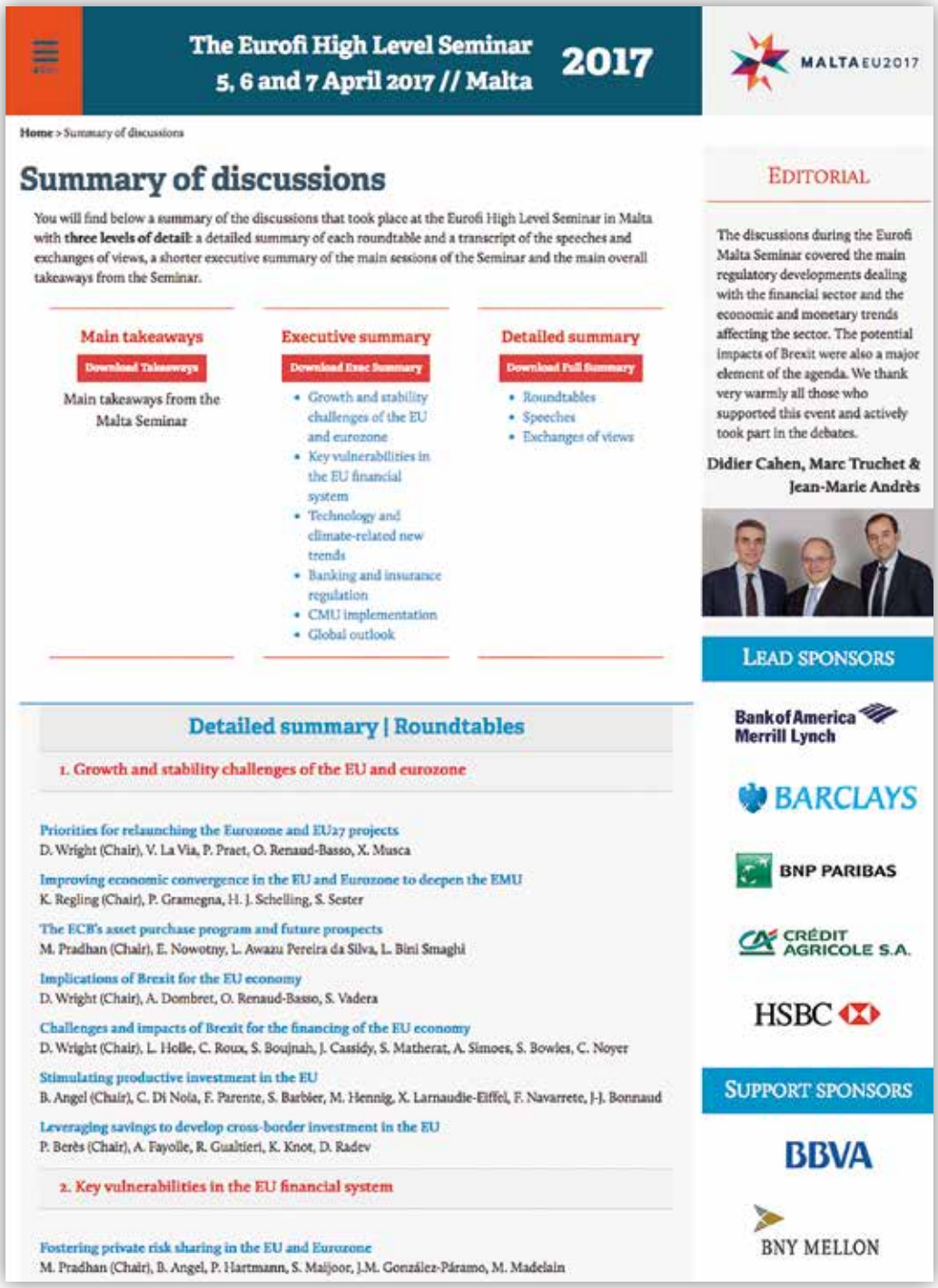

The Eurofi High Level Seminar 2017
5, 6 and 7 April 2017 // Malta

MALTA EU2017

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Summary of discussions

You will find below a summary of the discussions that took place at the Eurofi High Level Seminar in Malta with **three levels of detail**: a detailed summary of each roundtable and a transcript of the speeches and exchanges of views, a shorter executive summary of the main sessions of the Seminar and the main overall takeaways from the Seminar.

Main takeaways

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Main takeaways from the Malta Seminar

Executive summary

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- Growth and stability challenges of the EU and eurozone
- Key vulnerabilities in the EU financial system
- Technology and climate-related new trends
- Banking and insurance regulation
- CMU implementation
- Global outlook

Detailed summary

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- Roundtables
- Speeches
- Exchanges of views

Detailed summary | Roundtables

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K. Regling (Chair), P. Gramegna, H. J. Schelling, S. Sester

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D. Wright (Chair), A. Dombret, O. Renaud-Basso, S. Vadera

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Editorial

The discussions during the Eurofi Malta Seminar covered the main regulatory developments dealing with the financial sector and the economic and monetary trends affecting the sector. The potential impacts of Brexit were also a major element of the agenda. We thank very warmly all those who supported this event and actively took part in the debates.

Didier Cahen, Marc Truchet & Jean-Marie Andrès

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