Views

The EUROFI Magazine

SOFIA | APRIL 2018

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The Eurofi High Level Seminar 2018

Sofia | 25, 26 & 27 April

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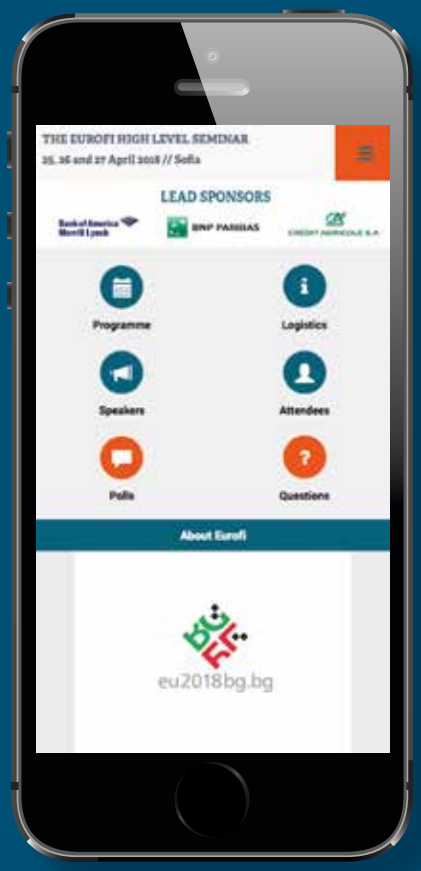

The **Eurofi**
High Level Seminar

SOFIA | APRIL 2018

EDITORIALS & OPENING INTERVIEWS

I. MACRO-ECONOMIC AND EU INTEGRATION CHALLENGES

II. GLOBAL COORDINATION & BREXIT IMPACTS

III. CMU IMPLEMENTATION AND SUSTAINABLE FINANCE

IV. REDUCING FRAGMENTATION IN EU FINANCIAL MARKETS

V. FINTECH AND DIGITALISATION

VI. IMPROVING FINANCIAL STABILITY

The Eurofi Sofia High Level Seminar

Over 700 representatives of the European and international public authorities and of the financial industry are gathered in Sofia to discuss key policy issues impacting the financial sector, the macro-economic environment, new trends such as technology and sustainable finance and also the potential impacts of Brexit and of changes in global regulatory coordination and how the EU may react to them.

All these changes are both challenges and opportunities to review the overall financial services objectives of the EU27 and define how key policy initiatives such as the Banking Union and Capital Markets Union may be adjusted or completed to increase the competitiveness and integration of the EU27 financial sector. One key subject of discussion during this Sofia Seminar will be how to further integrate the EU banking sector, which would require a recognition of banking groups in EU legislation and a removal of the current national approach to bank prudential and resolution regulation in the Banking Union.

Most of the 200 speakers taking part in the Eurofi Sofia High Level Seminar have expressed their views in this Magazine, providing a comprehensive overview of thoughts and proposals on these issues. We thank them very warmly for their thoughtful contributions and hope that you will read them with great interest. ●

Didier Cahen, Marc Truchet and Jean-Marie Andrès, EUROFI

David Wright

President, EUROFI

The EU facing multiple crossroads - decisive leadership needed

This is the first time EUROFI is holding one of its half-yearly seminars in Bulgaria. We are truly delighted to be in Sofia and on behalf of all EUROFI members and delegates we thank the Bulgarian Presidency of the European Union for their very friendly and hospitable welcome and all their valuable support. We are certain of yet another large turnout of many of the EU's top financial experts from both the public and private sectors from all over Europe and we warmly welcome again speakers and participants from outside the EU which is a growing feature of our meetings.

Commentators often speak of the EU being at the crossroads. Which way to turn? Which policies to prioritize? How to ramp up economic growth, integrate the Eurozone and financial markets, reduce public debt, build European "appartenance" etc?

It seems to me, as usual, the EU is facing many difficult, complex "crossroads" simultaneously:

- A new European political cycle beginning in 2019.

- European politics being much less predictable as new parties and policies continue to shake up and challenge the post-war dominance of the traditional political parties. Economic stagnation, high unemployment, immigration and distributive inequalities are at the heart of these upheavals.

- A United States President and staff bent on uprooting post-Bretton Woods multilateralism and world trade rules by transactional bilateralism. US-China trade tensions are growing and the EU risks being caught in the crossfire. This is very serious. Will this growing trade tension spillover to financial services and markets?

- A new cluster of financial policy issues topping the agendas, very different economically from the traditional ones, encompassing the social, environmental, digital, distributive and criminal elements of finance. Green finance, sustainable development and infrastructure financing; gender equality and the social governance issues of firms; fintech; fairer taxation; far greater transparency of offshore tax shelters ; cybercrime, terrorist financing, money laundering....
  Finance was always a foreign policy weapon but it is becoming more so today.

- And of course the crossroads of Brexit - what outcomes will there be ? Could it still be reversible? Can the least economically disruptive outcome be agreed? Or is this a damage limitation exercise, maybe not even, as the EU's so far impressive legal and institutional solidarity confronts the mutual recognition financial services trade thinking emanating from the UK. Is it really in the UK's long-term interest to be outside the single market and the customs union? This crossroad is very near, end-March 2019.

In one sense this could all be summed up as being positive. Some overdue fresh thinking. Space for new issues and new ideas. Perhaps the recognition that the worst of the hugely destructive 2007 financial crisis is over and that the financial system, ceteris paribus, is safer and sounder, better and sufficiently capitalized, with leverage under control, liquidity improved, derivatives trading more and more on-exchange, netted and cleared thereby reducing system wide risk?

Or are dangerous new hidden financial market risks lurking in the shadows? If so, what are they? And where? I am sure EUROFI Sofia will be able to enlighten us with nearly 200 speakers taking the floor.

Approaching these multiple crossroads, as ever, needs crisp and decisive EU decision making, to deepen and move forward with the essential Eurozone and banking union reforms at the European Council in June.

Accelerating progress on capital markets union and linking it more with digital trading and technologies to break down cross-border barriers.

The EU urgently needs a good PEPP outcome.

The EU must work on tackling its multifarious insolvency laws.

The European Supervisory Authorities need strengthening to fully play their rightful public interest European roles, including selective supervisory powers, fully respecting subsidiarity and proportionality. And they must be properly and sustainably financed in the process.

It is also critical that the EU remains a firm and steadfast leader of multilateralism providing real leadership at the global level in the U.N., WTO, FSB, Basel Committee, IOSCO etc by promulgating and coordinating powerful European views. The EU needs to be seen far more as the real champion of multilateralism, building coalitions of the willing against multilateral subterfuge and corrosive bilateralism. The world demands this; the poorer nations, emerging countries want the EU to lead and shape and share in building a better, fairer world, with binding disputes settlement and enforcement powers built around international law.

Former European Commissioner Emma Bonino recently quoted Chancellor Adenauer:

"Europe was a dream of few. Became a reality for many. And will be a necessity for all".

At the multiple crossroads the EU is facing it has three options: turn back, stall, or decide to lead decisively in the common interest.

The answer is obvious. ●

Q&A

Vladislav Goranov

Minister of Finance,
Republic of Bulgaria

Challenges in financial services area are also opportunities

The recent economic and financial crisis in 2007-2008 made more acute some of the already existing challenges in the financial services area in Europe and created new ones for regulators, supervisors, financial institutions and consumers.

In response to these challenges we introduced and currently implement new harmonised rules at EU level that are to guarantee better financial stability. We also started building new elements of the EU financial architecture and advanced with projects such as the Banking Union and the Capital Markets Union. We learned to be prudent throughout the whole economic cycle, including in good times of economic growth. Today the business has more channels to finance its activities. Consumers of financial services are now better protected.

In the financial services area the European Union proved that challenges may be seen as opportunities. The policy window is still open for improving further financial stability, access to financial services for the business and consumers' confidence. It is our common responsibility now to keep the momentum, paving ahead the road of success.

Meanwhile, new challenges are emerging at the horizon that will affect how financial services interact with the real economy. The promotion of sustainable finance, the impact of new technologies in the financial sector, the global developments and Brexit negotiations are among these important challenges that shall be further handled today.

WHAT ARE THE PRIORITIES OF THE BULGARIAN PRESIDENCY IN THE FINANCIAL SERVICES AREA?

The Bulgarian Presidency is working towards deepening of the Economic and Monetary Union, through focusing our efforts on the completion of the Banking Union, advancing the Capital Markets Union and discussing the EU fiscal framework.

A key priority for the Bulgarian Presidency is the completion of the Banking union. We work very hard to achieve as soon as possible a balanced compromise on the Risk Reduction package, put forward by the Commission in November 2016. We expect to agree at Council level on this package at the ECOFIN meeting in May 2018 and to be in a position to start discussions with the European Parliament during the second quarter of 2018. The Bulgarian Presidency will concentrate all its efforts to achieve maximum progress on technical level on the European Deposit Insurance Scheme.

On 14 March 2018 the European Commission has published a new set of draft rules that aim at tackling the NPLs issue and to further reduce risks in the EU financial sector. These new rules provide for sufficient loss coverage by banks for future NPLs, accelerated out-of-court enforcement of loans secured by collateral and further development of secondary markets for NPLs.

Another important priority of the Bulgarian Presidency is the building up of the Capital Markets Union. Delivering the main blocks of the Capital Markets Union is a substantial part of the agenda and a key challenge for us. Thus, it is the Bulgarian Presidency objective to do its utmost to advance the negotiations in the Council on the legislative proposals on supervisory oversight of central counterparties, as well as on the updating of the requirements vis-a-vis third-country Central Counterparties; on the review of the European System of Financial Supervision; the establishment of a Pan-European pension product and on the proposal for introducing a new prudential regime for investment firms. We will continue the work on the establishment of a framework for recovery and resolution with a view to achieve maximum progress. We are ready to start the negotiations with the European Parliament on the first revision of the European Market Infrastructure Regulation based on the Council's negotiating mandate in December 2017.

Recently the Commission has published its communication on the progress made under the Capital Markets Union. It presented also the FinTech Action Plan and adopted a number of new legislative proposals: the cross-border distribution of investment funds, covered bonds, crowdfunding, etc.

The 2018 Commission's working programme is very ambitious and many new proposals were released in March 2018. The Bulgarian Presidency is also reasonably ambitious and will do its best to achieve a substantial progress in legislative dossiers in the financial services area.

WHAT ARE THE REMAINING ISSUES TO ACHIEVE AN AGREEMENT ON EDIS AND THE BACKSTOP TO THE SINGLE RESOLUTION FUND?

The efforts to prepare the ground for an agreement on EDIS and to design the backstop to the Single Resolution Fund are one of those challenges that we shall turn into opportunities. It is not easy to find balanced and workable decisions. However, finding them will further strengthen the financial stability in the Banking Union.

The Bulgarian Presidency continued the work on the EDIS proposal in compliance with the mandate of the Ad-Hoc Working Party on strengthening of the Banking Union and the ECOFIN Council Conclusions of June 2016 on a Roadmap to Complete the Banking Union. According to the Roadmap, the negotiations on EDIS at political level shall start as soon as sufficient further progress has been made on risk reduction measures. Thus the start of the negotiations on the fundamental issue of the final design of EDIS is still pending a political decision.

On 11 October 2017 the Commission published a Communication on Completing the Banking Union that sets out an ambitious path to ensure agreement on all the outstanding elements of the Banking Union. As regards EDIS, the Commission put forward some suggestions to facilitate progress in the European Parliament and the Council on steps towards EDIS, in particular through exploring possibilities to introduce EDIS in a more gradual manner, commensurate to progress achieved with regard to risk reduction and the tackling of legacy issues. The Presidency therefore decided to intensify the technical work on the different alternatives for the initial model of EDIS. The aim is to give sufficient basis for informed discussions after a decision is taken to start the political negotiations.

Technical work on the creation of a common backstop to the Single Resolution Fund has been ongoing for a few years already. Several options of package solutions are being elaborated, laying the grounds for a decision by the European Council in June this year to approve one of these options. The most essential elements of the options concern the provider of the backstop, the scope of its use, its size and governance. It is now time to deliver.

ARE THE RECENT PROPOSALS TO DEEPEN THE EMU LIKELY TO CREATE THE CONDITIONS FOR A FURTHER ECONOMIC INTEGRATION WITHIN THE EURO AREA?

Deepening of the Economic and Monetary Union is a process that will be continuing for years and the recent proposals by the Commission certainly contribute to that. Some of them are being already formally discussed by the working groups of the Council and technical details are being worked out, so progress is expected in the short term.

Other proposals are more conceptual and general, giving start to high level political discussions for the medium- and long-term. There are ideas that collect general support but meet legal and parliamentary limitations, which will in any case postpone implementation. Others are taken less enthusiastically, but that does not devalue the good elements of the package.

All in all, there is a broadly shared view that the EMU needs to be deepened until it reaches a genuine state. The direction is set and the topic is at the top of the political agenda. The benign economic times provide a good opportunity, but of course there are many more factors affecting the pace of the process. The exact timeline for the deepening of the EMU is to be defined, but what is certain is that it will go forward in the future. ●

Q&A

Dimitar Radev

Governor,
Bulgarian National Bank

Evolution of monetary policies and integration of the EU banking markets

HOW ARE MONETARY POLICIES AND TOOLS LIKELY TO EVOLVE WITHIN THE EU IN THE FORESEEABLE FUTURE?

The monetary policy normalization is not generally questioned. Indeed, the ECB unconventional measures allowed the euro area banking sector to sail safe, avoiding a liquidity drain. However, keeping such measures for very long might have unfavourable consequences. Banks may become accustomed to accommodative financing conditions and easy access to liquidity, postponing necessary restructuring or strengthening of their balance sheets. Therefore, the remaining issue is not the direction in which monetary policies would evolve, but rather the pace of normalization.

Broadly speaking, future steps will depend on two major factors: economic developments and inflation dynamics. On the one hand, we are already witnessing a broad-based economic expansion and a decline in unemployment in the EU, which may require phasing-out the unconventional monetary policy measures sooner than later. On the other hand, economic expansion has not yet translated into higher underlying inflation that may justify continuation of monetary stimulus. Under the circumstances, the process of monetary policy normalization should be gradual, dependent on both broader economic developments and inflation dynamics, and carefully communicated.

As for the policy tools, further recalibration of the asset purchase program may be expected until the ECB sees a sustained adjustment in the path of inflation consistent with its inflation target. As currently communicated, the reinvestment of the principal payments from maturing securities purchased under the program would continue after the end of net purchases for an extended period of time. The sentiment of market participants is that the ECB would change the forward guidance on the interest rates later this year before increasing them around the middle of 2019.

It is reasonable to expect that the evolution of monetary policy conditions in the non-euro area EU member states, such as Bulgaria, will generally follow the developments in the euro area. Otherwise, a widening of the interest rate differential vis-à-vis the euro area may give rise to volatility in capital flows and exchange rates within the EU. Depending on the specific economic and inflation developments the pace of monetary policy normalization may differ, but not significantly, across those countries. In Bulgaria, more specifically, the monetary stance under the currency board arrangements will remain strongly influenced by the ECB monetary policy.

HOW TO REBUILD ENOUGH MONETARY POLICY FIREPOWER WITHIN THE EU IN ORDER TO DEAL WITH A POTENTIAL FUTURE CRISIS?

Our recent experience suggests that we need flexible and complementary policy measures to effectively deal with a crisis. The ECB response to the global crisis was well managed and precisely scaled. The risks of a liquidity collapse and complete disintegration of financial markets were avoided. However, in the midst of the crisis the monetary policy measures were supported by fiscal measures, as well as by urgent decisions to shape and implement structural reforms in different sectors of the economy. The lesson we learned was that it was erroneous to place all expectations for economic recovery and sustainability in the monetary policy basket. Monetary policy can be effective in dealing with a crisis only if supported by other economic policy instruments.

Looking forward, the standard monetary policy measures can mitigate cyclical fluctuations in the economy in the short run. However, their longer-term effectiveness in alleviating the impact of a crisis or stimulating economic growth would depend on the overall resilience and flexibility of the economy. The latter are conditional on policies that are outside the mandate and tools of central banks, and involves a wide set of fiscal and structural policy measures. As of today, the low inflation rate remains a challenge to the monetary policy suggesting continuation of the ECB low interest rates policy while the acceleration of economic growth, driven by domestic demand, might signal an accumulation of overheating pressures in some euro area countries, and perhaps requiring non-monetary policy interventions.

In a more strategic context, having the worst of the global crisis behind us, now is the time to rebuild buffers, to restructure and strengthen institutions, and to streamline regulations. To this end, the staged broad-based reforms in banking sector regulation, fiscal policy, labour and product markets should be completed as perceived. Specific priorities are well known and include further deepening of the EMU by: completing the Banking Union; building a Capital Markets Union; continuing with fiscal consolidation and filling up fiscal buffers; and further developing a sound crisis-prevention framework.

HOW TO ADDRESS THE OBSTACLES THAT HINDER FURTHER INTEGRATION OF THE EU BANKING MARKETS? AND IS THERE A NEED TO RESTORE TRUST BETWEEN THE NATIONAL SUPERVISORS?

The Bulgarian Presidency of the Council of the EU places strong emphasis on the completion of the Banking Union and the continuing work on the development of the Capital Markets Union. These are landmark institutional changes in the EMU providing an essential response to fragmentation in the EU single market in financial services.

Financial integration is not an end in itself but a means for an efficient and sustainable monetary union. The remaining fragmentation in the EU banking sector, more specifically, remains a challenge for the increasingly integrated EU economy. Moreover, if banks' assets are weakly diversified across member states they are prone to country-specific shocks, and if losses are incurred they will mostly be borne by creditors, investors or ultimately national budgets. In this context, the key priority is to complete the Banking Union.

EU financial integration also requires, and will be facilitated by, convergence in the regulatory standards and practices of supervision. Since 2011 the European Banking Authority has contributed substantially to the creation of the European Single Rulebook in banking. More recently, the Single Supervisory Mechanism and the Single Resolution Mechanism have centralised decision-making in the respective areas, also providing the framework for intensive and efficient cooperation between national authorities in both the euro area and non-euro area member states. The multitude of currently working supervisory and resolution colleges in the EU give plenty of examples for very good cooperation.

In this context, the slowing down of financial integration in the aftermath of the global crisis does not necessarily reflect a lack of trust between national authorities. Still, there is a need to further enhance cooperation, nationally and across borders. The recent crisis gave us important insights into details of supervisory and economic policies and practices that had been hard to see in "normal" times. Equipped with new knowledge and experience now, we should be capable of better responding to a crisis in the future. ●

Q&A

Valdis Dombrovskis

Vice-President for the Euro and Social Dialogue, also in charge of Financial Stability, Financial Services and Capital Markets Union, European Commission

EMU, Banking Union, CMU - time to accelerate

WHAT ARE THE PROSPECTS OF GLOBAL REGULATORY COORDINATION AND HOW IMPORTANT IS IT FOR THE EU FINANCIAL SECTOR AND ECONOMY?

The EU is currently in its sixth year of uninterrupted economic growth. This sustained economic expansion is only possible thanks to the major reforms that were put in place after the crisis. Building on the financial reform agenda agreed in the G20, the EU adopted more than 40 pieces of legislation to restore financial stability and market confidence. The reforms made the financial system more stable and resilient. Today, banks are stronger and much better capitalised than just few years ago.

For healthy economic growth to continue also in the future, we need to remember the lessons from the crisis. It showed that our financial system is truly international, and that financial stability requires both decisive action in each jurisdiction and close coordination across borders. That is why the EU is committed to maintaining and developing strong international standards to avoid regulatory arbitrage and renewed instability. To sum it up: global markets need global rules.

For instance, international cooperation is crucial for maintaining a level playing field for banks. We welcome last December's agreement on reforms to the Basel III framework, which represents the last major piece of the global post-crisis regulatory reform.

It is essential that all major jurisdictions implement all the key elements of the agreement. We are committed to doing so here in Europe, and we have already started assessing the overall impact of the agreed package on EU bank lending, including with a public consultation. In any case, we intend to make full use of the transitional arrangements that were agreed, so EU banks have ample time to prepare for the new rules.

Along with the implementation of reforms agreed in international standard-setting bodies, we also need to continue evaluating the effects of the reforms we have taken so far. In Europe, we carried out an assessment of the overall impact of our financial rules on the economy – the Call for Evidence - whose results are feeding into policies

today. And we want to make our legislation more growth friendly when possible, while sticking to our prudential requirements, as we demonstrated with our November 2016 Banking Reform Package.

So the Commission supports the work of the FSB in performing a sound analysis of the combined effects of the internationally agreed reforms, to identify and, if necessary, address any material unintended consequences. In particular, we welcome the ongoing evaluation of the impact of financial reforms on financial intermediation and on the availability and cost of infrastructure finance.

WHAT ARE THE KEY PRIORITIES FOR A FURTHER DEEPENING OF THE EMU AND WHAT IS THE AMBITION OF THE PROJECT ?

With the economic recovery firmly underway, now is a good time to deepen our Economic and Monetary Union. We cannot and should not wait for another crisis.

That is why completing the Banking Union is at the top of our agenda. Along with the Capital Markets Union, this would help integrate European financial markets, increase the shock-absorption of our economy, and alleviate the need for public risk sharing.

As of today, two pillars of the Banking Union are up and running: the Single Supervisory Mechanism and the Single Resolution Mechanism. But to manage a banking crisis with the least possible impact on financial stability and taxpayers, we need more than these two elements. In 2016, Finance Ministers unanimously agreed on a Roadmap to complete the Banking Union by reducing and sharing risks in parallel, and we are working on this basis.

On risk reduction in the banking sector, we have come a long way. Banks' capital and liquidity positions have improved, we have made progress on governance and supervision, and we have set in motion a process to significantly enhance banks' resolvability.

In November 2016, we presented our Banking Reform package, to further reduce risks in the banking sector while supporting strong banks. We should now finalise the negotiations, so banks can get clarity on the leverage ratio, the net stable funding ratio (NSFR), and the future framework for bail-in buffers, namely the total loss-absorbing capacity (TLAC), and the Minimum Requirement for own funds and Eligible Liabilities (MREL).

At the same time, we should remain firmly focused on reducing non-performing loans. In three years, their share in the EU has been reduced by about one third, from 6.7% to 4.4%. But their levels are unequally distributed, and still high in certain Member States. To further support Member States in this effort, we presented in March a package of proposals to help banks reduce NPLs and prevent their accumulation in the future.

In fact, with that package, we go beyond- the risk-reduction measures originally planned in the Council's Banking Union roadmap.

We now need to move forward with discussions on a common backstop to the Single Resolution Fund. And we need to set up a European Deposit Insurance Scheme, or EDIS, to make sure that depositors enjoy the same level of protection, regardless of where their account is held within the euro area.

Taking into account legitimate concerns from Member States, we presented last autumn our ideas to move more gradually towards such an insurance scheme, step by step. One idea is to restrict EDIS to providing temporary liquidity support in a first phase. This would not involve any mutualisation of losses. Then, in a second phase, we could move to co-insurance, conditional on an asset quality review to confirm that legacy risks from the crisis – such as NPLs - have been dealt with.

The Banking Union and the Economic and Monetary Union are interlinked, and completing them both is part of a political agenda which is currently entering a critical phase. Compromises need to be found as soon as possible, and ahead of the leader's meeting in June.

WHAT ARE THE KEY PRIORITIES FOR MOVING TOWARDS A CAPITAL MARKETS UNION? WHAT IMPACT IS EXPECTED FROM A REVIEW OF THE FUNCTIONING OF THE ESAs?

In the past few years, we have taken fundamental steps towards completing the Capital Markets Union - our ambitious programme to deepen, diversify, and further integrate capital markets in the EU.

So far, three legislative proposals and many other measures have been adopted: For example, we have made it cheaper and simpler to raise capital on public markets, with our Prospectus Regulation. And we have adopted new rules to promote a safe and deep market for Simple, Transparent and Standardised securitisation.

But with Brexit on the horizon, the EU needs a true single market for capital more than ever, to channel capital to job-creating investments and underpin a resilient Economic and Monetary Union. And despite steady progress, CMU is far from complete. Out of 12 legislative proposals tabled so far, nine are still under discussion by the co-legislator.

To put in place the building blocks of the Capital Markets Union by 2019, we are following a strategy to progress along three dimensions:

- allowing consumers and investors to benefit fully from the single market thanks to new EU-wide financial products;
- removing barriers to deeper capital markets through clearer and simpler rules for businesses; and
- achieving more consistent supervision of EU capital markets, to protect investors and financial stability.

But the European Parliament and Member States also need to do their part: they should accelerate work to get CMU past the finish line before the next European elections.

In early March, we also set out our plans to take CMU in more innovative and greener directions.

We presented an Action Plan to harness the opportunities of FinTech, including a proposal with new rules to help crowdfunding platforms grow across the EU's single market. We also adopted a comprehensive strategy for a financial system that supports the EU's climate and sustainable development agenda. This Action Plan on Sustainable Finance aims to connect finance with the needs of our planet and our society, and legislative proposals will follow in May.

Finally, we presented further initiatives to strengthen EU capital markets, notably by reducing barriers to cross-border distribution of investment funds and by introducing an EU-wide framework on covered bonds.

The Commission stands ready to engage actively with the European Parliament and the Council on all the pending proposals relevant for the Capital Markets Union. ●

Q&A

Danièle Nouy

Chair of the Supervisory Board,
Single Supervisory Mechanism,
European Central Bank (ECB)

Building a strong and even foundation for the Banking Union

HOW DO YOU EXPLAIN THE LOW LEVELS OF CROSS-BORDER CONSOLIDATION AND INTEGRATION IN THE BANKING UNION?

Many causes are at play here, but three stand out. First, banks' risk appetite has diminished since the financial crisis. That, in turn, limits the banks' interest in engaging in cross-border consolidation. Second, the crisis also triggered ring-fencing at the national level. And third, regulation in Europe is less harmonised than it should be and this, too, acts as a brake on cross-border consolidation.

Take, for instance, the issue of cross-border exposures between entities of the same banking group. In my view, regulatory requirements for such exposures should be waived within the euro area – as long as some prudential safeguards are in place, of course. There should be a waiver on large exposure limits. And that is indeed our policy, as communicated in our Regulation on the exercise of national options and discretions, ONDs for short. However, it is up to the Member States to actually apply this waiver – and not all of them do. Several countries have used the option – available to them until 2028! – to apply their own national policy on this waiver. This overrides our policy and makes the playing field for euro area banks less level.

In turn, this affects the usability of waivers on liquidity requirements. Large exposure limits constrain the movement of funds, putting a limit on the amount of liquidity that cross-border banking groups can move around freely. Banks therefore have less reason to apply for liquidity waivers in the first place. In a broader context, this also reduces the incentive to engage in cross-border mergers. What's the point in being a cross-border banking group if you cannot reap all the benefits that brings?

And finally, there should be cross-border waivers on capital. Introducing such waivers would be another important

step towards a truly European banking market and a true banking union.

HOW SHOULD WE ENCOURAGE MORE INTEGRATION? COULD THE REGULATORY FRAMEWORK FOR BANKING GROUPS BE REVIEWED WITH THIS IN MIND?

Well yes, we obviously need to further harmonise regulation. A first step would be to have more EU regulations and fewer directives. As regulations are directly applicable in all Member States, they ensure a high level of harmonisation, in particular within the Banking Union, which ensures their consistent implementation. Directives, on the other hand, need to be transposed into national law and the outcome in most cases differs widely across countries.

Another step would be to tackle ONDs. European banking regulation contains quite a number of these ONDs, which give authorities some leeway in applying the rules. Supervisors have agreed to exercise a number of ONDs in a harmonised manner across the euro area. But the remaining ONDs are in the hands of national legislators, including the one on large exposure limits that I just mentioned. Such ONDs need to be harmonised too, for example by transferring responsibility for exercising them from the national legislators to the national competent authorities, and hence the Single Supervisory Mechanism for the euro area.

Fit and proper rules also offer plenty of scope for further harmonisation. People who manage banks must be fully qualified to do so. Their suitability affects banks' governance – an area where major weaknesses have emerged in the recent past. In Europe, it is up to supervisors to check whether bank managers are indeed "fit and proper". But the approach to checking fitness and propriety differs considerably across the euro area. We need far more harmonisation here.

There is much debate on how to proceed with the Banking Union. In my view, completing the Banking Union is not just about risk reduction. It is also, very importantly, about creating a union! Risk reduction is music to the ears of supervisors; but if it is the sole focus and if the Banking Union is built on the current fragmented legal foundation, we run the risk of missing out on some of the expected benefits of the Banking Union. Personally, I don't think this would be the right way to proceed. The Banking Union needs to have an even foundation, bringing us once again to the conclusion that we need more regulatory harmonisation. Without harmonisation, integration will always be constrained.

WHAT CONDITIONS ARE REQUIRED FOR THE EURO AREA TO BE RECOGNISED AS A SINGLE JURISDICTION IN INTERNATIONAL BANKING REGULATION?

I would say that we should first consider ourselves as a single jurisdiction. This means that we should put an end to the post-crisis national ring-fencing, and begin moving towards truly harmonised regulation. Practically, this means, for instance, accepting the possibility of cross-border waivers for liquidity, solvency and large exposures under fully harmonised prudential safeguards, at least within the euro area. In international regulation, this plays a role with regard to capital surcharges for global systemically important banks (G-SIBs), for instance. Cross-border exposures are a factor in calculating the capital surcharges for G-SIBs. But this is not even the most important point: Does it make sense to think of cross-border exposures within a Banking Union? I believe that it is now time to recognise the progress already made in developing a truly European supervision and to address the remaining legal fragmentation I just discussed.

Together with the completion of the Banking Union, this would significantly strengthen our case for a single jurisdiction. The important thing is that Member States see themselves as part of a union, a single jurisdiction, and act accordingly. They should do away with the post-crisis ring-fencing mindset and embrace harmonisation. The important part of Banking Union is union; it is about being stronger together. ●

I. MACRO-ECONOMIC AND EU INTEGRATION CHALLENGES

Issues at stake

The euro area economic expansion continues to be strong and broad-based across countries and sectors. With this economic recovery underway, now is a favourable time to deepen the Economic and Monetary Union.

Several challenges however need to be considered. Ultra-loose monetary conditions have contributed to economic growth but their persistence over a significant period of time can increase risks for the economy. In addition, public debt in Europe remains high and rising interest rates may reignite government debt sustainability concerns in the absence of further structural reforms. Finally, developing private risk-sharing remains challenging with the persistence of fragmented regulations in most financial sectors.

Content

Deepening the EMU

Euclid Tsakalotos

Minister of Finance of Greece,
and Professor of Economics
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Deepening EMU and the social question

It has been said about politics that more important than the answers are asking the right questions. What is the goal of deepening EMU? Less time than one would think has been spent on this question. Everybody – or nearly everybody – agrees that something needs to be done but there is little attempt to tie proposed solutions to delineated shortcomings. Decreasing the chances, or at least the severity, of a new financial crisis? Increasing the long-term rate of growth? Promoting convergence within EMU? Countering right-wing nationalistic and centrifugal forces? All of these?

Lack of clarity is slowing progress on what has come to be called the Macron Agenda. Part of the reason has to do with political differences between member states. Should we proceed in tandem with risk sharing and risk reduction in financial markets, or do we need to prioritize, at least, in the first instance risk reduction? Do we need a fiscal capacity for the Eurozone, and an element of stabilization to address asymmetric shocks, or is it a matter of each member state putting its own house in order with respect to fiscal matters so as to react on its own to shocks? Would an ambitious plan for investment in European public goods put Europe on a higher growth trajectory, as well as alleviate regional divergences, or can we simply rely on member states continuing with a structural reform agenda? Debates on these, and other questions, have been going around in circles in recent Eurogroup and Ecofin meetings without any obvious oscillation to an agreed equilibrium of consensus.

And yet it seems obvious to a majority of professional economists that EMU lacks some of the basic tools that make other monetary unions work, notably banking union and risk sharing with respect to finance, and a budget at the European level that can act as both a stabilization and an equalization mechanism. For instance, the opposition to QE in Germany is perfectly understandable as very low interests create serious problems for pension funds and other savings institutions. Indeed, QE has led to too low interest rates for some and not low enough for some other Member States. The obvious response is that we do not have enough policy instruments to match our goals. A fiscal capacity at the European level, as well as a more expansionary policy in those member states with more space for such a policy, would have been a great help in getting the policy mix right.

But even this does not go far enough. One can have financial stability and growth but still have poor jobs, or jobs with no prospect for an acceptable career path, high levels of social exclusion and inequality, and large regional divergences in economic outcomes. It is these issues that are driving nationalistic and centrifugal forces. In short, without dealing with the social issue deepening of EMU will simply not work.

It would be difficult to claim that the debate on deepening EMU has captured the European public imagination. It has hardly figured in recent national elections throughout Europe. And yet unless there is a European public space for debate on how Europe is going to be more democratically accountable and socially inclusive, how can we possibly expect to challenge the forces of Euroscepticism? I end loyal to my opening dictum. Of all the ideas for deepening EMU, which ones will do most, and how, to adress the social and democratic deficit that lies at the heart of the European malaise? ●

Isabell Koske

Deputy Director, Organisation for Economic Co-operation and Development (OECD)

Strengthening economic convergence and resilience in the euro area

Is there income convergence between euro area countries?

The promise of economic convergence is at the core of the economic and monetary union. Real convergence in per capita income levels across countries is an important pre-requisite to garner strong, lasting support for the European project and the single currency. In the decades leading up to the Maastricht treaty in 1992, countries with lower GDP per capita enjoyed faster growth than richer ones, and the dispersion of GDP per capita across countries fell.

However, the process of real convergence among the original eurozone members has slowed or even stalled since then. Income dispersion across countries has widened since the crisis. For newer euro area members, income gaps with "old" members continued to narrow up until the financial crisis, but convergence for these countries also slowed thereafter.

What went wrong?

The common currency was expected to deepen the integration of capital, goods, services and labour markets, stimulating productivity and income convergence. Yet, the Single Market is still unfinished business. Trade integration, labour mobility and price convergence within the euro area remain well below what is observed across US states. Intra-EU trade in services has grown steadily, but remains limited. Financial market integration within the euro area was fragile before the crisis and has gone into reverse.

The sovereign debt crisis exposed weaknesses in the design of the euro area that have frustrated steady growth and convergence. Fiscal policies, which were supposed to work with the common monetary policy to smooth business cycles, often ended up being pro-cyclical and some countries had to tighten fiscal policy too rapidly during the downturn. The bulk of risk sharing across the euro area should happen through diversified private investment and financing opportunities, but it is held back by the incomplete banking union and fragmented capital markets. At the same time, public risk sharing through fiscal transfers, which would help weather large negative shocks, is virtually non-existent.

What should be done?

First, further reforms in the architecture of the monetary union are needed to enhance its resilience and ensure its long-term sustainability. Progress to complete the banking union should be made rapidly. Much has been achieved so far on banking supervision and regulation, but less so in the area of crisis resolution. Collective action to complete the banking union should focus on creating a common fiscal backstop to the Single Resolution Fund, and reinforcing the guarantee of deposits through a European deposit insurance scheme. Making good progress on the Capital Markets Union is also essential to deepen the integration of capital markets. Furthermore, a euro area-wide fiscal stabilisation tool would help complement member states' fiscal policies and accommodate common shocks when monetary policy is constrained.

Second, the way to sustainably restart the convergence engine is through productivity growth. There remains ample scope to close the productivity gap between the European Union and the United States. To boost productivity and promote investment, the EU needs to give the Single Market a fresh impetus, by removing the remaining barriers in services, digital, energy and transport. Actions at the EU level should come with renewed national efforts to foster long-term growth. The reform impetus has steadily declined since 2011-12, with slowing implementation of OECD Going for Growth and European Semester country-specific recommendations. The strengthening economic expansion offers a good window to reverse this trend. OECD estimates suggest that an EU-wide push for reforms to boost productivity could alone raise EU GDP by as much as 0.7% by 2023. Such actions would prove decisive to help durably revive income convergence and strengthen popular support for the euro project. ●

Forthcoming unwinding of QE

Vitas Vasiliauskas

Chairman of the Board,
Bank of Lithuania

The time is approaching to seriously consider a smooth transition from the APP

The times of muted recovery are over. We have witnessed the strengthening of broad-based growth and steadily declining unemployment, providing conditions for inflation convergence to our objective. This has increased my confidence that it is time to transition from the Asset Purchase Programme (APP). However, the closure of the programme should not be abrupt.

The scope of returning to normal has increased

The normalization of unconventional monetary policy is challenging. The use of new instruments in addition to the short-term interest rate has expanded the dimension of the normalization strategy. The ECB Governing Council has already built an agenda for a few steps ahead, spanning an extended period of time. The APP net purchases will be ended gradually rather than abruptly, ensuring a smooth transition of sufficient length. With respect to the sequencing: the start of the rate hikes will occur well past the end of the net purchases, leaving the reduction of reinvestments until the very end.

Due to a lag between monetary policy cycles in the euro area and the US, we are able to take into consideration the experience of the Federal Reserve. This includes market reactions to different episodes of communication, which have had a significant impact on financial conditions.

The normalization strategy includes answers to questions such as how our balance sheet will look after we return to normal. We intend to cautiously reduce the balance sheet in favour of financial market functioning. However, the balance sheet might remain larger than it was before the financial crisis. This would reflect a potentially higher demand for reserves in the banking system, due to structural changes of the interbank market (such as segmentation) and contemporary regulatory measures (such as capital requirements, liquidity coverage ratio, and net stable funding ratio), which limit banks' risk-taking and increase their dependence on liquidity provision by the central bank.

The timing, scope of normalisation and low-interest rate environment we have been experiencing since the financial crisis all require well-structured communication >>>

>>> to smooth the process of normalization. Understanding this, we employ forward guidance, which has so far proved to be a successful policy instrument. We should be ready for an increase in market volatility, which has been exhibiting unnaturally low levels. Any further policy steps will be well-discussed, data-based and gradual, providing sufficient time for markets to adjust.

The window of opportunity has not yet been fully exploited

Accommodative monetary policy has provided a window of opportunity for boosting resilience and has bought time for structural adjustments. However, the window has not yet been sufficiently utilized. I see significant long-term challenges, both across the euro area and the advanced economies as a whole. First, although the private sector has managed to deleverage successfully, sovereign debt has been elevated, and in most cases, it remains high. In this vein, strengthening the sustainability of government finances is of critical importance.

Second, on a broader note, globalisation and technological developments have been significant drivers of economic growth, but they have been followed by increasing inequality and skill-mismatch.

Third, while ageing processes are going to intensify in the developed world, youth unemployment remains high. Fundamental solutions need to be constructed to deal with these challenges, but these lie beyond the scope of monetary policy.

Notwithstanding the above, the window of opportunity provided by monetary policy will stay open – even with normalization, balance sheet and interest rate policy will continue full force. A gradual removal of accommodation will take time. ●

Luis M. Linde

Governor,
Banco de España

Monetary policy and financial stability

It is difficult to assess the effect of monetary policy on financial stability, as the sign and intensity of such effect are typically shaped by many factors. The evidence suggests that the non-standard measures applied in recent years have not been detrimental to financial stability in the euro area. For instance, it is typically argued that such measures might have depressed bank profitability, as a result of reduced net interest income and negative returns on excess liquidity. However, these effects have been largely compensated by positive effects via capital gains on banks' marketable assets, increases in the quality of loans and a stronger demand for new loans.

Other indicators suggest that banks overall have not increased their credit risk-taking in a relevant manner since the start of our non-standard measures. Having said that, there is some degree of cross-country heterogeneity in terms of financial risks. For instance, there are signs of emerging vulnerabilities in real estate markets in a number of euro area countries. Macro-prudential authorities should therefore continue to closely monitor those vulnerabilities, given the strong link between real estate valuations and banks' exposure to mortgage credit risk, which the financial crisis so dramatically illustrated. Looking forward, an important question is how the eventual unwinding of QE will affect long-term interest rates, which can be thought of as the sum of the expected path of our short-term policy rates and a premium that reflects duration and credit risk. >>>

>>> What matters is the amount of duration and credit risk that is absorbed by central banks as a result of their asset purchase programs. Even if the Eurosystem were to reduce or eliminate its flow of net asset purchases, the stock of risk absorbed by the ECB and national central banks will remain at the current high levels for some time, as a result of our commitment to reinvest maturing assets within the large APP portfolio already accumulated by the monetary authority. After that, one may conjecture that the stock of risk in the Eurosystem balance sheet will decline gradually, as we have seen in the case of the US FED. So as long as our communication on our asset purchase program remains clear and transparent, in principle we should not expect abrupt changes in risk premia.

On the expectations component of long-term rates, our communication points to a sequencing of events in which our first interest rate increase would not take place until well past the end of our net asset purchases. Now, current long-term yields reflect market expectations of when exactly this timeline is going to materialize. In principle, an abrupt increase in those yields would only happen if the end of net asset purchases were to be announced to take place much earlier than expected by the markets. In sum, while it is difficult to foresee how the adjustment of our QE policies may affect long-term rates, it also seems clear that a gradual and predictable approach to that adjustment should be useful in avoiding unnecessarily adverse repricings.

Finally, let us consider how an increase in long-term interest rates may affect the euro area. Long-term rates largely reflect the expected path of our future short-term policy rates. Any increase in the latter would be part of a process of monetary policy normalization, which in turn should only start once we see convincing signs of a sustained adjustment of medium-term inflation towards its aim of below but close to 2%. This means that nominal interest rates should broadly increase in parallel to an improvement in the inflation outlook. As a result, real interest rates, those more relevant from the perspective of the solvency of treasuries, nonfinancial companies and households, would not increase as much. This said, the ample cross-country heterogeneity in the euro area in terms of net indebtedness means that an eventual increase in real interest rates, even if homogenous across countries, may have very different effects across and within countries. It is important that those countries with higher ratios of private and public debt continue to make progress on their deleveraging processes and fiscal consolidation strategies. Moreover, they should do so in a growth-friendly way, in order not to unnecessarily hurt economic activity and hence their ability to repay their debts. ●

Yves Mersch

Member of the Executive Board,
European Central Bank (ECB)

Monetary policy in the euro area: solid expansion with timid price pressure

The euro area economy currently is solidly expanding and the upswing is broad-based. Recent data indicate that in the near term the economy is likely to expand even faster than had been expected. The monetary policy measures introduced since 2014 have effectively supported growth and employment, with real GDP growth expected to remain consistently above potential growth in the coming years.

In spite of the favourable growth dynamics, underlying inflation continues to be subdued. While our policy measures have been successful in preventing the disinflation of 2014 from spiralling into deflation and are contributing to an improved inflation outlook, an >>>

>>> ample degree of monetary accommodation remains necessary to secure a return of inflation rates towards levels that are below, but close to, 2% over the medium term. Looking ahead, the evolution of monetary policy will be firmly guided by the outlook for price stability. In this regard, the transition towards policy normalisation will begin once the Governing Council assesses that there has been a sustained adjustment in the path of inflation. Such a judgement will be based on three criteria for inflation: convergence, confidence and resilience. Convergence implies that headline inflation will need to be on track to reach levels below, but close to, 2% within a medium-term horizon. The Governing Council will also need to have confidence that the upward adjustment in inflation has a high enough probability of materialising and that it can do so on a sustainable basis. Thirdly, resilience, it will need to be ensured that the sustained adjustment in the path of inflation will be maintained even without additional net asset purchases.

In fact, confidence has recently risen and convergence is being confirmed - partly because the temporary decline in the inflation rate has been weaker than our internal calculations had predicted when we had reduced the purchasing program from EUR 60 billion to EUR 30 billion. More resilience will follow eventually. Still, patience and persistence with respect to our monetary policy is required. The former is necessary as it takes time for price pressures to build-up and the latter reflects the fact that the pick-up in inflation still needs to be supported by the prevailing monetary policy stance.

Once the Governing Council judges that progress towards meeting the three criteria is sufficiently advanced, our net asset purchases will be brought to an end. This is in line with our guidance on the expanded asset purchase programme (APP). Thereafter, the monetary support necessary for inflation to converge to our aim of below, but close to, 2% will be provided by reinvestments continuing for an extended period of time and policy rates remaining at their present levels well past the end of our net asset purchases. Policy decisions will continue to be firmly guided by the outlook for price stability for the euro area as a whole and not for any individual country.

The ECB remains committed to its price stability mandate, but other actors need to do their part to boost the resilience of the euro area and individual economies. Governments should take advantage of the increasingly solid and broad-based recovery to rebuild their fiscal buffers in line with the Stability and Growth Pact (SGP). At the same time measures to increase euro area economies' productivity should be forcefully pursued. And finally, the completion of the banking and financial unions would be a substantial step towards strengthening the euro area's capacity to withstand any future shocks. ●

Luděk Niedermayer

Member of the European Parliament, Committee on Economic and Monetary Affairs, European Parliament

Quantitative monetary policy: ordinary policy for extraordinary times?

Central banking has undergone revolutionary changes over the past few decades. It has developed from a secretive institution focused on regulation of capital flows and circulation of banknotes to highly professional technocratic institution setting up short term interest rates to reach its inflation target receiving high credit for stability of economies and creating preconditions for economic growth observed at the beginning of the 21st century. >>>

>>> Highly sophisticated know-how supporting this mission included state-of-art DSGE models for monetary policy and mathematics-based systems used in regulation of banks allowing promotion of financial stability. Transparency became unprecedented, exceeding by far levels of transparency in the rest of the public sector. Short-term interest rates of open market operations were the key tool for delivering central banks' goals, and quantitative theory based on influencing quantity of money rather than its cost played only marginal role.

In 1998, however, this highly sophisticated approach showed first signs of weakness with collapse of the LTCM hedge fund that failed to recognise that markets are not always efficient and liquid.

With the 2008 crisis in the financial sector, fiscal stress and fall of global demand, central banks faced a new situation with sharp decline in inflation and collapse of markets. Even extremely low nominal interest rates represented high real interest rates and dysfunction of the markets was limiting functionality of monetary policy. Overnight, the task of central bankers changed.

Instead of technocratic stabilisation of inflation close to inflation target via monetary policy performed in efficient financial markets, central banks became the last resort for support of a weak financial system and were expected to bring economies back to growth.

Two new concepts of monetary policy emerged out of necessity; a shift from qualitative monetary policy to quantitative policy, and high predictability of future interest rates known as forward guidance. Change in monetary policy model was probably the only feasible solution to delivering monetary stimulus to the economy and the necessary support to the financial sector.

Full allocation of bids in OMO tenders (instead of netting demand) was essential to support liquidity of banks with limited access to interbank markets. Forward guidance allowed banks and investors to use cheap short-term central bank funding for purchases of higher yielding longer term assets, therefore encouraging the private sector to invest. This was not without risk to central banks, who had to give up the ability to swiftly react to unexpected rise in inflation. These measures together with structural reforms have brought most economies back to growth. Still, the cost of the crises was substantial in both financial and social terms.

Today, growth is back and inflation is slowly rising to normal levels, banks are better capitalised and financial system better regulated. In many countries, fiscal deficits have improved. As a consequence, interest rates slowly climb back to positive numbers. Central banks are gradually exiting quantitative monetary policy. It will not be an easy journey.

Some economies can experience fast recovery after a long stagnation potentially leading to sudden upswings in inflation. In such case and under current circumstances, monetary policy would be too slow to react. Not to mention the risk of bubbles created by pressure of "quantitative money" on inflation of asset prices.

Whether we decide to criticize or praise the shift in mind-set of central bankers and their choice of instruments, the central banks deserve credit for courage and decisiveness, with which they acted at the time of crises often replacing actions by governments that were too paralyzed or financially weak to react. Recovery would have been more difficult and the crises costlier without such monetary actions.

It should not, however, imply that over-reliance on monetary policy or on its unorthodox tools should be the new normal in future. Monetary policy should not replace sound and responsible fiscal and economic policy, and governments should create space that will allow central banks to fully focus on transition "back to normal". We are still in the middle of this delicate process, and at this stage risks do exist. ●

Boris Vujčić

Governor, National Bank of Croatia

The good times have to be used to resolve the remaining issues

When the global financial crisis hit, the European economy and the financial system suffered from many weaknesses. Ten years later, the banking system looks much stronger, while the financial sector infrastructure and the European economy appear to be in a much better shape. The financial architecture has been greatly improved. The single banking supervisor has been created, systemic risks across Europe are monitored on a regular basis through the European Systemic Risk Board (although some areas, such as shadow banking, still remain somewhat opaque), while the Single Resolution Board has become operational. In addition, the favourable cyclical momentum has spread growth both geographically and across sectors, increased employment and led to the resumption of inflation.

Nevertheless, some risks are still lingering from the last crisis, while some new risks are appearing. The former are the "usual suspects"; vulnerabilities are still scattered over some euro economies, some structural reforms at the national levels not proceeding at the swift enough pace, the pockets of unemployment remaining stubbornly high, especially among the Europe's youth, while the divergence in income levels persists. Also, prior to the crisis, the headline fiscal indicators were seemingly good, but the structural deficits were underestimated, a fact which was "below the radar" at the time. Fiscal adjustment has progressed, but the crisis has left the legacy of elevated public debt. Any increase in sovereign risk could have an adverse impact on debt sustainability for the most vulnerable countries, and since many banks still hold the large quantities of domestic government bonds, these tensions could easily spread across the financial system.

New risks relate to the potential mispricing of risks and excessive risk-taking, stemming from the prolonged period of monetary policy easing. In many developed countries, financial asset prices grew strongly, reflected in a fall in bond yields and increases in equity indices and price-to-earnings ratios, not necessarily accounted for by the macroeconomic and financial fundamentals. Pension funds seeking to ensure adequate returns and investors "in search for yield" may have supported the emergence of financial bubbles. Moreover, as the implementation of QE also led to asset shortages, reducing the eagerness of the member states to advance structural reform agenda. In addition to that, new areas of risks are emerging, as can be seen in the new FinTech structures and markets, such as peer-to-peer lending. Furthermore, the easing of lending conditions by commercial banks has also been noted in a number of countries, raising concerns that banks can be tempted to grant loans to potentially vulnerable customers as a way of shoring up profits eroded by prolonged low interest rates. In the past 10 years, lenders were averse to risk and credit activity was muted, setting the ground for a new cycle posing a potential threat to the financial stability.

As long as the unwinding of the expansion of the Fed's and ECB's balance sheets occurs gradually, in relatively good market conditions and with a careful communication strategy, the effects on the market in the future should not be disruptive. In addition, many countries have in recent years built the extensive network of institutions that take care about financial stability and deal with macroprudential policy, using many other instruments besides monetary policy interest rates in order to address potential financial stability risks. If such risks do materialise, monetary policy can buy some time, but cannot address the underlying causes, such as delaying the implementation of reforms in individual member states or inadequate financial supervision. Against such a background, many commentators reiterate the JFK's old dictum that "the time to repair the roof is when the sun is shining". This momentum has to be harnessed in order for us to be prepared before the next crisis. For instance, a greater integration of capital markets, the European deposit insurance scheme and other remaining issues need to be tackled now, when the times are good. It is in Europe's code to endure, reform and reinvent itself, and sustain. ●

Luigi Federico Signorini

Deputy Governor and Member of the Governing Board, Banca d'Italia

ECB confidence in the sustained return of inflation to levels below, but close to, 2 per cent

Since early 2014, the ECB has been facing a very challenging macroeconomic environment, as the risk of deflation and the possibility of expectations de-anchoring from levels consistent with price stability have increased sharply. To combat these risks, the ECB has adopted bold and unprecedented measures: official rates were brought close to their effective lower bound, those on banks' deposits with the Eurosystem were lowered to negative levels; targeted long-term refinancing operations were introduced; and an asset purchase programme was put in place.

The policy package had a considerable impact on the financing conditions for households and financial corporations in the euro area, thus supporting aggregate demand, keeping inflation expectations well-anchored and avoiding the materialization of a deflationary trap. Notwithstanding this overall positive assessment, fears that a prolonged recourse to a bold set of measures might cause unintended consequences in specific sectors of the financial system are legitimate.

Exceptionally accommodative monetary policy may have contributed to depressing bank margins. However, the overall impact on bank profitability has been negligible, as the negative effect on margins was compensated by increased demand for credit by the private sector.

An additional side effect that we are carefully monitoring is the risk of asset bubbles. Yet the available evidence does not point towards widespread overvaluations of financial and real estate assets, nor does it signal exuberance in lending for the time being. In case of identified risks to financial stability, the first line of defence should involve macroprudential policies, as has recently been the case in particular sectors of some European countries.

Looking forward, the decisions of the ECB's Governing Council will continue to be shaped by economic data and by the progress of inflation towards levels consistent with the definition of price stability; its actions will remain prudent and persistent. In line with its forward guidance, the Governing Council will prolong the net asset purchases until the end of September 2018, and in any case until it sees a sustained adjustment in the path of inflation that is consistent with its aim. When asset purchases come to an end, forward guidance on the policy rates and the reinvestment of maturing securities could be used to modify the monetary policy stance and ensure that financial conditions remain consistent with a sustained adjustment of inflation towards the definition of price stability.

In case of a deep and globally widespread downturn, monetary policy would not stand still. The room for manoeuvre seems limited, but this impression has already proved groundless on more than one occasion. In principle, there are no obvious limits to what central banks can do and other new extraordinary and unconventional tools could be considered should recourse to 'extreme' instruments be deemed appropriate.

However, monetary policy alone cannot guarantee strong and lasting growth. The economic reform efforts to foster technological progress and strengthen human capital must proceed, especially as the recovery consolidates. By supporting euro-area economic activity and preserving price stability, monetary policy continues to provide favourable conditions for speeding up the process of structural reforms and absorbing its short-term costs. Raising euro-area potential output growth is the best safeguard to protect the economy against the next crisis and financial instability.

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Fostering private risk sharing

Johan Van Overtveldt

Minister of Finance, Belgium

Fixing the roof while the sun is shining

In 2012, the EU committed to put in place a fully-fledged banking union. Fully operational, it will shield both depositors and taxpayers from financial sector distress and boost the credibility and resilience of the European banking sector at the service of the real economy, in good and bad times.

Yet, there is still some road to be covered to install the three pillars of the banking union. Undeniably, great progress has been achieved in building a credible single supervisor for the euro area, that promotes a level playing field from Dublin to Riga, from Helsinki to Valetta.

The track record of the second pillar, the resolution framework, still needs to be set. Recent cases were handled efficiently at European level but raised questions on which types of banks need to be allowed to fail instead of resolved, which levels and quality of bailin-able buffers are sufficiently high to avoid bail-out with European taxpayers' money, and what tools should be given to the resolution authorities to ensure that crisis are handled swiftly and effectively. As long as these questions linger, it is unclear who will pick up the bill. Risks are still largely to be borne by the national level, as has been illustrated by recent cases, also in the absence of a common fiscal backstop for the single resolution fund.

National taxpayers remain also at risk in the absence of a European deposit insurance system. In case European supervisors cannot avoid the failure of a bank, and European resolution authorities decide to liquidate (parts of) a banking group, national deposit guarantee schemes need to (partially) indemnify depositors. This still may, have important implications for the national real economy and the sovereign.

As finance ministers, accountable towards European and national taxpayers, we therefore have the moral duty to push the agenda forward as swiftly as required, which necessitates also measures at national level to shore up balance sheets. Outstanding risks need to be further reduced. But we also need to ensure that on the road towards a fully integrated banking union, we ensure that shocks do not discredit the entire process. As long as Europe, respectively the SSM and SRB, decides over life and

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>>> death, yet consequences are born locally, calamities can easily lead to immediate fragmentation and potentially disintegration of the entire European project.

Until we have a fully operational banking union, we need to strike the right balance between the interests of citizens in which large cross border banking groups are headquartered and those in whose country subsidiaries of such groups are active. To protect the deposits of the latter, policy makers have built in safeguards to provide the supervisory authorities with the possibility to require cross border banking groups to put in place risk-based capital and liquidity buffers at national level.

A similar approach was followed for the building-up of bailin-able buffers (MREL). This home/host balance recognizes the need to efficiently allocate capital and liquidity within EU banking groups, and, at the same time, to offer assurance that the interests of all citizens are equally preserved in case of crisis. Of course, these additional buffers need to be carefully calibrated based only on the firm-specific and systemic risk-profile of local institutions.

At the same time, we are already seeing the successes of the banking union in its current form. Fragmentation in regulation and supervision is decreasing and cross border banks more and more contribute to financing the real economy of the euro area as a whole. Complementary to the banking union, the fastest way to further advance this is by furthering the capital markets union.

If we can make real progress, which implies for instance harmonising national insolvency laws, capital markets will be complementary to the banking union by offloading banks balance sheets, supplying funds to underserved, often innovative, firms, and backstopping the drying up of the banking channel in case of distress. Efforts should be doubled in this area, in particular given that the current favourable economic and financial environment will not last forever.

In conclusion, completing the banking and capital markets union is the project to further promote the integration of the European banking landscape. However, we need to progress in the right order. Ambition is needed to finish the banking union in full without creating additional and avoidable risks along the way. ●

Andreas Dombret

Member of the Executive Board,
Deutsche Bundesbank

Cross-border finance from a supervisory perspective – it's not that simple

Financial integration across borders may contribute to strengthening the common currency area. For example, it is seen to facilitate absorption of regional shocks and to contribute to transnational private risk sharing. The European banking union can play its part in fostering financial integration. For example, the implementation of the Single Resolution Mechanism is a major step towards reducing fragmentation. Another important step was the establishment of a new class of non-preferred senior debt, which further harmonised the creditor hierarchy in Europe and makes available a new instrument which can reliably be bailed in. Both support a harmonised resolution of failing cross-border banking groups within the banking union. >>>

>>> Regarding existing fragmentation, however, we should not be too quick to condemn everything out of hand. While there are reasons for greater financial integration across borders, there are counter-arguments as well. For instance, the latest Eurostat survey among corporates points to various economic reasons for banking sector fragmentation in Europe, for example that companies seem to prefer local banks to finance their investment projects. Also, whether cross-border consolidation has a positive or negative effect on financial stability will vary from one case to the next. Furthermore, cul-tural differences and varying financial habits play a part. Supervisors should not, therefore, promote cross-border inte-gration and instead take a rather neutral stance on the general topic of cross-border consolidation.

In the same vein, we should preserve adequate priorities for the banking union. For example, the main aims of the new EU recovery and resolution framework are to prevent banking crises as well as to have shareholders and creditors bear losses instead of taxpayers. Thus, in terms of cross-border banking, it has to ensure that risk absorbing capacities are in line with the actual distribution of risks across the banking group and located in entities where losses are most likely to arise.

This limits the use of capital waivers in cross-border business. Some have argued in favour of allowing cross-border groups to use a capital waiver even when the parent institution and the subsidiary intending to use it are not based in the same member state. Such a cross-border capital waiver presents another step towards a completed European bank-ing union and might also work against fragmentation of cross-border banking groups. But as long as neither insolvency law nor resolution law nor company law are harmonised within the EU or even within the SSM, the introduction of a cross-border waiver entails unpredictable risks, especially in crisis situations.

Instead, the EU resolution framework must prioritise the goal of being reliable and credible in an emergency case. With regard to institutions operating across borders, stakeholders need to be confident that sufficient loss-absorbing and re-capitalisation capacity will also be available to subsidiaries of resolution entities in different jurisdictions. In addition, we need to ensure robust MREL requirements as well as a sustainable subordination requirement across jurisdictions.

So, while there is a case for fostering financial integration in the euro area, it is important to preserve the overall spirit of a balance between liability and control in order to maintain the overall functioning of our financial architecture. ●

Philippe Bordenave

Chief Operating Officer, BNP Paribas

There is no attractive business case to create pan European banking groups

In the 10 years since the financial crisis, consolidation in the European banking sector has been very limited, contrary to the United States, where the five biggest banks hold over 40% of domestic assets, compared to 20% in the EU. The main driver is the regulatory and supervisory framework in Europe, which has not been conducive to creating an attractive business case for pan European integrated banking groups. Thus, in reality, in each EU Member State, lending to the economy remains largely domestic. At the same time, the market share of US banks in European investment banking is now nearly 50%, >>>

>>> while EU banks' share is only 38%, down from 43% shortly after the crisis[1]. These figures speak for themselves and point to a structural problem in Europe. European policy makers have expressed their wish for industry consolidation, as a way to increase financial stability, but the current regulatory framework creates barriers to carry out significant cross-border acquisitions. Without adjustments to the current legal and regulatory framework, cross-border consolidation will not happen, except for limited and selective acquisitions related to specialized businesses.

Despite major achievements, the existing regulatory framework still favours fragmentation of banking markets in the EU

Faced with an acute sovereign debt crisis, Europe has embarked in an extremely ambitious journey to create the Banking Union. The set-up of the Single Supervisory Mechanism, after an unprecedented Asset Quality Review, has been a major achievement, implying acceptance of a critical transfer of sovereignty, with the aim of achieving convergence in supervisory practices for directly supervised banks, and progressively expanding supervisory convergence to less significant institutions. The Single Resolution Board has been put in place and has started to handle a number of distressed situations. The Single Resolution Fund is being financed by the industry, with hundreds of millions being contributed every year by large banks, with the goal of avoiding the use of tax-payer money to rescue ailing banks.

Despite such game-changing institutional architecture being now in place, the Banking Union is not fully functioning as an internal market for financial services. In practice, banks are not operating in a single banking market but as a sum of separate entities by country, because international regulations, intended to apply at consolidated level, have been transposed in Europe at solo level.

As a consequence, EU financial regulation puts European banks at a disadvantage with their peers in other jurisdictions, notably the US. To illustrate this point, when J.P. Morgan lend money in any US state, there is no increase in its G-SIB cross-border score, and it has no impediments to move liquidity throughout the United States. In the Eurozone, unfortunately, that is not the case. When BNP Paribas Fortis lends to a Belgian corporate, it costs more in terms of capital for our Group than when BNP Paribas SA lends to a French corporate! Is it really intended by policy makers ?

Such constraints not only hinder the operations of pan Eurozone banking groups, but also reduce the efficiency of ECB's monetary policy transmission, leading to a need for lower rates and higher liquidity provision for longer.

To put an end to this situation, Europe needs to regard the Eurozone as a single constituency so that the creation of the SSM, SRM and SRF can deliver its intended benefits. If Europe does not, no one else will, not other international bodies, and certainly not the markets, and the sovereign/bank nexus, which led the Eurozone to an extreme crisis in 2011/2012, will continue to prevail.

The revision of the CRR / CRD provides the opportunity to address barriers to effective Banking Union

The current revision of the CRR / CRD is an opportunity to take decisive action and signal the political will to strengthen the financing of the European economy. I would therefore make two specific recommendations:

- Recalibrating the G-SIB score to account for the single jurisdiction: This would mean that European G-SIBs and O-SIIs would not be unfairly penalized due to a methodology that considers activities within the Banking Union as cross-border, thus increasing their capital requirements.
- Removing liquidity requirements: Allowing the LCR and NSFR to be applied on a consolidated basis only, within the Eurozone, would make a significant improvement to the free flow of liquidity.

Europe needs to move decisively to materialize the existence of a true euro area single banking market. The economic recovery takes hold and needs strong, >>>

>>> large and diversified banks to finance it through competitive lending across the monetary union and through providing pan Eurozone access to capital market products. Otherwise, the Eurozone will continue to lose its financial sovereignty, and will be vulnerable again at the time of the next crisis, despite all efforts put into swift building of the Banking Union.

Let's avoid accumulating pre-requisites such as EDIS and other risk reduction debates, that make us lose track of our overarching collective duty to consolidate the EMU in a turbulent world. ●

1. Source: "Towards a more integrated banking sector in Europe", Oliver Wyman report, February 2018

Vittorio Grilli

Chairman of the Corporate and Investment Bank EMEA, J.P. Morgan

The priorities, challenges and prospects for further integrating EU financial markets

There are signs of challenges to the decades of global cooperation that started post-WWII, despite the post-crisis emphasis placed on global minimum standards and international coordination. Europe should resist protectionist trends, especially regarding financial markets, which are stronger and more resilient when globally managed and diversified. And while Europe keeps its financial markets open, it must also focus on deepening them to become a credible leader for the global financial system.

Trends away from consistency and minimum standards towards localized, or even retaliatory policies, not only adds complexity in implementation, but can have negative implications from a financial stability perspective: fragmentation of global markets; build-up of risk concentration based on regulatory arbitrage; reduced operational resiliency. The EU has an opportunity to drive a policy agenda that not only creates greater efficiencies, including deeper and more liquid capital markets, but also by nurturing the development of new global centres of excellence, as well as boosting exports of financial services. The largest and most successful global financial centres are characterised by their openness, access to global pools of capital and liquidity; and scale and financial ecosystem. These characteristics jointly facilitate cross-border business, enabling firms to provide the best services for their clients around the world.

For example, UCITS is a great European success story, which has helped establish the EU 'brand' for asset management. The EU can build on the success of UCITS if it continues to bear in mind the international dimension in its policy-making. Recent proposals for the next generation of European prudential requirements include a requirement that conflicts with important US legislative obligations and poses risks to the continued competiveness of certain lines of business in Europe). Similarly, a proposed recast of the European resolution regime would deviate payments moratorium powers from international standards, creating disruption to the global derivatives markets. When introducing new rules, due consideration should be given to their impact on international regulatory consistency.

While the openness of Europe's financial markets is important for global risk management, Europe can only be a credible leader on this front if it also >>>

>>> focuses on integrating its own financial markets. The Capital Markets Union (CMU) is the right framework for this work. A CMU will improve companies' access to capital, by making it easier, for example, to issue a bond, to go public or to get a syndicated loan. This is even more important as the UK leaves. A study from the think tank New Financial shows that companies in the EU27 (i.e. the EU without the UK) rely on bank lending for just under 80% of their debt funding, compared with 55% in the UK. One reason why small and mid-sized companies tend to avoid the capital markets is because of onerous and complicated requirements for the information they have to publish, such as the prospectus for a bond issue.

And progress has been made. We have seen the modernization of the EU prospectus regulation and legislation to kick-start the securitisation market. A European Commission Expert Group issued a report that makes a total of 22 policy recommendations to create more integrated, efficient and resilient European corporate bond markets. We have also seen a proposal for a pan-European personal pension product and are encouraged by updated language designed to incorporate lifecycle funds within the default option. We also support the Commission's efforts to solve Europe's non-performing loan (NPL) problem, as reflected in their recent package.

In the final year left to this Commission and Parliament, progress should be accelerated on the CMU so that the momentum carries over to the next mandate; a CMU 2.0 of sorts. While some of the low hanging fruit has been picked, more fundamental change remains necessary to create an open and true Single Market for financial services. While this change should be advanced through concrete policy proposals, it should also involve a shift in how policymakers conceive of new rules and their impact on capital markets. ●

Vincenzo La Via

Director General of Italian Treasury,
Ministry of Economy and Finance, Italy

Banking Union: sharing risks to reduce them

Ten years after the outbreak of the global financial crisis, the financial system is much safer and more resilient today, thanks to a series of institutional and regulatory measures that were designed to reinforce the global financial sector.

At the global level, the largest banks are better capitalised and are subject to greater market discipline than a decade ago. Toxic forms of non-banking/shadow banking activities, which were at the core of the global financial crisis, are no longer a threat to the financial stability. Other non-banking activities are now subject to more rigorous rules, which are aiming to transform such activities into resilient market-based finance. Reforms to over-the-counter derivatives markets have reduced opacity and complexity related to these transactions with improved transparency. Financial infrastructures, such as central counterparties, are also operating in a considerably more solid foundation.

In Europe significant steps have been taken in addition to the globally-agreed reforms. In particular, the strengthening of the Single Market has advanced with the creation of the Banking Union and the Capital Market Union.

A Banking Union is necessary to succeed in limiting market fragmentation and in creating a true level playing field for firms all across the European Union. A >>>

>>> fully-fledged and successful Banking Union requires an appropriate matching between risk reduction and risk sharing measures.

Many achievements have been attained on the risk reduction side, notably: (i) strengthening prudential safeguards of banks with increased capital and liquidity requirements; (ii) reinforcing supervision through in-depth EU wide stress tests by the EBA and creating the Single Supervisory Mechanism; and (iii) implementing domestic legislation following the Bank Recovery and Resolution Directive and establishing the Single Resolution Mechanism.

On the risk sharing side, that according to what was stated in the 2016 roadmap should have gone hand in hand with risk reduction, the achievements attained so far are limited, with particular reference to already agreed measures such as a common European deposit insurance scheme and a common European backstop.

In this regard, creating a European Deposit Insurance System would significantly improve the functioning of the Banking Union, through ensuring more resilience, boosting confidence, which is a key ingredient for the success of the Banking Union, and in turn reducing risks. It is equally important to establish an effective common backstop to the Single Resolution Fund with the utmost urgency. This is not only for enhancing the financial capacity of the Fund but also for the overall credibility of the Single Resolution Mechanism.

The two latter measures, that in effect are crisis mitigation tools, have long been agreed in principles in order to bring the Banking Union to completion but the necessary action to finalise them are still lagging behind. It is time to make concrete and significant steps forward.

A final effort is required to bring to completion the ambitious project for the creation of an efficient and effective Banking Union, which will strengthen not only the financial sector but the entire design of the European Union, enhancing confidence and credibility.

The European response to the financial crisis has been effective thanks to, among other factors, the unity demonstrated by the member states, that has allowed to deal quite successfully with a series of critical situations in many countries. Sharing risks at European level has proved to be the right means to reduce them. This is an important lesson never to be forgotten. It is this unity in intents and the confidence in each other that we should continue to use to build the future of Europe. And this will create the best barrier to emerging risk and potential causes of instability for the future. ●


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Elke König

Chair, Single Resolution Board (SRB)

Real defragmentation of the Banking Union: the way forward

The European Commission's risk reduction package proposes to implement important international provisions in order to reduce risks and achieve further progress towards the completion of the Banking Union. These proposals also suggest partially waiving certain cross-border capital and liquidity requirements to address the fragmentation of national banking markets. >>>

>>> The SRB welcomes the Commission's efforts to make progress on the completion of the Banking Union and to enhance resolvability of big banks with the implementation of TLAC and the introduction of a creditor hierarchy. At this point, we should take a step back and identify further elements, which impede the completion of a fully-fledged Banking Union.

The Single Supervisory Mechanism tasked with reducing the occurrence of crises ex-ante and the Single Resolution Mechanism equipped with common rules for the orderly wind-down of a failing bank ex-post have proven to be two important pillars of Banking Union. The missing third pillar, a common European Deposit Insurance Scheme with appropriate safeguards is a pre-requisite for the completion of the Banking Union, as it would harmonize the level of depositor protection throughout all Member States.

However, efforts are also needed in other domains. In this context, the divergence of national insolvency laws is a major obstacle towards a fully-fledged Banking Union. In the current system, the counterfactual of no-creditor-worse off (NCWO) might produce different results in different countries depending on the national insolvency regime and thus negatively impact on the orderly wind-down of a bank. The SRB therefore strongly encourages legislators to harmonise national insolvency laws, in order to create a level-playing field.

This harmonisation would facilitate resolution planning for cross-border banking groups within the Banking Union. For these banking institutions, the SRB's Internal Resolution Teams (IRT), assess a bank's critical functions and business model as a whole. Based on this assessment, the SRB determines the preferred resolution strategy and the appropriate amount of MREL for the banking group as a whole and at entity level to allow for potential internal upstreaming of losses and downstreaming of capital. However, we must be aware, that in the current framework insolvency is clearly entity-specific as is NCWO.

It is crucial to bear in mind that without statutory or at least contractual changes to this framework, the focus during the resolution of banking groups will have to remain at entity level and thus limit the scope of national or cross-border waivers. In this domain, the legislators are clearly in the driving seat. At the same time, we should explore alternative means of internal loss absorption with appropriate safeguards, so that a single-point-of-entry strategy across Banking Union Member States could be effectively carried out.

While harmonised rules certainly help to ensure effective supervision and resolution, the consistent enforcement of these rules and close coordination and cooperation among authorities are equally decisive for the functioning of the Banking Union. Hence, the cooperation of ECB and SRB must be improved even further, and the updated Memorandum of Understanding will help in this regard. Moreover, the cooperation and monitoring between the individual national competent and resolution authorities and their interaction with the European level requires further intensified efforts.

In this way, it can be expected that the trust of national authorities in the effectiveness of the European supervisory and resolution regime would be considerably strengthened.

Overcoming the outlined obstacles to the fragmentation of the Banking Union can be a major contributor to financial stability, enhance resolvability and depositor protection and help build trust and confidence in the functioning of the Banking Union among the different national authorities.

Once the Banking Union has been completed with the full potential of all three pillars realised, Member States and their respective supervisory and regulatory authorities would have little reason to maintain any ring-fencing practice or to erect barriers to the free movement of capital and liquidity across national borders within the Banking Union. ●

Roberto Gualtieri

Chair, Committee on Economic and Monetary Affairs & Member of the Brexit Steering Group, European Parliament

Reaping the benefits of an integrated banking market

Drawing the lessons of the financial crisis has been the main driving force behind the idea of the creation of a true single market for banking services. The Single Rulebook, the Single Supervisory Mechanism, and the Single Resolution Mechanism have been already major achievements contributing to a more resilient banking sector. However, banking Union remains incomplete, and important and crucial elements are still missing. In this respect, a limited cross-border banking activity is one sign of a still fragmented European banking market and is showing that there is no time for complacency.

Recent attempts tried to revitalise the process in order to ensure a timely completion of the Banking Union project. The Commission tried to revive the discussion with its Communication on Completing the Banking Union of October 2017. The Communication underlines the importance of finalising the already proposed measures and announces additional ones.

The completion of Basel III prudential framework within the Single Rulebook for banking is crucial. Currently ECON Committee is working on a balanced position on the banking package consisting of a review of the capital requirements directive (CRD V) and the regulation (CRR II), the bank recovery and resolution Directive (BRRD) and the Single Resolution mechanism regulation (SRMR), in order to combine necessary risk reduction with appropriate incentives towards healthy support to the real economy. A timely adoption of these proposals is therefore important, as the provisions therein should contribute to facilitate further integration of the European banking market. However, it appears evident that as far as an equal level of protection of deposits will be effectively ensured across the Banking Union, and a credible backstop will support the Single Resolution Fund and the necessary instruments for direct recapitalisation of credit institutions, it will be difficult to overcome the political obstacles at removing the current limitations that prevent cross-border institutions from managing own funds and liquidity requirements efficiently at a group level.

"The completion of Basel III prudential framework within the Single Rulebook for banking is crucial. "

- ROBERTO GUALTIERI

While we currently register a strong asymmetry between risk reduction and risk sharing measures and the two dimensions should proceed in parallel, additional measures that go beyond the 2016 risk reduction roadmap have been agreed in order to facilitate progress on risk sharing. In this respect, the Council Action Plan of July 2017 and the Banking Union Communication have addressed the issue of NPLs. While noting that the recent Commission progress report confirms the trend of falling NPL ratios in Member States and shows that a sustained economic recovery in the euro area is the most effective factor for tackling this problem of NPLs, we have welcomed the additional measures and stand ready to contribute positively and constructively to this joint work. The legislative proposals published by the Commission in March 2018 will be dealt swiftly in Parliament, with the aim of putting into force an effective prudential backstop based on calendar provisioning while avoiding negative incentives which might result in unjustified balance-sheet losses for banks and in a contraction in credit supply. At the same time, we have called the SSM to align its supervisory expectations with the new legislative requirements as far as they will be adopted, and to focus on possible bank-specific additional measures instead of defining rules of general nature. It remains valid, as the European has repeatedly underlined, that NPL are clearly a significant source of risk, but in order to be credible risk reduction should devote equal attention to market risk and to appropriate measurement of risk of illiquid assets.

Despite all these remarkable progresses as regard risk-reduction, the euro area is still prone to deleveraging due to foreign risk exposure and denomination risks. This is mainly due to the absence of a European risk-sharing mechanism, which could prevent the bank-sovereign nexus. Indeed, as long as national insurance schemes are tied to the solvency of their governments, banking crises have still the potential to threaten governments. Partial guarantees can mitigate this nexus, but as long as there is no real risk-sharing - via a fully-fledged common deposit insurance mechanism and a common backstop - default risk in both banks and sovereigns can give rise to self-fulfilling speculative attacks. We should therefore proceed to the setting up of the third pillar of the Banking Union. The Banking Union Communication brought forward additional ideas in this respect. The Parliament is currently debating the EDIS proposal at committee level.

While it was important to address decidedly the legacy issues of the financial crisis, we must now go back to the common goal we wanted to achieve when we started this journey: a well-functioning single market for wholesale and retail banking in the European Union which should safeguard diversity of banking models and at the same time promote financial integration. In order to allow citizens to reap the benefits of such an integrated banking market, the discussion has to be revived and timely progress has to be achieved on the pending and forthcoming legislative proposals aiming at the completion of the Banking Union. The European Parliament is ready for this. ●

Paul Hilbers

Director Financial Stability,
De Nederlandsche Bank

Integrating the European banking market

Cross-border consolidation for European banks can bring many benefits. Customers would find cheaper products due to more intense competition and economies of scale. Member states would benefit as more private risk-sharing helps to dampen shocks. And most importantly, financial stability improves due to a further reduction of the sovereign-bank nexus. After all, banks would become less attached to their home market. Consolidation therefore is a robust form of financial integration that improves the functioning of EMU.

Then why isn't it happening? Part of it is due to temporary factors that are only starting to wane. The crisis led to fragmentation, often accompanied by national solutions. Regulatory uncertainty only decreased recently with the agreement on Basle 3.5. And Brexit does not help either. Another part is because the banking union isn't finished yet. Non-performing loans are resolved only slowly. Supervision is a success, but resolution needs improvement and a European deposit insurance scheme is still lacking. As the cost of bank failures are still partly borne by member states, many national supervisors have concerns about large cross-border banks. A last part lies in differences in culture and the tax treatment of financial instruments. Europe will therefore not achieve the degree of integration of the US anytime soon.

What can be done to stimulate consolidation? A first priority to reduce uncertainty is a swift implementation of Basle 3.5. Translation into European regulation may take some time. Second, effective reduction of non-performing loans would also help. A third priority is strengthening the banking union with more effective resolution and a European deposit insurance scheme. However, further risk sharing should be preceded by further risk reduction. One key element is the reform of the regulatory treatment of sovereign exposures. A fourth priority is developing the capital markets union to stimulate non-bank financial intermediation.

Financial stability is a national and a European responsibility. It is a key task of member states, especially as long as the banking and capital markets union are developing, and integration is incomplete. In this intermediate situation, countries need sufficient leeway to differentiate instruments in line with national circumstances and risks. For example, differences in the size and concentration of banking sectors are still large. As the impact of bank failures will differ, it requires differentiation in systemic risk buffers between countries. But financial stability is also a European task, and more harmonization may certainly be feasible if integration progresses further.

New issues are on the horizon. Fintech and cyber risks may have more important effects on bank business models than for instance changes in capital requirements. Climate change may also have far-reaching effects. These topics are discussed in countries and at the European and global level. Supervisors are also critically assessing the combined impact of recent changes in regulation. European cooperation and collaboration in this area is key, also to maintain financial stability. ●

Are public and private debts sustainable?

Marco Buti

Director General for Economic and Financial Affairs, European Commission

Waste neither a serious crisis nor a good recovery

The economy of the EU is experiencing the longest period of uninterrupted economic growth since the financial crisis of 2008. The EU economic expansion has outpaced that of the US since 2016, and is broad-based, robust and expected to last. Stronger nominal growth is helping to tackle many legacies of the crisis, as high rates of unemployment, but also major vulnerabilities linked to high government and private debt ratios and shares of non performing loans in some Member States.

Increased private debt and net foreign liabilities in the pre-crisis period were mostly the result of reduced risk premia and abundant savings and liquidity at global level, which were at the root of search for yield and a risk-prone attitude. The recession implied further growth in already high debt ratios, despite widespread deleveraging by households and corporations. Persistent subdued or negative nominal growth made deleveraging difficult and bank balance sheets worsening in a number of countries. Current account reversals in the euro-area coincided with large contractions in domestic demand and, in view of persistently subdued demand dynamics in surplus countries, euro-area rebalancing remained largely asymmetric. The government sector helped cushioning the impact of deleveraging on the economy, but at the cost of a protracted growth in government debt as a share of GDP, on top of major revenue losses.

Resuming growth since 2013 permitted to accelerate the pace of deleveraging without further compression in domestic demand. Private agents could rely on growing incomes and asset values to repay debt. NPLs started declining, creating the conditions for improved credit conditions. Government debt ratios in the EU have gradually set on a declining trend, while the debt ratios of other major advanced world areas such as the US and Japan have not embarked yet on a downward path.

The path to recovery was made possible by the responses that national and EU policies devised faced with exceptional challenges. Crisis-hit countries carried out long overdue bold reforms. New EU-level institutions and rules were created for Member States to deal with crises and to regulate, supervise and resolve banks. Monetary policy adapted its instruments to address deflation risks while official rates reached the lower bound.

>>>

>>> Despite recent achievements, overall debt levels remain at historically high levels. The ongoing expansion opens the case for monetary policy normalisation, while pockets of risk linked to strong asset price growth could gradually emerge. Looking forward, this means persisting vulnerabilities and reduced room to use macroeconomic policy tools in counter-cyclical way.

The EU should now take the opportunity to put growth on a sustainable footing while ensuring a durable correction of existing imbalances. This requires keeping reform momentum and addressing national vulnerabilities and risks, but also progress towards completing the EMU, in particular the banking union and capital markets union. Given the institutional calendar, the window of opportunity will close soon and we should not rely again on market pressure to take difficult decisions. As the saying goes, "never let a good crisis go to waste". This is the time not to waste a good recovery. ●

Rolf Strauch

Chief Economist, Member of the Management Board, European Stability Mechanism (ESM)

Fiscal policy and monetary policy normalisation in the Euro area

The euro area has entered the expansionary phase of the business cycle. Growth is above potential and there are good prospects that it will remain strong in the near future. Last year, euro area GDP grew at 2.3% and the vast majority of forecasters' project GDP growth above two percent for this year. In the medium-term, growth will slow down and move towards the long-term potential. All euro area economies are expanding – and several countries have caught up after the double-dip recession, thanks to the structural reforms implemented in the context of ESM programmes. At the same time, major external imbalances existing at the start of the crisis have been overcome. In view of these encouraging prospects, inflation is expected to increase in the medium-term.

Against that background, the ECB reduced the pace of its asset purchases in January, and is expected to take further steps towards monetary policy normalisation in the near term. For the moment, net purchases will run until the end of September, or continue beyond that moment if the ECB's Governing Council deems it necessary. Interest rate moves are expected only "well past the horizon of the net asset purchases". Financial markets are adjusting to this setting with moderate increases in long-term rates and an exchange rate appreciation.

European institutions project the aggregate fiscal stance of the euro area to be broadly neutral across countries over the coming years, and debt levels are expected to drop further. Given the growth performance and debt structure, policy normalisation does not pose an immediate sustainability risk for any euro area country. Many countries have used the past years of low interest rates to extend the maturity of their debt. Therefore, changes in monetary policy will only slowly feed into higher interest rate costs. In the case of Greece, ESM lending ensures that the sovereign will face low average interest rates and manageable financing needs over the years to come.

"There is a need to learn from the past and create the necessary policy space to handle periods of weaker growth in the future."

- ROLF STRAUCH

Yet, there is a need to learn from the past and create the necessary policy space to handle periods of weaker growth in the future. Countries with high debt levels, low long-term growth potential, and small economies experiencing high output volatility need to create fiscal buffers to avoid pro-cyclical fiscal tightening in future downturns. Indeed, low private and public savings in the early 2000s were factors in causing the most recent European crisis. From that perspective, all countries need to make an effort to live up to the requirements of the European fiscal framework, including the debt rule. This is even more important considering that the room for manoeuvre of monetary policy to react to any future downturn may be limited at the current level of interest rates. ●

Alexander Batchvarov

PhD, CFA, International Structured Finance Strategist, Bank of America Merrill Lynch

Household debt sustainability is all relative

Household debt has more than doubled in the EU since year 2000. Mortgages represent the dominant share of consumer debt in Europe. The residential mortgage debt doubled from €2tn to c. €4tn in the Eurozone, and from just above €3tn to c. €7tn for the EU, according to EMF. Relative to disposable income, household debt declined in some of the crisis-stricken countries (Ireland, Spain), but continued rising in others, jumping over the 100% line in Belgium, France and Poland. In a number of countries the above ratio stands north of 150%, e.g. Denmark, Ireland, Netherlands, Luxembourg, Sweden, UK.

One would think that with recent low interest rates, the increased borrowing would be based on fixed rate, protecting borrowers from future hikes. In fact, floating rate and short-term fixed mortgages have come to dominate many EU mortgage markets such as Sweden, Spain and Portugal, Italy, Ireland and the UK, and only in a few countries borrowers have locked in medium to long-term mortgage rates, e.g. Belgium, Germany and Netherlands. On average, many EU countries' households are entering the rate tightening cycle with historic high debt levels, while their savings have declined or stayed unchanged after the financial crisis, as have their liquid financial assets. This suggests, in our opinion, higher sensitivity to rate increases.

A related issue is the way household debt is financed. In the Eurozone, c. 50% of residential mortgages is financed by covered bonds (CB). In some countries, the share of CB is high: 140% of GDP in Denmark, 48% in Sweden, c. 20% in Spain and Portugal, and c. 10% in Netherlands and France. CBs are not a homogeneous bullet-proof product, as often presented, and their pricing was positively affected by ECB QE and excessively favourable regulatory treatment, we think. The high correlation between mortgages, CBs, banks as issuers and investors, and ECB QE stock is creating a high systemic interdependence at a time of monetary policy normalisation. On the other hand, the role of RMBS in financing the EU mortgage markets has shrunk for reasons which are a mirror image of those supporting the expansion of the CB market.

> *"Households are entering the rate tightening cycle with historic high debt levels."*
>
> - ALEXANDER BATCHVAROV

A household debt burden at unprecedented high levels and rather skewed mortgage funding markets suggest high sensitivities to interest rate rises, and argue in favour of slow monetary policy normalization in the Eurozone. The systemic risks that have been built up during the period of ultra-low rates can be addressed through regulatory policy measures, which seek to re-establish the level playing field across different funding instruments as part of the deepening of the CMU. The introduction of high single-digit asset encumbrance limits for universal bank CB issuers is long overdue, as is the application of the same high standard of transparency for all asset-based capital markets instruments.

Bank lenders need to be prepared to address the negative impact of interest rate hikes under the specific circumstances of each affected borrower, applying the lessons learnt during the financial crisis; otherwise, they face a rise in their yet-to-be-resolved NPL portfolios. Tightening macro-prudential requirements are also part of the toolbox and several national regulators are already applying such tools. ●

Colin Ellis

Chief Credit Officer for EMEA, Moody's Investors Service

Debt sustainability in the EU is resilient to interest rate rises

Debt sustainability generally refers to the borrower's ability to generate resources sufficient to cover operating expenses and interest costs now and in the future. There is no single magic number that can define debt sustainability, regardless of whether a borrower is a bank, company, household or a government. In a market context, the sustainability of debt will also depend on other factors including the ability of market participants to assess and price risk, the transparency of market mechanisms and clarity around default scenarios.

Currently, low interest rates are clearly supporting debt sustainability. When interest rates eventually rise, the context will be critical: increases should at least in part reflect a stronger macro environment, including robust economic and employment growth, that will boost household incomes, corporate earnings and tax revenues. The current >>>

>>> cyclical upturn means that the need for emergency monetary stimulus should fade over the coming year, and some normalisation of policy will take place. However, many companies have already taken advantage of low yields to lock in lower fixed rates and longer maturities.

Borrowers with fixed rate debt will have time until they need to refinance debt or borrow for new investments. Issuers with shorter maturities or variable rates will be more exposed to rate rises, but many still have earnings profiles that can withstand higher interest burdens, and rises in policy rates are factored into our ratings. Riskier corporates – typically rated single 'B' and lower – are likely to face the biggest challenges when rates rise, and some will default. This risk may be underpriced for some borrowers.

"When interest rates eventually rise, the context will be critical: increases should at least in part reflect a stronger macro environment, including robust economic and employment growth, that will boost household incomes, corporate earnings and tax revenues."

- COLIN ELLIS

The household sector also appears to have pockets of weakness. Research from ING suggests that almost a quarter of European households have no savings to rely on, and a third would struggle to pay debts if interest rates rise. That puts the pressure squarely on central banks that are conscious of the need to tread a careful path of gradual tightening, not least because any distress in the household sector could swiftly transmit to the corporate sector via weaker consumption, and to banks via higher NPLs. Given high levels of debt for household sectors across the EU, the same increase in rates may have a more negative impact on consumption than in the pre-crisis period. Happily, there is no sign of strong underlying inflationary pressure that would necessitate faster hikes in rates.

Sovereigns, like corporates, have also taken the opportunity to restructure their debt profiles, with several countries lengthening the average tenor of their obligations. This effect has generally been modest, but has been more pronounced for some countries like Belgium and Spain. More generally, fiscal space remains constrained, with debt-GDP ratios much higher than in 2006 for most countries. Like many emerging markets, individual euro area member states issue debt in a currency they cannot control; and given three past sovereign defaults in the currency union, greater clarity and guidance from the authorities around future restructuring mechanisms would be helpful.

All told, debt affordability metrics generally remain robust. While borrowers will come under more pressure as interest rates rise, central banks are well aware of these risks, which should prove manageable overall. ●

Review of the operation of the ESAs

Burkhard Balz

MEP, EPP Coordinator, Committee of Economic and Monetary Affairs, European Parliament

ESA competences: better framed to the inside, substantially strengthened to the outside

The decision about how to revise the ESA competences has to done in a forward-looking, but also in a backward-looking perspective. Looking back to more than seven years of experience with the ESAs, we have the opportunity for a comprehensive lesson learnt exercise. Looking ahead to the challenges waiting for us, like the build-up of a CMU and the continuation of the risk reduction agenda, we also have to anticipate how the ESAs may contribute to addressing them. Thus, the ESA review has to be considered in a twofold way: in terms of strengthening competences, but at the same time in terms of assessing existing competences and potentially reducing or reframing them.

The decision about how to strengthen, reduce or reframe competences also has to be taken in a twofold way, first in an inward perspective, looking at the functioning of standard-setting and supervision inside the EU, and second in an outward-perspective, looking at the regulatory and supervisory interaction with the international level.

Speaking from the inward perspective the accountability, the ownership of the process and the separation of powers are principles that should guide us through the revision of all three Regulations. On the accountability of the ESAs it is true that progress has been made, in particular where the ESAs delivered on mandates provided for by the Commission or the co-legislators. Where, however, the ESAs took action on their own initiative, accountability is still lacking, such as in the transparency of the decision-making, the use of consultations, the alignment with existing legislation. What adds positively to accountability is the ownership in the decision-making. An ESA is not effective without effective NCAs which are the ones having to apply the rules that are made on the EU level. Their role in the decision-making is key to enforce the decisions the ESAs recommend to be taken, including those on supervisory convergence. Their role also ensures the active participation of the relevant national markets in the development of the standard-setting, which safeguards the diversity of the markets and enhances the credibility of the overall ESA work. Any future governance structure of the ESAs should take account of how the ownership and the transparency of the ESA decisions can be strengthened. This includes a clear separation of power within the authorities. There should not be reliance

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>>> on the ESA management alone to determine which body inside the ESA is deemed appropriate to take a decision. A verifiable decision-making and a separation between the executive and the legislative powers inside the authorities is a prerequisite for the exercise of all future competences.

Speaking from the outward-perspective, there, the strengthening of the ESAs should have priority, in particular in international fora and in equivalence decisions, which will have more and more relevance after the withdrawal of the UK from the EU took effect. The ESA review offers an opportunity to build a joint appearance internationally. We should make use of it. ●

Felicia Stanescu

Head of Financial Services Policy and International Affairs Unit, DG Financial Stability, Financial Services and Capital Markets Union, European Commission

No integrated markets without integrated supervision

The financial crisis marked a watershed for financial supervision in Europe: to rebuild trust in the financial system the EU created in November 2010 the European Supervisory Agencies (ESAs) - namely the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) - which together with national supervisors and the European Systemic Risk Board (ESRB) form the European System of Financial Supervision (ESFS).

Seven years later it is time to take stock: overall, the ESAs have made a significant contribution. They have successfully shouldered a heavy work load of developing numerous technical standards, become respected voices in the market and created a level of supervisory cooperation which was hardly imaginable at the time of their establishment.

Nevertheless, the design of EU financial supervision remains work in progress: new challenges –technical developments, the need to fight climate change, Brexit – require action by the ESAs, too. Also, the EU has committed to complete the Banking Union and to establish a Capital Markets Union to deepen market integration for the benefit of European citizens: a truly integrated financial market promotes jobs, growth and investment in all EU Member States, by channelling savings more effectively to their most productive uses. It helps savers and investors to obtain higher returns, while consumers and businesses can obtain better financing conditions. But such an integrated financial market requires more integrated financial supervision: common rules are not enough, they also need consistent application and enforcement across the EU.

To reach those objectives, the Commission tabled the ESA review package last September. It focuses on three deliverables:

- **More supervisory convergence**
  For achieving more consistent supervisory outcomes, existing convergence tools should be enhanced and new ones added. Moreover, ESMA should be entrusted with direct supervision of specific sectors which have major cross-border activities and are governed by fully harmonised rules. Finally, the ESAs are given a prominent role in promoting sustainable finance and FinTech by coordinating supervisory actions in this area on the EU scale.
- **A more efficient governance**
  The decision making of the ESAs needs to be improved. While the Board of Supervisors remains the main decision making body, entrusting a smaller body – the new Executive Board consisting of independent full-time members – with certain decisions will make the ESAs more efficient and effective.
- **Sustainable funding**
  Changes to the funding regime aim at greater flexibility for the ESAs' budget, while keeping the current checks and balances, and at a fairer distribution of the costs of supervision. Direct industry contributions will help making the funding of the ESAs more sustainable.

All these changes will result in the necessary strengthening of the European component in supervision, without putting into question the crucial role of national supervisors for financial supervision. ●

Contributor: Johannes Erhard

Jean-Paul Servais

Chairman, Financial Services and Markets Authority, Belgium (FSMA)

ESA review: ensuring the right level of supervision at the right level

Harmonising financial regulation (single rulebook) and ensuring a harmonised supervisory approach is a prerequisite to having a single European financial market. Further steps in the ESA review to strengthen supervisory convergence are therefore to be supported. One needs also to consider, however, which authority is best placed to supervise the harmonised and national rules. When reviewing the European System of Financial Supervision, one should ensure the right level of supervision at the right level. In this respect, we believe that the main distinction to be made is between wholesale (B2B) and retail (B2C) markets.

Wholesale securities markets are more integrated and are mainly regulated at European level. As such, a case can be made for a strengthened supervisory role for the European Supervisory Authorities (ESAs), and ESMA in particular. ESMA has already been granted supervisory powers for credit rating agencies and trade repositories and it has a natural role to play as regards selected B2B activities of a similar nature.

By contrast, retail markets are by definition less integrated. European securities markets are in this respect very different to the banking market. This is due to different industrial structures within the EU, different local investor preferences and behaviour, different applicable national laws (tax legislation, contract law, general consumer protection law, etc.), language barriers and so on. The European securities market is a combination of many local ecosystems.

The industry also recognises the importance of these ecosystems, as they offer very different products to various Member States across the EU depending on local investment behaviour and preferences. It is also clear that producing investor documentation in the local language is key to protecting consumers and ensuring a high level of investor trust.

Given the above, National Competent Authorities (NCAs) are best placed to supervise the compliance of retail products with the applicable legislation. NCAs have developed expertise in the applicable legislation, understand the language, thanks to their proximity to the local market have a good view of the products sold there, are close to local investors and understand their preferences and vulnerabilities.

"Transferring supervisory powers over retail products to ESAs would ignore the existence of local ecosystems and risks leading to less efficient supervision."

- JEAN-PAUL SERVAIS

Transferring supervisory powers over retail products to ESAs would ignore the existence of local ecosystems and risks leading to less efficient supervision. A split-up of supervisory responsibilities between the ESAs and the NCAs in some areas could also result in losing the overall picture needed to grasp all risks at local level. For example, efficient supervision requires both ad hoc prospectus approval and ongoing disclosure supervision of listed entities to be combined at national level. The same is true for the authorisation and the ongoing supervision of the proposed pan-European personal pension products. ●

Anneli Tuominen

Director General, Financial Supervisory Authority (FSA), Finland

ESA review proposals support supervisory convergence

The ESAs play a crucial role in enhancing financial stability and ensuring a level playing field and high-level consumer protection on integrated financial markets. Current supervisory structures must be adjusted to keep pace with integration. It is important that the ESAs have sufficient tools to ensure supervisory convergence and to respond in a quick and effective manner to supervisory problems with a cross-border dimension. The Commission's proposal has many good elements, but some adjustments are required.

In terms of consumer protection, the increase in digital services flowing across borders highlights the importance of cross-border consumer protection and the role of the home country supervisor. The ESAs should be able to ensure that NCAs are up to their tasks and to tackle cases where the home country supervisor has not done enough to supervise its entities' behaviour abroad. Supervisory manuals, efficient use of peer reviews as well as active use of mediation and/or breach of Union law tools are important elements in this regard.

The Commission's proposal also addresses a critical level playing field issue.

EIOPA is proposed to have a coordinating role in the internal model approval process. This would be a major step forward. >>>

>>> In the SSM, the internal models have been a key supervisory focus area. The ECB wants to ascertain that banks using internal models comply with regulatory standards, that the results of the modelling are driven by actual risks and that a level playing field between banks is obtained. The challenges of the modelling are in no way a privilege of the banking sector.

On the other hand, adjustments are required in the division of work between the Boards of Supervisors and the proposed Executive Boards. The supervisory responsibilities remain mainly at the NCA level. Accountability of supervision requires that the NCAs have a say in matters within their remit. The Boards of Supervisors should remain competent on matters such as the strategic supervisory work plan, stress tests and outsourcing. As regards ESMA, the organisation proposed in the EMIR review should also be better aligned with the one proposed in the ESA review.

"Current supervisory structures must be adjusted to keep pace with integration."

- ANNELI TUOMINEN

The role of the Joint Committee could also be strengthened. Attention should be paid to e.g. ensuring sufficient staff resources for the JC. Moreover, the decision-making procedure of the JC is currently too complex.

The longer-term vision of the Commission is to have a single European Capital Markets Supervisor. However, the Commission neither presented a vision on the long-term supervisory architecture for the CMU nor a road map towards that end. Furthermore, the proposed direct supervisory tasks for ESMA are not fully substantiated. Centralised supervision works best in areas where the number of market participants is relatively low and the activities are inherently cross-border, such as supervision of market data providers or administrators of critical benchmarks. ESMA should also have a strong role in data collection. On the other hand, in areas with close links to financial consumer protection, the supervisory tasks should remain close to the consumers at the NCA level, but with improved coordination by the ESAs. ●

Developing financial markets in South East Europe

Dragan Tevdovski

Minister of Finance, The former Yugoslav Republic of Macedonia

Capital markets in Macedonia - an important step for regional and EU integration

The financial system in the Republic of Macedonia has a relatively simple structure of financial institutions and the products and services they offer. Banks dominate the financial sector, being the biggest pillar of the system and by far the dominant source of corporate funding. For instance, as of 2016, around 85% of financial sector assets belonged to banks, followed by pension funds with 9,4% and insurance companies with 3,5%, as well as a minor share of other financial institutions.

Recently there have been several regulatory measures aimed at improving the capital market infrastructure and introducing higher standards for market participants. Here, I would like to emphasise three key recent and future measures that I believe will give further impetus to capital market development and economic growth in Macedonia, and further to better regional cooperation and European integration.

First, our stock exchange has a small number of listed companies, low level of market capitalisation and relatively low liquidity. In order to overcome these structural weaknesses, the SEE Link regional platform for securities trading was established recently. This platform, supported by the European Bank for Reconstruction and Development, is now used to trade securities of over 1.200 companies from Macedonia, Croatia, Bulgaria, Serbia, Bosnia and Herzegovina and Slovenia. The connection of stock exchanges via the SEE Link platform eases investor access to stock exchanges in the region and increases transparency and will surely contribute to higher levels of trading.

Second, following the example of various European countries, in November 2017 the Macedonian Government established the Council for Capital Market Development. The Council will serve as a forum for dialogue between key stakeholders and propose measures for continuous development of the capital market.
Third, there can be no capital market development without a proper legal framework. Therefore, during 2018, two key laws will be adopted: the Law on Financial Instruments and the Law on Securities Prospectus and Issuers

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>>> Transparency Requirements. The final aim is harmonisation of Macedonian legislation with the EU in this area, which will be achieved by following the latest EU directives. Needless to say, the completion of this complex step will ensure a level playing field for investors, thus giving them further incentives to invest in the Macedonian capital market.

In circumstances when our private and public sectors have considerable financing needs and investors are interested in attractive and sustainable projects, the connection between countries in the region and in Europe is an essential step in attracting additional capital. Therefore, one of our key aims is creating an open and efficient capital market, connected with European markets, which will undoubtedly facilitate our integration in the European economy, simultaneously with the progress our country makes towards EU integration. In order to achieve this, we must have a secure and stable capital market, better protection for investors and other market participants, as well as strong supervisory mechanisms. ●

Pierre Heilbronn

Vice President, Policy and Partnerships, European Bank for Reconstruction and Development (EBRD)

Efficient capital markets will promote the SEE region as a legitimate investment destination

I am often asked to nominate the most important priorities for developing capital markets in South Eastern Europe (SEE). Is it alignment with the other markets of the EU in terms of regulation and integration of financial market infrastructure? Or is it facilitating investment from outside the SEE region and consolidating the region's financial sectors? The answer is actually all of these and much more!

"Integration to the broader EU is critical to the prosperity of the SEE region but the development of the region's markets remains challenging."

- PIERRE HEILBRONN

Integration to the broader EU is critical to the prosperity of the SEE region but the development of the region's markets remains challenging. SEE has a small population, whilst 90% of the region's companies fit into the EU definition of an SME. Additionally, many of the worthwhile reforms instigated by the EU to ensure financial stability are expensive to implement in a single market basis. At the same time, the challenge is to ensure that the SEE retains its regional identity as a viable investment destination.

The development of the region's capital markets is a strategic priority and the EBRD has established a team of dedicated capital market professionals to support this process. The Bank backs up its policy engagement with significant investment in both debt and equity capital market transactions. The EBRD also has equity stakes in several of the region's exchanges such as Romania and Croatia and has actively encouraged the development of various platforms and listing programs to promote SME financing.

However, the fundamental problem for all market participants remains the limited investment products and poor secondary market liquidity. To promote market development, the EBRD develops solutions that address the problem of illiquidity in a way that also supports the lofty goals of regional integration in an efficient and cost-effective manner. Two EBRD-supported projects – the completed SEE Link and the planned CSD Link – will link many of the region's stock exchange's trading, clearing and settlement infrastructures in order to mobilize both interregional and intraregional investment flows. The completed links will provide a major boost to liquidity by streamlining cross-border transactions, providing international and local investors with a single connection point to execute and clear transactions on all of the region's major >>>

>>> exchanges. A planned Central Counterparty (CCP) supporting the region would also enhance liquidity and promote integration.

The EBRD, with the support of the EC, is also engaged on a very ambitious project to activate 16 million residual dormant retail share accounts resulting from the Mass Privatization Process (MPP) of the 1990s, so that account holders can derive a greater economic benefit from their shareholdings. A pilot project is being launched in Romania with funding provided by the EC SRSS. If successful, this could enhance retail confidence in the equity market and release up to EUR 8.1 billion of additional "free float" into the region's market capitalisation.

The EBRD approach to capital market development is flexible and undergoes constant revision. The Bank is currently reviewing its equity and debt investment and divestment strategy with a view toward more active management strategies that further support capital market development. ●

Debora Revoltella

Director Economics Department, European Investment Bank (EIB)

Financing innovation and growth in CESEE

Financial intermediation in CESEE is strongly bank-centered. This characteristic of the financial sector is fully reflected in the financing structure of firms. According to the EIBIS (2017)[1], across the CESEE region, firms finance the majority of their investment by internal financing (70%, vs 62% in the EU). Bank loans account for the highest share of external finance (45%), followed by leasing (23%). Equity finance plays a negligible role, consistently with the low levels of market capitalisation[2], market liquidity or numbers of IPOs[3].

Today, access to finance is not the main impediment for firms in CESEE. Only 9% of firms are "external finance constrained"[4]. However, there are important segments where access to finance remains difficult. The share of finance-constrained firms is higher for young firms, innovative firms or those that largely invest in intangible assets.

Strong reliance on debt negatively affects firms' resilience in times of crisis. Following the financial crisis, companies in Europe suffered from severe debt overhang that depressed corporate investment. In addition, our studies show that more diversified finance sources are associated also to more innovation and more investment in intangible assets. But firms do not want equity!

To better understand why firms continue to rely so much on debt, Brutscher et Al. (2018) conduct a randomised online experiment, estimating the determinants for the demand for equity. The results show a persistent bias against equity financing. The interest rates that make firms indifferent between a loan offer and the benchmark equity offer is in all cases higher than the cost of equity. Firms with better growth prospects and larger investment projects are more likely to accept equity offers. However, even for those, loans remain more desirable than equity.

As more equity finance supports the stability of the system, there is a case to incentivise both the demand and the supply of equity. On the demand side, authorities might consider narrowing the difference between the tax treatment of equity and debt, or harmonising national/European disclosure requirements for firms and reducing costs of listing. On the supply side, in the context of the Capital Market Union, efforts are being taken to further develop local capital markets, by developing national strategies, improving the business environment via stable legal, judicial and administration systems, favourable conditions to incentivize SMEs to go public and for investors to invest on local capital markets.

"Policymakers might consider some type of preferential treatment of venture capital to stimulate demand."

- DEBORA REVOLTELLA

However, in small countries like in the CESEE region capital markets are naturally capped by the size of the economy, so more cross-border cooperation and integration at the regional and EU level is crucial, also as a way to attract international capital flows. Private Equity and Venture Capital are an alternative, still underdeveloped (EUR 1.6 bn market size in 2015) but with a few cases of success in the region. Policymakers might consider some type of preferential treatment of venture capital to stimulate demand. Business angels, venture capital and private equity in fact combine active ownership and offer the opportunity to gain access to managerial experience and new markets. These are crucial elements in integrating CESEE firms into globalised production chains. ●

1. http://www.eib.org/infocentre/publications/all/econ-eibis-2017-cesee-overview.htm
2. 43% in Croatia and 28% in Poland, largest equity markets in % of GDP, Latvia and Slovakia, with less than 5%, the smallest.
3. IPOs by value in CESEE account for 3.3% of the total in the EU28 in 2016, Federation of European Stock Exchanges.
4. This is the proportion of firms dissatisfied with the amount of finance obtained, sought finance but did not receive it, did not seek finance because they thought borrowing costs were too high or they would be turned down.

Ivan Takev

Chief Executive Officer,
Bulgarian Stock Exchange

Challenges and funding opportunities for small- and medium-sized enterprises

The exchanges have a role throughout each company's lifecycle.

All the countries in the SEE region, despite the structural differences they have, share one similarity: they are all over-dependent on their banking sectors as a source of funding of small- and medium-sized enterprises (SMEs). The fewer and less accessible forms of financing ultimately prevent companies from reaching their optimal capital structure and, as a result, limit their growth potential and profitability.

Over the recent years, many surveys on the way SMEs fund their operations have been conducted. While they all differ in terms of methodology and scope, all of them unanimously reach to the same conclusion: the SMEs, regardless of which part of the world they belong, are seriously underfunded. According to a recent IFC report, the funding gap that the Bulgarian micro-companies and SMEs experience accounts to USD 6.5 billion or 13% of the country's GDP.

It seems that the transition to digital economies can also be a barrier for some companies to obtain adequate financing. The emergence of innovative companies with revolutionary products often is impeded by their inability to obtain sufficient resources. To some extent, the financial industry lags behind the trends in the digital economy. Most of the time banks require sufficient collateral in order to provide a loan while most of the small companies have nothing but a great idea.

That is why, in order to better serve their purpose, financial markets must find a way to transform themselves into something new that could respond to the evolving needs of the economy. In this sense, the Capital Markets Union (CMU) concept is of great importance for a country like Bulgaria, especially in the light of the SME-oriented measures underlying the concept.

Regulated exchanges are able to play a vital role throughout entire company lifecycle: from early-stage start-ups till mature listed large-cap companies. In order to support each company while it grows in size, they can partner with or build themselves a crowdfunding platform (which is part of the CMU), so they can get into the focus of each business since its inception. As the companies grow, they will move onto other types of funding: private equity and venture capital. The exchanges do not have much in common with this type of financing but in the developed world there are quite a few partnerships and platforms that connect stock markets and PE/VC. Launching a private market in financial instruments would be the next step.

"The exchanges have a role throughout each company's lifecycle."

- IVAN TAKEV

The EU regulations provide flexibility to SMEs to raise capital below a certain threshold via IPOs but without publishing a prospectus and with lightweight ongoing disclosure. The next step would be the newly-introduced by MiFID II SME growth markets which will reach their full potential with the Prospectus regulation application in 2019.

For Bulgaria will be of great importance to continue with its efforts to strengthen and integrate its capital markets. Initiatives like SEE Link, an order-routing platform launched by the exchanges in Bulgaria, Macedonia and Croatia, with the support of EBRD, now covering eight countries in the Balkans, should be expanded beyond trading and the obstacles for cross-border investments should be eliminated.

Once this happens, SEE Link will become a manifestation of the CMU concept itself, ultimately removing the barriers of investability. ●

II. GLOBAL COORDINATION & BREXIT IMPACTS

Issues at stake

The financial system is truly global in many areas. Global regulatory and supervisory coordination is therefore essential to preserve a level playing field across financial markets and mitigate the risks associated with global firms and highly interconnected activities. It is also one of the most important components of a sustainable open economy, which is essential for achieving sustainable growth.

A challenge however is the wish of some jurisdictions to act more independently in order to ensure that regulation takes into account their own specificities and does not affect inappropriately their domestic financing mechanisms. In addition, Brexit is both a challenge and a possible opportunity for the EU27 requiring the Union to review its overall financial services objectives.

Content

Future of global regulatory and supervisory coordination

Olivier Guersent

Director General for Financial Stability, Financial Services and Capital Markets Union, European Commission

Future prospects of global financial regulatory coordination

We all have much to gain from integrated financial markets based on international standards. If all major jurisdictions apply the same set of key standards, this makes the financial system safer and creates the level playing field for financial institutions that is needed for free trade, competition and growth.

But for international financial regulatory coordination to be effective, all parties must also stick to the commitments they have taken. A "beggar thy neighbour" competitive approach to regulation, or simply failure to coordinate, bears the risk of leading to a race to the bottom in regulatory standards. If the G20's achievements were to unravel, we would run the risk of regulatory arbitrage and renewed instability. In the end, excessive leverage and risk-taking incentives would be created, the financial system would become less transparent and its systemic actors would be harder to resolve. This would be a bad outcome for all jurisdictions. I remain however hopeful that our main international partners will continue to share our view that international cooperation benefits all jurisdictions, collectively and individually.

As we have successfully done in the past, we have to agree on the main principles of the most important financial regulatory reforms, which will minimise the danger that financial institutions can engage in arbitrage by shopping for the most favourable jurisdictions. The most important precedent may be the Basel capital requirements, which have been aiming at levelling the playing field in the banking sector since 1988, with the recent agreement on the finalisation of Basel III as the last success example. The Financial Stability Board, first established in 1999 as Financial Stability Forum by the G7 countries, promotes strong, shared international standards; dynamic implementation; and cooperation in financial regulation and supervision. Priority areas where implementation of the standards is particularly crucial are Basel III, compensation practices, effective resolution regimes and policies, reforms to address too-big-to-fail problems associated with systemically important financial institutions, transparency and safety of over-the-counter derivatives markets, and policies to address shadow banking risks. It is evident that the coordination is most important where cross-border banking and financial >>>

>>> flows are extensive, but much of banking and financial supervision remains national or regional.

How could the international standard-setting process be improved? Certain rules could certainly be more granular to avoid excessively divergent implementation and to create a level playing field. For this, language could sometimes be more precise. At the same time I want to underline that those standards should have the right elements of flexibility to take into account the specificities of local financial markets. They should be a result of a good, inclusive process in the international regulatory field, with transparency and accountability, but at the same time they should not be a straitjacket for those that want to be more ambitious. And if specificities of certain jurisdictions need to be accommodated, there need to be ways for this to be done where it does not undermine the integrity of the overall framework.

Regarding the settlement of disputes, given the experience in the arbitration court for trade agreements, I doubt that we can achieve a consensus on a common dispute settlement authority in the field of financial services regulation, even if theoretically this would be a first best solution.

Naturally, adequate implementation monitoring of the agreed standards is key for them to be effective. Our current mechanisms to guarantee this ensure transparency through progress reports, the Regulatory Consistency Assessment Programme of the Basel Committee, Financial Sector Assessment Programs by the International Monetary Fund and peer reviews. At the level of rule-making in particular, this is effective. We could however try to improve and foster use of the third level of implementation monitoring in standard setting bodies, which examines consistency in the outcomes of implementation. More in general, we constantly need to reflect on what more we could do to inspire greater transparency and better governance of some of the international bodies, so that our domestic lawmakers are assured of adequate democratic control over the work.

Finally, beyond the standard setting process, the EU is aiming at constantly improving cooperation with third country financial regulators and supervisors. For instance, within the Joint EU-Asia Pacific Forum or the EU-US Financial Regulatory Forum, we try to discuss as early and often as possible respective rules and policies to improve transparency, reduce uncertainty, and generally promote better compatibility of each other's rules in consistency with international standards. ●

Sandie O'Connor

Chief Regulatory Affairs Officer,
JPMorgan Chase

The importance of global regulatory coordination

In the wake of the 2008 financial crisis we have witnessed many new and revised regulatory initiatives intended to increase the resilience of markets and market participants. These initiatives have generally been mandated and globally coordinated by the G20 (particularly the Pittsburgh Summit in 2009), and then elaborated upon by global standard setters (like the Basel Committee) with the objective of consistent implementation across key markets. This international, cooperative approach has been essential; effective and efficient financial markets do not function solely within national boundaries. They are connected and global in nature, providing market participants with broad access to competitive markets and diversified capital for investing and risk management. >>>

>>> However, we now observe that the international financial regulatory environment may be trending toward greater localisation and protectionism. Regulators (both rule-makers and supervisors) tend to be tasked with protecting their own jurisdictions as a primary objective, a bias that can exert pressure on the overall objective of a well-coordinated global financial system. Brexit heightens the risk of regulatory approaches that fragment markets in the EU most acutely, but also more broadly for global market participants.

Fragmentation of markets typically reduces access to capital flows and liquidity pools resulting in higher costs to both issuers and investors for capital formation, funding, and risk management. Additionally, fragmentation may also create incentives for risk concentrations and reduced operational resiliency – all of which have negative consequences for market participants as well as local and global economies.

At the European level, as the Capital Markets Union (CMU) moves forward, all regulatory initiatives should take account of, among other things, whether they further connect the EU with global capital markets. Developing the CMU is not an objective in itself but a means to support economic growth in Europe and increase market-based financing to add diversity to bank lending. Growth is enhanced by ensuring EU firms and investors can efficiently access financing, investments, and risk management services, from both internal and external sources. We should consider, for example, how a more flexible Intermediate Parent Undertaking requirement, could support a non-EU firms' ability to fully engage in EU markets, achieving both regulatory policy and market development objectives.

Further, we believe global policymakers should strive for consistent implementation of international standards. Global investors and issuers should be able to rely on a minimum, consistent standard of financial institution resilience and market functioning. This will support capital flows from jurisdictions that are net investors to those jurisdictions that provide investment opportunities. Minimum standards also ensure that within a jurisdiction there is less incentive for a risk concentration to build which could otherwise impact financial stability more broadly.

Finally, mutual recognition and deference to comparable regimes should be the presumptive path and jurisdiction-level approaches should only be employed where there is a material domestic regulatory objective. Assessments of comparability should be made on an outcomes rather than line-by-line basis. This approach should reduce the incidence and impact of extraterritorial regulations, and also enhance engagement and transparency among global policy makers further supporting global financial stability.

Looking ahead, global cooperation and mutual recognition will become ever more important as the evolving opportunities and risks associated with cybersecurity, data management, and FinTech are borderless, have impacts across the sector and reach beyond the traditional regulatory perimeter. ●

Olivier Prato

Head of Basel III implementation, Basel Committee on Banking Supervision (BCBS)

Now is the time for full, timely and consistent implementation

The finalisation of Basel III reforms in December 2017 represents a major milestone for the Basel Committee's response to the global financial crisis. The Group of Governors and Heads of Supervision (GHOS) endorsed the reforms by reaffirming their expectation of full, timely and consistent implementation of all elements of Basel III. Differences in implementation should not be a source of regulatory fragmentation after many years of negotiations that have led to these global minimum standards. Achieving full, timely, and consistent implementation reinforces the mutual trust that underpins all types of international accords and negotiations for the current generation and the next.

The finalisation of Basel III marks a shift in the Committee's agenda from policy to implementation. The Committee's Regulatory Consistency Assessment Programme plays a key >>>

>>> role in ensuring that the Basel III framework, including the recently finalised reforms, are implemented as agreed by Committee members and the GHOS. The Committee will also be devoting more time to evaluating and monitoring the impact of its reforms. These impact assessments include monitoring variability in risk-weighted assets and assessing potential changes in excessive variability, a core objective of the final Basel III package.

The Committee's agenda will also renew its traditional focus on bank supervision, including developing guidelines, monitoring their implementation, and identifying best practices in areas where promoting strong supervision and supervisory coordination is critical, such as stress testing, Pillar 2 practices, risk data aggregation and risk reporting, supervisory colleges, corporate governance, risk management and risk culture. The Committee also regularly discusses emerging risks and challenges posed to banks and bank supervisors. Current examples include the implications of fintech developments, supervisory practices implemented by member jurisdictions to mitigate cyber risk, and ways of applying the Basel III reforms proportionately and effectively for smaller and less complex banks.

"The finalisation of Basel III marks a shift in the Committee's agenda from policy to implementation."

- OLIVIER PRATO

While the focus of the Committee's work is now on implementation, effectiveness and supervision, a limited set of outstanding policy items remain. These include completing the consolidated Pillar 3 framework to reflect the finalisation of Basel III, discussing the longer-term regulatory treatment of expected loss provisioning and sovereign exposures and addressing certain specific issues relating to the revised market risk framework.

Basel Committee and GHOS members have shown their resolve and commitment to international regulatory cooperation in completing the Basel III finalisation package. These reforms will make global capital frameworks more robust and improve confidence in banking systems. Now is the time for jurisdictions to fully implement these reforms and not yield to the temptation to dilute, delay or deviate from the globally agreed-upon framework. ●

Shunsuke Shirakawa

Vice Commissioner for International Affairs, Financial Services Agency, Government of Japan (JFSA)

Enhancing cross-border cooperation under the multilateral regulatory regime

The finalization of Basel III is the last piece of G20's rule-making process for financial regulatory reforms. Thus, the main responsibility has now shifted to national authorities to implement the agreed measures in a full, timely and consistent manner. From the viewpoints of Asia which is located between the two major financial markets US and Europe, the finalization of Basel III has been particularly welcomed because it would remove regulatory uncertainty and help maintain the multilateral regulatory regime of banking regulations.

To implement the globally agreed measures, relevant authorities need to be engaged in their own domestic rule-making process in each jurisdiction. It is imperative for them to transpose the global standards faithfully in their own rule books to ensure a level playing field for internationally active financial institutions and to prevent regulatory fragmentation of global markets.

On the other hand, as global financial regulations are getting increasingly complicated, we need to pay due attention to compliance costs for regulated institutions. It may not be desirable to impose one-size-fits-all regulations on all the institutions regardless of their size and/or risk profile. Nevertheless, we should avoid watering down of domestic rules for global firms in consideration of compliance costs for smaller domestic firms.

We should also bear in mind that unilateral measures for prudential purposes taken in one jurisdiction may have unintended effects on foreign financial institutions, if they were applied in a disproportionate manner to risks involved. For instance, regulations on structures of foreign financial groups to ensure smooth resolution could hinder their activities in that jurisdiction. Those measures may be substituted by closer cross-border cooperation between home and host authorities.

Although the post-crisis rule-making phase has come to the end, we cannot be complacent on what we have achieved. We are already facing new challenges which could expose our financial systems to dangers from different directions. I would like to point out two challenges here: shrinking and aging population and emerging risks derived from innovation of financial technologies.

"JFSA is willing to deepen our regulatory and supervisory dialogues with foreign counterparts."

- SHUNSUKE SHIRAKAWA

Japan is at the forefront of shrinking and aging populations. Such changes will surely affect the profitability of financial institutions and the financial system as a whole. Risks faced by Japanese financial institutions are exacerbated by a persistent low interest environment. Therefore, the JFSA (Japan Financial Services Agency) intends to drastically change its supervisory approaches from the backward-looking and rule-based ones to more forward-looking and dynamic ones focusing on sustainability of their business models. >>>

>>> Many other jurisdictions including Europeans could also face similar problems soon. According to the WHO World report on ageing and health, the number of people over the age of 60 is expected to double by 2050. We should learn from each other by sharing our experience and knowledge on effective supervision to address emerging risks under the increasingly challenging environment.

New financial technologies also involve various risks while presenting enormous opportunities for financial innovation and cost-cutting. For instance, we experienced a serious cyber-attack to a cryptocurrency broker and dealer in Tokyo. Although the JFSA is making utmost effort to deal with the case and to prevent another incident, we cannot take effective measures without cooperation with other relevant authorities both domestically and internationally. AML/CFT is one of the most prominent areas calling for more regulatory harmonization and closer supervisory cooperation to prevent illicit funds from being transferred through the global financial system.

Japan, as G20 chair in 2019, is committed to lead discussions at various G20 meetings for overcoming these challenges in collaboration with other members. In addition, the JFSA is willing to deepen our regulatory and supervisory dialogues with foreign counterparts including European authorities under respective bilateral frameworks. ●

Shiro Shiraishi

General Manager,
Mizuho Bank, Ltd.

The importance of coordinated and proportionate regulation

Global agreement is the key for banking regulations. Although the world's regulatory framework seems to be heading towards fragmentation, we should definitely maintain a framework to reach agreement on a global basis. As activities of global financial institutions are conducted on a cross-border basis, if each jurisdiction adopts original regulations without going through a process of global coordination and agreement, the level playing field would not be maintained and the possibility of regulatory arbitrage arises. That could lead to consequences such as excessive and unjustified regulatory compliance costs alongside inefficient capital and liquidity management. This in turn could give rise to unintended consequences regarding credit provision for the global economy. Fragmentation can also affect companies other than financial institutions by making their use of financial services less seamless while their activities have become borderless. Moreover, fragmentation gives rise to the possibility of regulatory arbitrage and abuse, not only for established resume in banking, but in new resume areas such as crypto-assets and Fintech.

We are already seeing some signs of regulatory fragmentation in the areas of capital floors and leverage ratios, etc. In addition to deviation from global standards at a policy level, there is already significant deviation at the implementation level, for example, in the myriad reporting regimes, which increase costs without adding sufficient regulatory value.

Another concern relates to the disproportionate aspects of certain regulatory proposals. Although all jurisdictions attempt to ensure that new regulation delivers its stated aims without over-engineering, it is doubtful, for instance, whether some of the more challenging MiFID II requirements have justified the effort and cost incurred and are proportionate to their stated aims.

"We should definitely maintain a framework to reach agreement on a global basis."

- SHIRO SHIRAISHI

Furthermore, we have seen some cases which draft regulation is published without thorough impact assessments being sufficiently conducted in advance. This could lead to the concerns that regulators might be taking a 'tit-for-tat' approach to regulation regardless of its own merits. One key upcoming example is the EU Intermediate Parent Undertaking proposal, which would require all G-SIIs to establish an IPU irrespective of their asset size in the EU. The principal of proportionality is integral to avoid financial service providers withdrawing from markets and thereby impacting the real economy.

We should make a sustained effort toward international coordination to establish the entire vision on regulation and to ensure that every jurisdiction legislates in accordance with it. ●

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Brexit way forward

Katharine Braddick

Director General,
Financial Services, HM Treasury

Financial services - cooperation post-Brexit

Regulation and supervision of financial services work best when done collectively, across borders and in the spirit of cooperation. This was a lesson learned painfully during the financial crisis, when the response of authorities across the world was too often disjointed and uncoordinated. Fostering reforms to promote greater coordination and cooperation was a priority for European governments and regulators in the aftermath, and should continue to be a key objective, even as the UK leaves the EU.

Cooperation is a fundamental principle of the UK's proposition for our future relationship with the EU on financial services, which the Chancellor of the Exchequer set out in March. A collaborative model of this nature would enable us to protect financial stability and avoid fragmentation of Europe's financial services sector, on which so many of Europe's people and firms rely.

The Chancellor set out three key elements for a partnership in his speech last month. The first is a regular and structured UK-EU dialogue, which would be responsible for agreeing the regulatory requirements for cross-border trade in financial services. These requirements should be assessed objectively according to outcome. Both the EU and the UK are committed to high regulatory standards for the sector, but as home to the world's most significant financial centre the UK cannot credibly be expected to passively accept rules written elsewhere without consideration for our interests. This is not about pursuing unfair competition.

For example, the UK's unique exposure to financial instability means we negotiated hard inside the EU to secure the right to impose additional capital requirements on systemic firms and to ring-fence the retail banking operations of integrated groups from their wholesale market activities. We cannot have less control of our sector outside the EU. Instead, we will need an objective process to determine whether our regulatory outcomes, potentially achieved in different ways, are sufficiently equivalent for agreed levels of market access to continue.

This would include assessing not only the rules themselves, but also the way in which they are enforced, drawing on international standards where they exist, or on additional principles for equivalence where the UK and EU have more developed rules.

>>>

>>> The second element is agreeing supervisory cooperation arrangements that are reciprocal, reliable and prioritise financial stability. There is no reason why our supervisors could not maintain a very close working relationship after the UK leaves the EU, and there a number of ways that they can do so. As the Chancellor has set out, this could involve fostering a proactive and extensive information exchange, authorised by the data-sharing agreements within the overarching FTA, going far beyond what is available in ordinary third-country relationships. Supervisory cooperation could cover market abuse, transaction reporting, and stability monitoring, as well as prudential concerns about individual firms and it could involve a version of today's college structures, covering both day-to-day supervision and resolution in crisis.

The third and final element involves addressing how this future partnership would work if, through this dialogue, there is a choice by either side not to maintain equivalent outcomes. The UK fully accepts that such a choice has consequences. We would need a clear institutional process and agreed consequences that are reasonable, proportionate, and applied in a way that is predictable for firms. An independent arbitration mechanism, that has the confidence of both parties, would need to be established to enforce such a system. Such mechanisms are common in free trade agreements.

We are clear that the UK cannot, and indeed does not, expect market access for financial services firms that replicates the existing system of passports. But we are also clear that the existing equivalence framework is not sufficient to manage the depth and breadth of cross-border trade that exists between the UK and the EU27, and because of the risk that ultimately taxpayers stand behind, the UK cannot be a ruletaker. Something new is needed. A partnership rooted in discussion, mutual understanding, and cooperation. ●

Bruce R. Thompson

Vice Chairman,
Bank of America

What are the challenges raised by Brexit for international financial firms?

Like many of our peers, Bank of America Merrill Lynch has, in recent years, consolidated our footprint in the EU into a smaller number of larger locations, with London becoming our EMEA hub. Brexit seems likely to change this direction of travel and, while in the medium to long term this may be a healthy outcome for European financial services, there are short-term issues that require consideration. However, these are not insurmountable challenges and, given its history of regulatory change, the banking sector should be well-placed to adapt to Brexit.

From the perspective of Bank of America Merrill Lynch, our over-riding priority is to ensure that we are able to continue to serve our clients seamlessly, at whatever point that the UK leaves the EU. Given the lead times involved, we have already begun to activate our Brexit plans; however recent agreement on a transitional arrangement will be important in reducing the operational risk of Brexit across the whole sector.

To ensure continuity for our clients, we have chosen Dublin as our preferred location for Bank of America Merrill Lynch's principal EU legal entities following Brexit. We chose Dublin because we already have a fully licensed and operational Irish-domiciled bank; we have a long-standing relationship with the national regulator and government; and our local employee base, at more than 700, is by some margin our largest in the EU outside of the UK.

In practical terms, we are undertaking a cross-border merger of our banking entities, merging our UK-based bank with our existing Irish one – a process that is well underway and >>>

>>> that we expect to be complete by the end of 2018. The cross-border merger process should reduce complexity for clients, particularly from a banking perspective. We will also be establishing an investment firm in Ireland, a process currently at a slightly earlier stage. In terms of jobs, we will move roles not only to Dublin but to a number of other EU locations, with the focus on where we will have the greatest concentration of clients.

Perhaps the most fundamental challenge raised by Brexit for firms like Bank of America Merrill Lynch is the need to reconsider our structure to ensure that we can continue to service clients following Brexit. Integral to any such planning are considerations around capital, oversight, and the potential impacts on clients and colleagues. At a macro level, with almost all banks with cross-border operations in the EU undertaking similar analyses, there is a possible risk of market disruption if collective preparations are poor or the basis of exit is not clear until late in the day. We recognise the steps supervisors in the EU and the UK have taken in order to minimise such impacts, by encouraging firms to get their plans made. Agreement on a transitional measure is also helpful in this respect.

Brexit will mean a significant change to the framework for financial regulation in Europe, a framework that we have all grown accustomed to in recent years. However, it may present opportunities as well – from our perspective, as an international firm, we welcome the possibility of a greater focus on international standards and bodies as a means of delivering convergence between different jurisdictions. While this is a long-term aspiration, it would be an important step in recognising the increasing globalisation of financial markets. Likewise, it would be positive if Brexit were to be a catalyst for the development of deeper European capital markets, completing the Capital Markets Union project launched earlier in the Commission's mandate. In the shorter term, we look forward to working with regulators and policymakers in the UK and the EU over coming months and years to deliver a Brexit that avoids disruption to the financial sector – and, more importantly, our customers. ●

Levin Holle

Director General, Financial Markets Policy,
Federal Ministry of Finance, Germany

Brexit and financial markets: key elements for a future relationship

As of today, the United Kingdom's withdrawal from the European Union will take effect in less than a year. Governments and market participants on both sides of the channel are well aware of the major challenges the UK's transition to becoming a "third country" involves. A transitional period, if agreed by the EU and the UK, should provide market participants in both jurisdictions with more time for necessary adaptations.

As negotiations between the EU Commission and the UK government on the framework for the future EU-UK relationship are just beginning, concrete results of these negotiations as to financial services are not easy to predict. The following aspects might shape what we will see:

To start with, the UK and the EU seem to agree that, based on their positions, "red-lines" and their emphasis on regulatory autonomy, a Free Trade agreement (FTA) will be the best basis for their future economic relationship. Such an FTA could indeed help to strengthen existing rights and obligations from WTO-Rules, thus enhancing the foundation for future cross-jurisdictional business.

While there is no consensus yet on the content of such an agreement, it is not unthinkable that it could also include financial services – as it has been the case with other FTAs the EU >>>

>>> has negotiated. Such an inclusion could i. a. serve as a possible anchor for continuing our constant, close and meaningful regulatory and supervisory cooperation. This should include data exchange and, where necessary, crisis management. Close cooperation and coordination were essential for overcoming the last financial crisis and for re-establishing international financial stability. The UK's withdrawal from the EU should not weaken this strong lesson.

Proposals from UK's financial industry have also suggested that financial regulation should as such - beyond the question of cooperation – become an integral part of an EU-UK-agreement, i. a. by mutual recognition of regulatory regimes as "equivalent" or "equivalent in outcome". Such recognition would clearly go far beyond the scope of any trade agreement we have yet identified. Instead, FTAs use "regulatory carve out"-clauses, where contracting parties explicitly state that nothing in the agreement restricts their right to regulate for prudential or stability purposes.

There are indeed strong arguments against negotiating regulatory requirements within an FTA: First, trade agreements pursue different goals from those of prudential regulation; they target deliberate market barriers such as quotas and tariffs, while financial regulation aims at reducing risks for market participants and for the stability of the financial system. Second, the highly specialized and constantly evolving nature of financial markets and instruments makes responsible judgements as to what constitutes "equivalent regulation" extremely difficult. The EU has established a system of regulatory 3rd country regimes that attempts to address this complexity for existing third countries. But it also needs to be pointed out that this system was not designed for such a large counterparty as the wholesale markets in the UK, but rather for smaller and more distant markets.

Finally, any agreement that excludes the right of a contracting party to unilaterally withdraw a former recognition of "equivalence" in case of new considerations would significantly curtail its regulatory independence. It is unlikely that the EU should accept such a constraint.

In summary: Brexit comes with adaptive challenges that market participants and regulators need to address. At the same time, the EU and the UK share an interest in continuing their close cooperation. It is neither in their interest to enter into deregulatory competition, nor to suffer harmful economic effects from unnecessary market barriers. They should continue to work together in promoting level playing fields within effective, responsibly regulated financial markets. ●

Steven Maijoor

Chair, European Securities and Markets Authority (ESMA)

Supervisory convergence is key to a post-Brexit Europe

The Brexit decision of 23 June 2016 has generated intense discussion and speculation on the nature of the UK's future relationship with the EU and what this changed relationship is likely to mean. Certainly, the fact that the UK has decided to leave the EU reinforces the urgency for the EU to progress with the CMU, the flagship project designed to ensure better access to capital markets in the EU to the benefit of growth and jobs.

Brexit poses two key challenges for the CMU. First, it increases the importance for the EU27 to further strengthen the EU internal capital market. While big steps have been made towards achieving a single rulebook, large national differences remains regarding the supervision and enforcement of that single rulebook. Second, it reinforces the need to ensure an appropriate framework for third-country regulation and supervision. >>>

>>> ESMA's work on supervisory convergence will therefore remain to be of key importance post-Brexit. In this context, ESMA has published general and sectoral opinions in order to address risks of regulatory arbitrage between the EU27 Member States receiving UK business. Through the opinions, we have re-emphasised important principles aiming at fostering consistency in authorisation, supervision and enforcement related to relocation without questioning in anyway the freedom of establishment, one of the main pillars of the EU.

The opinions are not the end of the story when it comes to our efforts towards achieving supervisory convergence. We have also set up a Supervisory Coordination Network. This network is a forum that allows supervisors from national competent authorities of the EU27 to share information and discuss cases which involve relocation of entities, activities or functions from the UK to the EU27. Through these discussions and exchanges, ESMA fosters similar supervisory treatment by national competent authorities across the EU27.

ESMA welcomes the Commission's proposal related to the ESAs review and notably in the area of supervisory convergence. The Commission's proposal builds upon the finding that ESMA's powers and instruments are currently not sufficiently strong to deal with all cases of regulatory or supervisory arbitrage, such as in ensuring consistent authorisation scrutiny and consistent supervisory outcomes. The Commission's proposal to give ESMA the power to issue opinions regarding delegation is efficient and proportionate. ESMA has already issued many opinions and experience shows that they help to achieve supervisory convergence while maintaining national authorities' responsibilities for the authorisation and supervision of supervised entities. This gives clarity to the financial sector.

Brexit is not only about the UK but is also about the EU's relationship with third countries in general. Based on the current EU equivalence regime, a number of non-EU financial market infrastructure providers offer critical and systemic functions for the EU single market. However, the supervision of these entities is conducted outside the EU, without the provision of any additional safeguards from an EU perspective. The proposal in the context of the ESA review, and the proposal for third country CCPs in EMIR 2.2 recognise this, and the benefits of pooling expertise centrally at the EU level. In line with our response to the public consultation on the operations of the ESAs, the mandate to supervise entities in third countries relevant to the EU should also cover credit rating agencies, trade repositories, data providers, benchmarks, and possibly trading venues.

Indeed, ESMA can play an important central role in the future, as a single access point for third country entities and to ensure consistent supervision of the risks that those entities might be creating in the EU. ●

Sylvie Matherat

Chief Regulatory Officer & Member of the Management Board, Deutsche Bank AG

Meeting the challenge – the EU response to Brexit

There are clear risks for the EU financial sector that come with Brexit. However, the changing status of the EU's only truly global financial centre is also an opportunity for the EU to reframe its own financial markets, building on flexibility, openness and competition.

With less than a year to go until the UK formally leaves the EU under Article 50, the clock is ticking and action to address cliff edge risks is urgently required. Action to ensure EU banks can continue to move data internationally and access financial market infrastructure globally. Action to avoid legal risk on contracts continuing past Brexit and to ensure day-1 equivalence for the UK where available under existing legislation. A smart and pragmatic approach to deliver regulatory certainty on these points quickly, will mitigate hard Brexit risks. It will also reinforce trust in the EU a custodian of stable and competitive markets.

Early clarity to provide regulatory certainty is essential; it is equally important that opportunities for the EU financial markets post Brexit are >>>

>>> not missed. However close the future relationship between UK and EU 27 is, the current reliance on London as the continent's gateway to international financial markets will have to change. Further developing the EU's own capital market will be essential. To achieve this will require political energy and an ambitious agenda to further harmonise rules across the single market, deliver greater consistency in supervision and to create the conditions for digital innovation in financial services.

It will also require a willingness to learn from the example of other successful financial centres. London was global financial hub before the single market. Its success was based on openness, a predictable regulatory environment and trusted legal system. In order to make the most of the opportunity to develop EU financial services post Brexit there should be a clear focus on continued openness, stability around the regulatory framework and consistency in the application of rules across the single market. These simple steps will help create incentives for activity to move without having to rely on the erection of regulatory barriers.

"Brexit risks can be mitigated – realising opportunities will require work."

- SYLVIE MATHERAT

The principles of consistent supervision, proportionate regulation, open markets and rigorous competition are already enshrined in the forward EU agenda for financial services: the Capital Markets Union and the European Supervisory Authorities Review will deliver greater consistency in the application of the regulatory rule book; completion of the Banking Union should allow free flow of bank capital and funding within the single market; and ongoing reviews of regulation will allow for any unintended impacts to be addressed. New initiatives such as the Fintech and Sustainable Finance Action Plans provide further opportunities to enhance the attractiveness of EU financial markets. The opportunity is there, we just need the vision and will to deliver it. ●

Joe Cassidy

Partner, Head of Brexit for Financial Services, KPMG in the UK

Brexit: still in denial?

For all the anxiety about the fate of Europe's financial industry in the wake of Brexit, few have been able to articulate the magnitude of the problem or the specifics of what the sector needs. This makes life tough for those policymakers striving to agree a deal. For one thing, Brexit uncertainty is as big a headache for European Union-based financial services companies, eager to retain access to the UK, as it is for British businesses heading the other way. For another, this industry goes well beyond conventional financial services.

The first of those two realities behoves negotiators to consider the interests of banks inbound to the UK as well as finding a means to support outbound business. The second is even more fundamental: while Brexit will have huge impacts on banks, investment managers and insurers, many large corporates will be affected in the same ways. Businesses in sectors ranging from aerospace to car manufacturing currently operate with banking licenses or depend on passporting regime as funds move through complicated supply chains across the EU; these companies need a deal that works for them too.

The uncertainties are daunting. We do not yet have any clear idea about how to frame contracts after Brexit, or how market access will be facilitated. The regulation of data flows across borders is a serious issue, particularly in the context of the general data protection regulation that comes into effect in May. And every business must confront counterparty risk – the extent to which Brexit poses threats to the counterparties with which they currently trade.

Agreement on a transitional deal is vital so businesses do not have to implement two major overhauls. Ideally, a standstill agreement would preserve the status quo from next March until a final deal comes into effect.

Companies will leave it as long as possible before making significant changes to their business model for fear of it proving ineffective or unnecessary in light of the final deal. Most firms are now building in short-term optionality, taking positions that will be reversible if the Brexit settlement delivers unexpected outcomes.

Without knowing the detail of the UK's relationship with the EU after 29 March 2019, there is only so much work these businesses can do. However, large investment banks are leading the way on Brexit preparations, the biggest corporates are ahead of the commercial banks – and certainly ahead of asset managers and insurers, many of which are just getting started.

Still, there is growing consensus that the balance of power in Europe will now shift, at least somewhat. Frankfurt, home to the European Central Bank, and Paris, which hosts the euro repo-market, are likely to take on greater importance as centres.

"This industry goes well beyond conventional financial services."

- JOE CASSIDY

Germany, in particular, is in a strong position, given its links to Asia, a trade corridor that is so vital to European businesses. Not only is Germany the largest economy in the EU, but also, it is Europe's only renminbi gateway outside London. That said, Germany's banking industry is fractured and often unprofitable – and therefore a tough challenge for new entrants. It cannot rely on an automatic Brexit boost.

There are, in other words, no easy answers for Europe's financial industry. And so the game of wait-and-see continues. ●

Douglas Tucker

Head of Compliance,
MUFG Bank, EMEA

Brexit: the consequences of uncertainty

The scope and importance of Brexit means it generates constant headlines, articles, opinions and even outright speculation. Some of this is balanced, while some reflects a particular political view or negotiating stance. It is hard to know what to believe. The picture also regularly changes with each public disagreement, set-back or breakthrough. I want to highlight the difficulties firms face in making strategic plans in this uncertain environment.

I view Brexit as a challenge to the efficient operation of global markets. The world is becoming more fragmented, and Brexit is adding to this dislocation through the break-down of a continent-wide financial trading zone. For global financial firms this will increase the costs of doing business in Europe. In addition to increased costs, though, firms must also deal with uncertainty.

Despite the length of time since the referendum, we are not yet clear about a host of vital questions. These range from technical points, such as continuity of contracts, transferring personal data, and location of CCPs, to fundamental structural matters, such as where our EU clients actually want to trade after the UK leaves the EU. Consequently, the building blocks of the European financial system are now unclear. So, deciding where to invest now comes with new and significant caveats and risks.

The length of time that this uncertainty will last is also significant. From the referendum, through negotiations on transition, to ratification of deals, to the exit of the UK and finally embedding a new 'business as usual' post-Brexit financial structure will take up an entire credit cycle. And who knows what divergence in financial rules will eventually arise and what the costs of doing business in the EU and UK will be at the end?

Further, in this negotiation between two sides whose interests diverge, we have disagreements about what the end-state might look like, particularly given the political requirements of the negotiators. Speeches regularly cover what cannot be agreed, or the problems inherent with any proposed solutions. From the outside this emphasises the risk that no-good end-state will actually arise.

Money spent on Brexit contingencies for an uncertain outcome might distract from more productive and predictable alternatives. This is the environment in which the management of global firms make their investment decisions. And all the time, the fast-growing markets of Asia and the powerhouse of the US are competing for that investment.

"The greatest impact of Brexit may not be an outcome of the negotiations, but rather a shift of investment away from the EU and UK."

- DOUGLAS TUCKER

It seems the only certainty with Brexit is uncertainty, and firms are acting accordingly. The greatest impact of Brexit may not be an outcome of the negotiations, but rather a shift of investment away from the EU and UK caused by the length and uncertainty of those negotiations. Unless politicians and negotiators swiftly agree a practical framework for financial services, it will be the real economy across the EU and UK which will bear the cost of that shift of investment. ●

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Impact of Brexit on EU priorities

Joachim Wuermeling

Member of the Executive Board, Deutsche Bundesbank

A plea for a digitally networked, global financial centre in the EU

The EU 27 will no longer have a global financial centre after Brexit – no matter what the new regime. But remaining financial centres could establish a "Digital City of Europe": an initiative to pool potential and work together as one globally competitive financial centre. The Eurofi High Level Seminar provides a good opportunity, less than a year before Brexit, to discuss this initiative.

What does the EU already have at its disposal for such a project? The outlook is encouraging: We live in a strong, diversified economic area; political systems are stable, and we have a single market with a reliable, harmonised legal framework and free movement of people, goods and services. The euro enjoys global confidence. Regulatory requirements are harmonised, the banking union has further boosted trust in our financial system and the emerging capital markets union may move financial integration further forward. Efficient market infrastructures enable fast and easy cross-border transactions.

Today, the EU 27's overall potential is spread over various locations and has not yet had a cumulative impact. Physical distance has – up to now – prevented EU financial centres from being globally competitive.

However, geographical proximity is becoming less important for a financial centre – if we make use of the new technological potential. Digitalisation opens up a totally new perspective for the EU 27's financial centres: to pool potential and cooperate as a single digital financial centre – not as a replica of old systems, but as a highly innovative technical project. Distributed ledger technology, global internet hubs or 5G networks are just some keywords. Supply and demand could band together on digital platforms as if they were all in the same place. Just as value chains in industry are today forged across continents, EU financial centres could digitally join forces.

What would it take to build such a "Digital City"? We have to meet three key challenges.

Specialisation and cooperation: EU member states and market players have different and sometimes conflicting interests. However, it is essential not to perceive a "Digital City" as a zero-sum game in which the gain of one side is the loss of the other, but to jointly develop the potential with everyone reaping the benefits. This may include financial centres limiting their own range of services, to specialise in certain areas and to cooperate online. Market-driven specialisation could help to create economies of scale and increase the potential for innovation.

Digital infrastructure: Cooperation requires a strong digital infrastructure on the basis of internationally accessible platforms. The EU 27's financial centres must form a

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>>> network in order to generate physical agglomeration effects of traditional financial centres on a digital level. This requires a high-tech digital infrastructure, for example for HFT, and digital standards for frictionless cooperation.

Legal framework: Despite all harmonisation efforts, the EU still does not have a legal framework that can compete with English common law. However, it may be possible to use the so-called 28th regime, a private law which does not replace national legislation but provides an alternative at the European level. Contractual parties can decide independently on the application, for instance in areas where complete harmonisation appears neither straightforward nor possible.

The idea of a "Digital City of Europe" and the political impetus for such a project are just one side. Policymakers can act as a catalyst by bringing the essential players together. Market forces are the key success factor, however. Many stakeholders, including financial institutions, tech companies and providers of market infrastructures, have to join forces. Coming in the wake of the financial single market, the banking union and the capital markets union, a "digital financial market union" would be an ambitious project. From a central banker's perspective, the success is desirable, since essential parts of Europe's financial business would then take place within our common jurisdiction. As a result, we would be better placed to safeguard the stability of the financial system. We would not be overly dependent on transactions outside continental Europe to fund our real economy. By the same token, we would have a share in open, global capital flows and financial markets - as a relevant player in our own right. ●

Olivier Guersent

Director General for Financial Stability, Financial Services and Capital Markets Union, European Commission

Addressing Brexit challenges head-on

On 30th March 2019 the United Kingdom will no longer form part of the European Union. The UK's withdrawal from the EU will come after more than forty years of membership in the European project, which have seen British businesses, consumers and authorities participate in and benefit from the European single market. The decision of the British citizens in the Brexit referendum as well as "red lines" stemming from the ensuing political process in the UK imply that the country can no longer be part of the single market after its withdrawal from the EU. Depending on the (yet uncertain) outcome of negotiations on the withdrawal and transition arrangements, this rupture brought by Brexit might get postponed by a couple of years.

So, what does UK's withdrawal from the European Union mean for EU financial services and our regulatory agenda?

First, we are tackling the imminent challenges posed by Brexit. By leaving the EU and leaving the single market, the UK will become a third country and UK firms will lose the passport in financial services. This entails certain cliff-edge risks. The Commission is working closely with all stakeholders, authorities and market participants alike, to ensure those risks are being addressed.

The Commission has in particular published various notices stressing the practical consequences for stakeholders across a number of sectors. Businesses should prepare to manage these consequences, including by relocation of activities or renegotiation of contracts to ensure the continuity of services for their customers. Market participants cannot afford to bet on the outcome of the negotiations, but should rather prepare for all eventualities, including a 'no deal' and 'no equivalence' scenario.

Second, we are looking beyond the Brexit date to make sure that our markets and their regulatory framework are fit for the future at 27 Member States. We are advancing as planned on completing the Capital Markets Union, which will open up markets to give better access to finance for EU businesses and more and innovative investment opportunities for savers.

In particular, our FinTech Action Plan sets out clear and concrete steps to enable innovative business models to scale up, support the uptake of new technologies, and increase cybersecurity and the integrity of the financial system.

Not less importantly, EU's Sustainable Finance Action Plan will create the conditions for more sustainable economic growth and development by reorienting capital flows towards more sustainable investments, such as the clean energy transition and the transition to a circular economy. >>>

>>> We are also putting additional emphasis on consistent regulation and supervision, both for financial institutions and for consumers and businesses using financial services in the EU. Our proposals on the review of the European Supervisory Authorities have been tabled to address the risks of regulatory arbitrage and to ensure a more level playing field and consistent investor protection and financial stability across the EU-27. Lastly, we are putting every effort to facilitate the completion of the Banking Union and we look forward to seeing definitive progress on the European Deposit Insurance Scheme (EDIS) and the backstop soon. ●

Nigel Phipps

UK Country Manager and Managing Director of Government & Public Affairs, Moody's

EU should maintain openness to other countries post Brexit

The European Union has a history of being open to third country financial markets. Instead of using extraterritorial reach to demand other countries comply with its laws, it created an effective system of equivalence, endorsement, and as-stringent-as tests to bring wealth and growth to the EU while mitigating risk.

This approach rests on communication with and confidence in other jurisdictions' rules and regulators, underpinned by international standards. In the wake of Brexit, this core value is coming under pressure at a time when the world needs a powerful voice in favour of openness and trust. If the system evolves to make it more difficult for investors to access the EU27 and for EU27 companies to access other financial centres and offshore securities, then the EU's relative standing will diminish at a faster rate amidst the rise of emerging markets.

Certain inefficiencies and one-off costs are inevitable as the UK removes itself from the EU, in effect unwinding the UK's dividend created by the single market. While retail markets have remained mostly domestic, portions of the wholesale market that are serviced out of London will have to move from the UK to the EU27 under EU rules and requirements. This will necessarily impact on efficiency and potentially effectiveness. In the case of credit rating agencies (CRAs), regulatory shifts will require most EU issuers currently rated from London offices to be rated from the EU27. While these short term implications have put a spotlight on the EU's approach to third countries, it is not – at its core – solely a Brexit issue.

The future of the EU and the creation of a successful Capital Markets Union should be the focus – and that is more broadly a single market issue. To create a successful CMU, member states will need to examine the most efficient use of their national savings pools while encouraging risk diversification away from banks. Of equal importance to the success of the union will be how it interacts with the rest of the world.

For developed market partners, the EU should remain open with a foundation in international standards. Regardless of negotiation outcomes, London will still be the largest global financial centre in Europe (if not the EU), able to provide liquidity and expertise in support of the EU27 economy. So for example, even though CRAs will move most ratings for the EU on to the continent, it does not change the fact that other ratings produced in the UK, such as those for large UK banks, will be important in the EU27. The biggest question for broader UK-EU relations post-Brexit is therefore how high a connectivity cost either side will impose.

For emerging market partners, EU policy makers continue to speak of mitigating imported risks. An examination of the risks the EU is simultaneously exporting to the emerging markets tends to be left out of the conversation. This would argue for a change in focus on third country approaches to provide space for the growth of domestic liquidity in emerging markets as opposed to the stringent imposition of EU standards.

The EU is at risk of creating an extraterritorial regulatory system more like those of the US and China. Instead, the EU27 may consider it more beneficial to continue its role of supporting global standards and encouraging their adoption while making sure those global institutions listen to the needs of the emerging markets. ●

Roberto Gualtieri

Chair, Committee on Economic and Monetary Affairs & Member of the Brexit Steering Group, European Parliament

Soundness and stability of the EU financial and supervisory system after Brexit

The withdrawal of the UK from the EU will affect the EU financial system. The main consequence of the UK leaving the Internal Market is that, after the transition period, the UK will lose all passporting rights as well as the right to freely provide services across the EU under home country control. In other words, the UK will become a third country and the EU acquis will no longer apply, including the Single rulebook on financial services.

The transitional period agreed in March, which foresees the prolongation of the whole EU acquis and of the UK participation in the Single Market, will provide additional time to prepare to this new situation and to define possible new arrangements. The necessary work on preparedness should in any case take into account all possible outcomes.

As the Council and the European Parliament have noted, while outside the Single Market it is impossible to ensure mutual recognition of rules, an appropriate level of access to financial services markets could be provided by reviewed and improved equivalence mechanisms, based on a proportional and risk-based approach, without prejudice to the integrity of the Single Market and the autonomy of the EU decision making. We welcome in this respect the ongoing legislative work and upcoming Commission proposals in this area, while underlying that decisions on equivalence are always of unilateral nature.

The aim of this exercise, which has already started with the ongoing >>>

>>> legislative procedure on third country CCPs, should be to minimize the disruption caused by Brexit and the financial fragmentation, while appropriately safeguarding financial stability and ensuring full compliance with the EU regulatory standards and their application. In this respect, it is important to underline that while each Free Trade Agreement has its own specificities, prudential carve-out and limitations in the cross-border provisions of financial services are a customary feature of FTAs.

This entails, on the one hand, the need for the industry to adapt to this new framework and set out a contingency plan. On the other hand, the EU must stand ready to review its legislation and ensure that it is eventually appropriate to keep its financial system sound and safeguard its regulatory regime and standards after Brexit.

Under this perspective, our task as co-legislators - and what we are already doing - is above all to carefully review and improve the equivalence mechanisms. In particular, we will not rule out a priori the possibility to recognise the equivalence of UK rules, including, in some cases and in specific sectors, the right to provide services in the EU. However, this will be possible only upon two main conditions. The first is that the EU carries out a proportionate and risk-based assessment of the impact brought about by the UK regulatory and supervisory framework on the European system, with the aim to always preserve financial stability, the integrity of the Single Market, the autonomy of decision making in the EU as well as the level playing field. The second condition is that the recognition of the passporting rights comes through a decision of the European Union which must be unilateral and discretionary in nature.

This is what the European Parliament has clearly expressed in its fourth resolution. And this is also the rationale behind the legislative initiatives that the Commission has been taking so far and that we strongly support. Reference is made, for example, to EMIR2.0 file, which sets out, among others, an enhanced supervision of systemic third countries CCPs. Indeed, Brexit is going to exacerbate a number of shortcoming of the current equivalence and recognition regime for third country CCPs, because a very substantial volume of euro-denominated derivatives transactions will then be cleared outside the EU and the Single Market. Similarly, through the ESAs Review the Commission aims to strengthen the ESAs, especially in terms of monitoring and enforcing equivalence decisions.

In the light of the above, increased supervisory convergence and harmonisation of third country regimes will ensure a level playing field to curtail regulatory arbitrage or a race to the bottom between Member States. ●

Ian Jameson

Managing Director, General Counsel and Chief Legal Officer, EMEA, Sumitomo Mitsui Banking Corporation (SMBC)

Brexit – friction, risk and cost

Europe's financial markets are facing unprecedented upheaval. Decades of regulatory cooperation and convergence have produced an integrated regulatory system which, while not perfect, provides the coherence and consistency required by the Single Market in financial services. Brexit will reduce the economies of scale and diversification achieved by the Single Market. This will inevitably lead to frictions, giving rise to increased risk and cost. Where will the areas of friction lie?

Market access: If no cross-border passport or similar arrangement exists between the EU27 and the UK after Brexit, the impact will be significant. The available third country equivalence regimes are no substitute for the passport and although cross-border service provision by third country banks may be tolerated in certain countries for certain products, it does not form a coherent regime and is always open to interpretation. The UK PRA has recently issued helpful guidance on business that can be done by third country branches in the UK, but lending banks will require a subsidiary to market cross-border in the EU27 after Brexit.

Capital and liquidity: As some banks are now discovering, the creation of a subsidiary in the EU27 is not only a time-consuming and expensive exercise, but is also likely to result after Brexit in higher requirements for capital and liquidity to cover the same aggregate amount of risk as before.

Risk management: Discouragement of back to back structures allowing banks to continue to manage risk in London will not improve risk management. Rather, it will serve to keep those risks within the EU27, where resources may not yet be sufficiently mature. Restrictions on the ability of EU27 firms to clear euro instruments through UK CCPs will fragment portfolios and lead to less effective risk mitigation.

Operational efficiency: Many banks have significant middle and back offices in the UK. Outsourcing should be undertaken with care, but efficiencies of scale will be lost and operational risk will be increased if outsourcing to those resources in London is disallowed. Banks should be permitted to continue to outsource functions to London as long as appropriate controls are in place.

Commercial certainty: Loss of the passport could affect the validity of certain contracts. The risk increases with the tenor of the contract. Considerable resources may be required to repaper transactions and the absence of a provision in the draft Withdrawal Agreement providing for continuity of existing contracts is a matter of concern.

Regulatory coherence: Given the importance of financial services to its economy, the UK cannot become a passive "taker" of EU regulation. There has been talk of the UK practising "managed divergence" from EU regulations, while nonetheless achieving the same regulatory outcomes. This could maintain a high degree of integration across the UK and the EU27, but what would be the legislative procedure to effect this? Who will judge whether coherence is maintained? And on which principles of interpretation will such judgments be based?

Banks face increased expenses, higher prudential requirements and loss of efficiency. We must cooperate to preserve as much of today's integrated regulatory system as we can as ultimately the costs of Brexit will be borne by Europe's consumers. ●

III. CMU IMPLEMENTATION AND SUSTAINABLE FINANCE

Issues at stake

Developing EU capital markets is essential to provide alternative sources of financing to businesses and infrastructures and better connect savings with the huge investment needs across the Union notably required to achieve the de-carbonization of the economy. This requires removing barriers to deeper capital markets, achieving more consistent supervision and developing new EU-wide taxonomy, labels and passports notably in the sustainable finance area, in order to allow investors to take full advantage of the single market for capital.

Finding the right balance between the pan-European and the local dimension of the development of capital markets in the Union however remains challenging, as well as fine-tuning banking and insurance prudential rules, so that they do not hinder long term investment.

Content

Further reducing fragmentation in the CMU

Marinela Petrova

Deputy Minister, Member of the Economic and Financial Committee, Ministry of Finance, Republic of Bulgaria

Further reducing fragmentation within the Capital Markets Union

The Capital Markets Union (CMU) consists of wide range of initiatives with the combined aim of deepening existing markets and developing non-bank funding sources to allow the free flow of capital across the EU. By 2019, the European Union shall meet the main targets in relation to the ambitious agenda of the CMU. The Bulgarian Presidency is working hard in order to achieve the maximum possible progress on the CMU measures and to facilitate the accomplishment of that ambitious agenda.

Following what was already achieved, the Commission moved forward with delivering new priority initiatives to strengthen the CMU action plan, having regard to strengthening the effectiveness of supervision to accelerate market integration by the review of the European System of Financial Supervision. Considering the undoubted support for enhanced supervisory convergence and further reducing the financial markets fragmentation, the Bulgarian Presidency is on the view that the EU should have a clear view how to shape the regulatory and institutional framework while respecting the proportionate division of powers between the national and EU authorities.

Another essential aspect that we are going to address is the removal of existing barriers for free movement of capital, especially in relation to the cross-border distribution of investment funds, in order to reduce the remaining fragmentation in this regard. Removing these barriers will increase the access to investments, increase the competition on the markets and reduce administrative burden as well as will lower the costs both for investors and for the industry.

Other important elements of the CMU are the initiatives which aim at creating European labels for certain products like the Pan-European Personal Pension Product (PEPP) and Covered Bonds. European labels based on high-quality standards and best practices will also contribute to the reduction of fragmentation. Ensuring level playing field is essential in order to allow equal access for all market participants and to be able to make easier and more effective use of the available financial resources. >>>

>>> In fact, the on-going EU initiatives provide new building blocks for the realisation of the CMU in the EU, the rapid establishment of which is highly desirable. Beyond doubt, further reducing of the existing fragmentation in the financial sector is particularly important also from financial stability point of view since it facilitates and supports cross-border private risk-sharing. The CMU, together with the Banking Union, should in turn contribute to the further deepening and completion of the Economic and Monetary Union.

Remaining challenge of the CMU project is to deliver more proportionate and simplified rules for SMEs by removing unnecessary regulatory requirements in a way that does not undermine financial stability in order to integrate further EU capital markets in a compatible way with the development of the local market ecosystems. ●

Laura Ahto

Chief Administrative Officer for Global Asset Servicing, BNY Mellon

Success of the CMU Project – visions of Sofia

The Capital Markets Union project is a major priority for the European Union. This we have been told many times over the past few years, including recently by the European Commission in a Communication with the ambitious title "Completing the Capital Markets Union by 2019 – time to accelerate delivery".

Yet the CMU project has suffered from a misalignment between its lofty ambitions, the diversity and difficulties of its specific policy actions (its "building blocks"), and the prospect of a major external blow to the project ("Brexit"). The actual achievements of the CMU project have so far been limited.

We need a vision, or visions, of how we can reconcile, and overcome, these challenges. The challenges derive from the reality that we have across Europe national capital markets, and national capital market infrastructures, that are deeply embedded in national corporate and securities law, and in national taxation systems. This is the result of the way national capital markets and national economies have developed over the past decades, and means that end users of capital markets, namely private individuals as savers, and corporations as investors, have a strong local bias.

This strong local bias generates a call for capital market supervision to take place at a local national level. And local capital market supervision generates a call for supervisory practices to take into account specificities in national markets and gives incentives for national supervisors to protect their national capital market infrastructures. These challenges will become worse, once the most significant European location for pan-European and global capital markets leaves the European Union.

Brexit forces us to take a hard look at what it means to build a capital markets union in an EU of 27 countries. Discussions on EU27 public policy for building a CMU for 27 countries have focused on systemic stability, on openness to global markets, and on developing the EU27 as a location for financial market activity. These are important characteristics, but they are more a set of minimum requirements rather than a fully-fledged vision for the future. >>>

>>> Important additional elements that can help build a workable vision for the CMU include a recognition that national markets function as eco-systems, and that a diversity of eco-systems and a multitude of different types of market participants are a strength, rather than a weakness.

In order for these diverse eco-systems to function, and to contribute effectively to an over-arching EU27 capital markets union, two key conditions need to be fulfilled. The first is that we need a "Single Capital Markets Supervisory Mechanism". This "Supervisory Mechanism" will ensure that we have one rulebook, with one interpretation, and with a consistent application, but will also be organised in such a way that there is an appropriate allocation of supervisory responsibilities between ESMA and the national competent authorities based on the principles of subsidiarity and proportionality.

The second key condition is that we need a high degree of integration and uniformity of process at the level of core capital market infrastructure. To function effectively, and to avoid the risks of fragmentation, a diversity of market structures and of market players must be based on the same core foundations. There is the need for truly integrated, harmonised, low-risk and low-cost trading and post-trading infrastructure in Europe.

For the first key condition, there are promising steps that are being taken. But the second key condition, and especially for post-trade processes, is very far from being fulfilled. But there is also a third element that needs to be taken into account.

When we build structures for an EU27 CMU, we need to ensure that we do not inadvertently close ourselves to the outside. We should build an EU27 CMU that is the heart of a pan-European capital markets area. These visions should give us the inspiration and guidance to make progress towards a real EU27 capital markets union that is an integral part of pan-European and global financial markets.

Otherwise, and as Bob Dylan has put it:
"The harmonicas play the skeleton keys and the rain
And these visions of Johanna are now all that remain" ●

Ugo Bassi

Director, Financial Markets Directorate, DG Financial Stability, Financial Services and Capital Markets Union, European Commission

Completing Capital Markets Union by 2019 – time to accelerate delivery

Deep and integrated capital markets are a priority for the Commission. They boost the productive use of capital, provide more long-term investment opportunities for investors, broaden and diversify the sources of funding for the real economy, and help to make the EU economy and EMU more resilient.

In the 2015 CMU Action Plan and the 2017 Mid-term review, the Commission has set out a comprehensive structural reform agenda around 71 actions aiming at reducing the fragmentation of EU capital markets. Progress has been achieved since. The Commission delivered 29 out of the 33 actions in the CMU Action Plan. With the 2017 Mid-term review, the Commission stepped up the level of ambition, aiming to harness new opportunities for capital markets such as financial technology and sustainable finance and to address key obstacles to capital markets integration. Six out of nine priority actions from the CMU Mid-term review were already delivered by the end of March 2018.

On 8 and 12 March, the Commission presented a comprehensive package designed to make further progress with the implementation of CMU. We have presented an Action Plan on how to harness the opportunities presented by technology-enabled innovation in financial services (the "FinTech Action Plan"), to make the most of the advantages offered by the Single Market in this fast-moving >>>

>>> sector. As a first major deliverable, we have put forward new rules that will help crowdfunding service providers grow across the EU's single market.

We also presented in March an EU enabling framework for covered bonds and measures to support the cross-border distribution of investment funds.

The Commission also adopted on 7 March a comprehensive strategy for a financial system that supports the EU's climate and sustainable development agenda. This Action Plan on Sustainable Finance aims to: i) reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth; ii) manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and iii) foster transparency and long-termism in financial and economic activity. Some of the announced measures are already under preparation for adoption in May. Notably, the Commission intends to propose a clarification of investors' duties related to sustainability and to introduce an EU-wide classification system of sustainable activities.

"Commission presented a comprehensive package designed to make further progress."

- UGO BASSI

The European Council agreed to put in place all the building blocks of CMU by 2019. The Commission is strongly committed to reach that goal as set out in the March 2018 Communication on "Completing the CMU by 2019 – time to accelerate delivery". The Communication aims to trigger a high-level policy discussion and call on the co-legislators to adopt the legislation to complete CMU as soon as possible and before mid-2019. Notably, the adoption of the proposed ESA review by the co-legislators is paramount to completing CMU. For instance, strengthening the ability of ESMA to ensure consistent supervision and enforcement and directly supervise certain capital markets is a much-needed step for further market integration and financial stability. The Commission stands ready to actively discuss with the European Parliament and Council ideas to accelerate current negotiations in order to ensure the final adoption of the ESA review before the European Parliament elections in 2019. ●

Markus Ferber

MEP, 1st Vice-Chair, Economic and Monetary Affairs Committee, European Parliament

CMU - Reform in light of Brexit

There is no way around it: the United Kingdom is Europe's biggest and most liquid capital market and will most likely remain so for a while. That means that on Brexit day, Europe's largest financial market will be located in a third country. That is bad news for the United Kingdom as doing business for UK banks and investment firms across the Single Market might become considerably harder and it is bad news for the EU as access to a deep pool of capital might get a bit harder. A lot is still up in the air as the framework for the future relationship between the EU and the UK is still unclear.

Strategically however, Brexit should be a wake-up call for the EU and the Capital Markets Union. In the long run it is more than undesirable to be largely dependent on a third country's capital market for the financing needs of the EU economy. The very idea of the Capital Markets Union therefore points into the right direction. However, although this has been one of the big flagship projects of the European Commission, not much has been achieved and the CMU half-time review has arguably been a rather thin read.

A lot of hope is pinned on the reform of the European Supervisory Authorities (ESA review). However, we should be clear what the ESA review can and cannot achieve. It can certainly help clarifying the responsibilities between national supervisory authorities and their European counterparts, it can streamline certain processes and potentially even certain supervisory functions could be lifted to the European level - if there are good grounds for it. So while, the ESA review can smooth out certain processes and make operating across the Single Market easier from a supervision perspective, it cannot solve the general lack of ambition regarding the Capital Markets Union.

Aligning rules that govern market structure (MiIFD II/ MiFIR), conduct (MAD/MAR) and publication information (Prospectus Regulation) can only be seen as the first steps to genuine pan-European markets. The next steps will have to be to deal with the challenges that come with digitisation for financial services, barriers SMEs face when accessing financial markets and, most importantly, the question of insolvency law.

"Brexit should be a wake-up call for the EU and the Capital Markets Union."

- MARKUS FERBER

Cross-border investments are only attractive if potential investors can be assured that contracts and claims can be enforced within reasonable timeframes and with reasonable effort. Otherwise, there is little chance to really boost cross-border trade and investment. Arguably, this is an area that is particularly delicate and contentious with many Member States, but a genuine Capital Markets Union can only happen if there is a certain degree of harmonisation in this area, too.

Brexit gives the CMU project a new urgency, but it also represents an opportunity to pave the way for more transparent, more efficient and better integrated financial markets in the EU - we should strive to make good use of that opportunity. ●

Mathias Papenfuß

Member of the Executive Board, Clearstream Banking AG

Brexit spurs urgency to break remaining barriers across EU financial markets

With the initiative of building a Capital Markets Union (CMU) going forward, joint regulatory efforts and market-led solutions are needed to foster a barrier-free environment for European financial markets – all the more so in view of the largest financial centre preparing to leave the Single Market.

Central Securities Depositories (CSDs) play an important role for the creation of efficiently integrated capital markets, as they ensure the safe delivery of securities in return for payments after a trade. We may not realise it, but we all indirectly rely on smooth and seamless post-trade processes: the small businessman seeking capital to expand, the young family looking to move into a new home and the senior citizen exploring opportunities for better returns on his pension savings.

It is therefore positive to note that a major leap towards greater harmonisation and cross-border issuance has been achieved via ECB's TARGET2-Securities (T2S) initiative – Europe's first single settlement platform. T2S represents a transformational change with knock-on benefits for operations through a coherent set of rules and processes, for example through common operating hours, deadlines and communication interfaces. However, adaptation to this new environment takes time: Market participants are working hard to complete major operational projects; while, at national level, a number of public bodies are yet to dismantle further procedural and technical barriers. For instance, legacy restrictions by European Debt Management Offices and National Central Banks states still require primary dealers in some member to open accounts directly with the local CSD to settle securities from primary auctions in T2S – preventing market participants to fully harness the benefits of this new architecture.

Beyond T2S, the restrictions also carry negative implications for realising the CMU objectives of a level playing field between market participants and deeper market integration. Close private and public sector cooperation is required to address these and other remaining barriers identified by the Commission's expert group on post-trade (EPTF) in 2017. Future legislation should be applied in a way that allows CSDs to offer their entire suite of services competitively. By hosting the two largest international CSDs in the world, Europe is already in a good position to achieve its eager ambitions; and Clearstream is the natural partner of choice to further integrate settlement practices in the Union, having already enhanced the T2S offering by bringing together collateral pools across Clearstream's domestic and international CSD businesses with its all-in-one service solution: OneClearstream.

"Financial infrastructures remain solid rocks in these turbulent waters."

- MATHIAS PAPENFUß

Finally, the chaotic dynamics and political uncertainties around Brexit have further urged to accelerate the EU-27 vision of financial market integration. As repeatedly proven in the past, financial infrastructures remain solid rocks in these turbulent waters of uncertainty, and it is in our primary interest to ensure that UK clients maintain access to our services in a post-Brexit era – for truly panEuropean capital markets will not only be beneficial for our home industries, but more attractive for non-EU issuers and investors alike. ●

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Priorities for developing sustainable finance

Christian Thimann

Chairman of the EU High-Level Expert Group on Sustainable Finance and Senior Executive, AXA

Sustainability – an opportunity for banks and insurance companies

Sustainability is the theme of our time – and the financial system has a key role to play in delivering that set of ambitions. Sustainability means making economic prosperity longlasting, more socially inclusive and less dependent on exploitation of finite resources and the natural environment.

This transition towards a more sustainable economic model requires large-scale investments in the economy. The European Commission estimates that to achieve the EU's targets for energy and climate policy alone, additional annual investments of €170 billion are required. The investments needed to meet the Sustainable Development Goals more broadly will be even higher. The current investment gap calls for rapid and substantial redeployment of capital towards sustainable activities that shall foster employment, productivity and competitiveness of the EU's economy.

Ensuring that the financial system contributes to economic sustainability is particularly important in the wake of the financial crisis. While the European economy has mostly recovered from the shock, it remains vulnerable. More efforts are needed to foster long-term investment, to protect the corporate sector against undue pressures to deliver short-term financial results and to create jobs across all regions of Europe.

This imperative of sustainable finance is nothing new; what is new is the momentum behind its implementation. The twin adoption of the 2030 Agenda for Sustainable Development and the Paris Agreement in 2015/16 has re-ignited discussions – and the impetus for action has been building since then. Most striking about this new drive is how many organisations and institutions are pushing together towards a single reform agenda.

Sustainability is an opportunity for banks: they need to demonstrate that the understand and integrate sustainability and ESG risks into their risk management frameworks but it allows them to re-engage fully with the real sector, show their critical role in project finance, early stages of infrastructure finance, ability

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>>> to support research, innovation and development, and investments in energy efficiency.

Sustainability is also an opportunity for the insurance sector that is already intimately familiar with climate risks and related natural catastrophe risk; the insurance sector needs to be sure to be aware of sustainability risks also on the asset side but it allows it to extend its product offer, bring to the fore and to the benefit of clients its expertise and data on climate risk and present itself as part of the solution to handle the rising risks that climate change will entail.

The European Commission has presented its Action Plan on Sustainable Finance in March this year. The plan is ambitious, comprehensive and timely. It deserves full support. ●

Daniel Calleja Crespo

Director-General for Environment,
European Commission

Unlocking sustainable investment opportunities

Sustainability has long been at the heart of the European Union project. Eight out of the top ten most likely and impactful global risks identified by the World Economic Forum in its 2018 “Global Risks Report” are environmental or linked to environmental degradation. Reorienting private capital to more sustainable investments and mainstream sustainability within the financial system is essential to deliver the Sustainable Development Goals and to preserve financial stability.

Sustainable finance has grown from a niche topic to a mainstream issue in the financial world, drawing worldwide attention from market actors, supervisory authorities and policy makers. However, despite increased investor appetite and the large amounts of liquidity available, it has almost become a cliché to say that there is a "lack of sustainable projects". This is something of a paradox, as supply and demand should be equated through price changes.

Yet, in the case of sustainable finance, market actors face imperfect information: there is little clarity or consensus on what is a sustainable project. This gives rise to the risk of greenwashing and associated lack of trust of investors.

A key element of the European Commission's Action Plan on Sustainable Finance is thus to establish a common language for sustainable finance, i.e. by developing a Taxonomy, a classification system defining which economic sectors and activities are sustainable. This Taxonomy will provide much needed clarity and certainty: Companies and project promoters will know what is required to qualify as sustainable, while investors will be able to invest in sustainable projects, confident that their investments are contributing to a better world. The European Commission is also exploring the use of the EU Ecolabel for certain financial products to allow sustainability information to be conveyed in a clear and understandable way to retail investors.

While a Taxonomy is a crucial step in the right direction, the transition towards a low-carbon, circular economy requires more than identifying specific activities that contribute to this transition. Ultimately, it is about making the whole economy more sustainable. For this reason, Environmental Accounting standards will need to be developed, which would enable comparing the environmental performance of companies and projects, and provide incentives for improvement. The Natural Capital Protocol, a business-led framework to identify impacts and dependencies relating to natural capital, provides a solid starting point for the development of such standards. >>>

>>> Of course, there are also technical bottlenecks which contribute to the lack of sustainable projects. For example, many sustainable projects – in particular infrastructure projects – require public actors to leverage private capital. Nonetheless, the capacity to structure and implement such projects varies widely across the EU and between sectors. The Commission has significantly boosted its financial and technical support for sustainable infrastructure investment, notably through the European Investment Advisory Hub and the European Fund for Strategic Investments (which has mobilised almost €265 billion) and committed to further reinforce advisory capacity.

In conclusion, the Commission's Action Plan marks a step forward in many areas of sustainable finance and reinforces the EU's global leadership in sustainable development. In particular, a common language, through both the Taxonomy and Environmental Accounting standards, is key to unlocking sustainable investment opportunities. However, it is not a stand-alone and self-propelling tool; it needs to be taken-up by market actors and embedded in the frameworks of supervisors and policy makers. This illustrates that sustainable development is a challenge that requires parallel action on several fronts and coordinated efforts. But it also shows that sustainable finance is an opportunity for many to engage, including financial intermediaries, institutional and retail investors, supervisors and policy makers. ●

Jérôme Brunel

Member of the Executive Committee, Crédit Agricole S.A.

Sustainable investment for sustainable growth: re-directing capital flows

Crédit Agricole finances a quarter of the French economy and believes that climate transition is one of the major challenges of our time. This has naturally led us to become involved in transforming the economy towards a less carbon-intensive model. The fact that over 170 countries have now ratified the Paris Agreement sends a powerful signal: the need to transition to a low-carbon, resource-efficient and circular economic system can no longer be ignored. We have committed to respecting a path of limiting temperature increase to 2°C by the end of the century.

One has indeed to bear in mind that the key role of a bank is to facilitate transitions and to support the resulting changes in business models. Our duty is to support our customers in a realistic but comprehensive way in this transformation, over the long term, by providing tailor-made and innovative solutions. For these reasons, in December 2017, two years after the Paris Climate Agreement, we decided to further increase our commitments. Crédit Agricole Corporate and Investment Bank (CACIB) has decided to increase the amount of green financing arranged worldwide to €100 billion by 2020; Crédit Agricole Leasing & Factoring, LCL and the Regional Banks will finance one out of every three renewable energy and energy efficiency projects in France by 2020; and Crédit Agricole SA has started incorporating climate as a criterion in all its credit risk assessments and will offset all of its direct carbon footprint until 2040 through the Livelihoods Carbon Fund. Finally, Crédit Agricole Group will exclude from its activities the fossil fuels that are most harmful to the environment. Coal extraction and coal power plants have already been excluded for several years.

We therefore welcome the recent initiatives launched at EU level to finance a more sustainable world, which are in line with our own actions. >>>

>>> Regarding standards and labels for green financial products, we support the development of an EU standard for green bonds that would create more clarity for issuers and investors and ensure a level playing field. In 2014, CACIB co-wrote the Green Bond Principles, an initiative which already encouraged transparency, disclosure and integrity in the development of the green bond market, where CACIB is a global leader.

We also support EU efforts to strengthen sustainability disclosure. Since 2011, Crédit Agricole has been using the innovative P9XCA methodology[1] to map its induced carbon emissions by sector and geographically. To the best of our knowledge, we remain the first and only bank to estimate the indirect carbon footprint of its corporate and investment portfolio[2].

Furthermore, to ensure that institutional investors consider environmental, social and governance (ESG) issues in their investment decision process and are more transparent towards their clients, our asset management entity, Amundi, was one of the first signatories of the United Nations Principles for Responsible Investment in 2006 (followed by Crédit Agricole Assurances). Amundi is a leader in the Socially Responsible Investment market with €170 billion in assets under management. ESG factors are a key element of their fiduciary responsibility.

Finally, as the green revolution is both a source of new opportunity and new risk, Crédit Agricole advocates a more appropriate regulatory and prudential framework. We developed in 2016, with the French Banking Federation, the main features of a preferential prudential treatment for exposures that promote this transition towards a green economy. Incorporating sustainability in prudential requirements via a "Green Supporting Factor" would contribute to maintaining EU leadership and help financial institutions continue to innovate and allocate the resources needed to meet the challenge of climate change. The financing of assets that contribute to the reduction of a systemic risk should not be subject to the same prudential requirements as other assets.

As a key player in the climate transition, Crédit Agricole firmly believes in the importance of developing the green economy and the leading role of banks in that respect. We will keep innovating and developing expertise to support our institutional and retail clients towards a more sustainable environment. ●

1. Developed in close cooperation with renowned academics
2. We estimate our "Scope 3 emissions": all indirect emissions of greenhouse gas due to the activities of the institution as provided by the accounting and reporting standards of the Greenhouse Gas Protocol.

Paul Tang

MEP, Committee on Economic and Monetary Affairs,
European Parliament

Short-termism is the single biggest flaw in the financial system

After the music stopped in 2008, the woes of the financial sector came to light. Counter to the prevalent adage from the 1980s, the sector turned out to be unable to fix its own flaws. After a bailout that cost trillions of euros and a range of (attempted) regulations, we can still not preclude the reappearance of a global financial crisis.

Perhaps the single biggest flaw of the financial sector can be described as short-termism. Or, more precisely, a narrow focus on short-term revenue maximisation, that is detached from the needs of the broader society. This bias has to potential >>>

>>> to wreak havoc at three levels: on the business itself that will have a blind spot for risks with a long-term horizon, on the environment in which a business operates and - on a more abstract level - on labour (workers), that will be subordinate to capital (shareholders) in a company´s strategy.

So, it will be in the interest of most to overcome this bias. To be fair, some financial institutions are starting to grasp this, and there are some best practices for divestment and integration of sustainability risks. Yet, the biggest problem of the sustainable finance niche is indeed that it is a niche, and not a broadly embraced way of doing business.

A case in point, a recent report by ICAN showed 329 financial institutions invested US$525 billion in 20 nuclear weapon producers between 2014 and 2017. The Dutch bank ING was responsible for US$756 million. In the same week, ING gave its CEO a 50% raise, which is also not a signal that the bank learned the lessons of the crisis.

So real chance will be contingent on the actions of politicians and regulators. Therefore, it is good news that the parliament and the European Commission finally show some appetite for action. The Commission presented an action plan with legislation on disclosure, standardisation and taxonomy. The European Parliament will be fully involved in the legislative process and is already formulating ambitious proposals in its sustainable finance own initiative report.

What is needed, is nothing less than change across the entire value chain of financial institutions. Banks, capital markets, intermediaries and asset managers have to move. A taxonomy is needed, not only for ´green´ finance, but also to determine whether investments are sound from a societal and governmental point of view. Therefore, as a draftsperson for the Socialists & Democrats group in the European Parliament, I have tabled proposal for a broad ESG definition - including inter alia sustainability risks, human rights and remuneration. Crucially, this definition has to be a ´living´ one, it should be possible to chance it as new risks emerge or become commensurable.

Yet, standardization of ESG risks and factors is only one step. A strong mandatory due diligence requires investors to prevent, mitigate and account for risks. In addition, disclosure of risks should be mandatory, drawing on best practices in EU Member States such as Article 173 of the French Energy Transition Bill that stipulates mandatory climate risk disclosure.

For banks, that still provide around 80% of financing across the European Union, it is especially crucial to integrate a long-term horizon. This means: divestment from exposure to assets with a detrimental ESG profile. Therefore, ESG factors should be integrated in the prudential framework of banks. And we should be realistic: to bring about a shift like that, a carrot is inadequate. A stick, in the form of a brown add-on factor, is to be preferred. Alternative options include exposure limits and specific capital surcharges. The goal is, again, to put a price on short-term markets failure.

As the High-Level Expert Group on Sustainable Finance put forward, a yearly extra investment of EUR 180 billion is needed to meet the goals of the Paris climate change agreement.

A thorough redirection of investments beyond short-term profit maximization is needed to put the financial sector in service of the society. This will not only prevents a recurrence of yesterday´s crisis, it will also avert tomorrow´s sustainability crisis. ●

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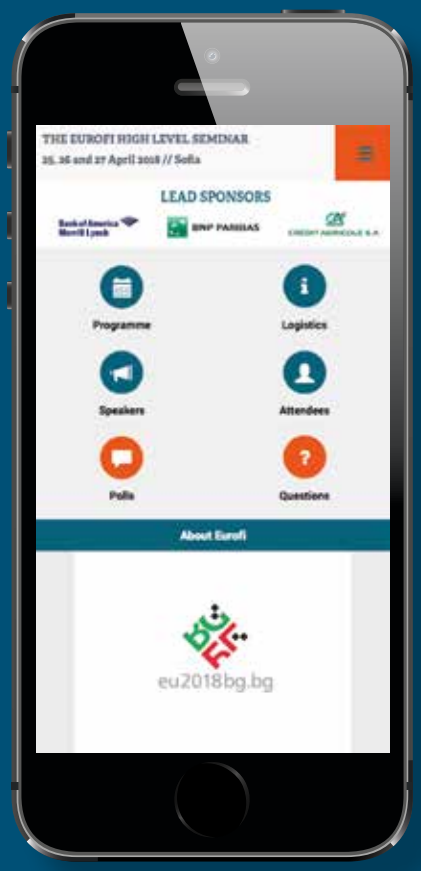

EU green finance framework

Jonathan Taylor

Vice President,
European Investment Bank (EIB)

24-carat sustainable finance

The fight against climate change is sometimes cast in such dire terms that it's hard to imagine there is time available to develop new financial products to win the battle. Certainly, there is an urgency, but financial tools must be molded with great attention to detail. That can be a test of our patience, but ultimately the results can be astounding. It was little more than 10 years ago, after all, that the European Investment Bank inaugurated the green bond market with the first Climate Awareness Bond.

The fact that we can now talk about sustainable finance or a green economy is a measure of the progress over that decade. Since those reading this magazine are likely to enjoy concrete measures, let me give you a few statistics about the EIB's work over that decade. We have issued more than EUR 20 billion of green bonds, supporting 160 renewable energy and energy efficiency projects around the world. We also use a lot of the money we raise on the capital markets with our conventional bonds to finance climate action. Last year alone we delivered around EUR 19 billion, or 28%, of our total lending for climate action. The EIB is the world's largest multilateral lender for climate action, but for other participants too there is now a substantial market in which to invest—and to promote a sustainable future.

The demand for environmental sustainability has been proven. It starts amongst consumers, the stimulus for business to go green. Taking their cue from that same demand, some governments have put in place regulation to ensure incentives are clear for the markets. In other instances, project developers have managed to decrease costs significantly for green projects giving them a competitive advantage vs. the brown alternative. Subsequently, supply of financing for environmentally sustainable projects has increased.

I see two main challenges.

The first is unilateralism. Investments necessary to adapt to some of the already inevitable impacts of climate change and investments to mitigate further climate change will only fully pay off if we tackle them in partnership all over the world. This is why the Paris agreement has been so valuable. Further progress to implement >>>

>>> the agreement needs to be made this year in Katowice. The EIB committed to provide around EUR 100 billion in climate financing in the five years to 2020, which we expect to mobilise around EUR 250 billion in climate investment.

The second challenge is a lack of transparency and accountability. When you invest in gold, there is a global standard of measurement, in carats, for the purity of what you buy – with 24-carat considered 99.99% pure gold (the rest being other metals). There must be a 'gold standard' for sustainable finance. The EIB Group has chaired the Green Bond Principles since 2015, steering the development of shared guidelines in the market. We have also coordinated the harmonization of an impact reporting framework for green bonds focusing on indicators for renewable energy and energy efficiency investments. We have supported the High-Level Expert Group on Sustainable Finance with a classification proposal for climate change mitigation activities and are now ready to take this work forward under the first ever EU Action plan on Sustainable Finance.

There needs to be great scrutiny of investments that claim to be 'green', 'sustainable' or 'socially responsible'. In parallel, there needs to be an equal increase in transparency about the environmental impacts of non-sustainable investments. The public needs to have a fuller picture of the impact on nature and natural resources from so-called 'run of the mill' investments. This will raise awareness--and increase demand for more green finance.

The EIB is financing sustainable projects that go beyond the climate change goals. Therefore, based on our experience with green bonds, we are in a good position to work on the development of other bonds that support broader sustainability objectives, and which can be ultimately linked to a broader range of Sustainable Development Goals. There is a lot of work still to be done. A steady, sensible approach has the capacity to provide the kind of transformational shifts in investment we have seen during the last decade. ●

Pervenche Berès

MEP, Committee on Economic and Monetary Affairs, European Parliament

Is Europe ready to tackle its investment gap and to make finance sustainable?

Europe is in urgent need to modernise its economy to answer the challenges of sustainability. In order to achieve its 2030 targets of the Paris agreement, no less than 180 billion euros per year are needed to fill the investment gap in a time when liquidity is more than ever still available.

Financial markets tend to value short-term benefits over long-term returns and plan accordingly, ignoring the impact of climate change as well as the economic potential of sustainable projects. These sectors (insurers, retail banks, etc.) must from now on take on board Environmental, social and governance (ESG) risks and factors in their prices and stop playing a part in "the tragedy of the horizon".

They are not the only one at fault: we should not overlook the investment driving role of the public sector and the required shift in political priorities. These are still largely decided based on a short-term horizon, making policy-makers reluctant to engage the initial costs of sustainable investments, as well as geopolitical concerns which benefit energy security over renewable resources.

The EU is fortunately starting to take the full measure of the challenge. After EFSI 2, that will – with the strong input and support of the European Parliament - spend at least 40% of its resources in infrastructure investments projects that contribute to reaching the Paris Agreement climate goals, the High-Level Expert Group on Sustainable Finance published a seminal report in January and the Commission an action plan in March.

The European Parliament is currently adopting an initiative report, where priorities will be identified and policies able to operate a real change in the financial world proposed. >>>

>>> First, information on the level of sustainability of investments has to be spread to all actors. Relying on the public's growing interest in environmental matters, the customers should be informed about their sustainability, as an extension of the fiduciary duty of financial intermediaries.

Higher in the financial chain of value, companies and actors such as insurers and accountants must be required to disclose material information on key ESG aspects and how they are considered or dealt with in the decision-making process.

This information should be processed and assessed by sustainability benchmarks and rating agencies that would provide clear guidance to market participants.

Finally, the public and regulatory sector are expected to take a major part to play. Initially, sustainability was unfortunately not a major concern in the Juncker plan. It is time now to give way to an ambitious policy of green and socially conscious public investment, for example by issuing green sovereign bonds.

"The European Parliament is currently adopting an initiative report, where priorities will be identified and policies able to operate a real change in the financial world proposed."

- PERVENCHE BERÈS

This is a request we have been making for a very long time. We must finally be heard. The same spirit now must feed into the future Multi-annual Financial Framework (MFF) that should duplicate the target of 40% EU spending contributing to the Paris agreement.

We know that voluntary measures and best practices guidelines will not be sufficient; we have to settle binding legislative action to force the redirection investment flows. This is the only way to provoke a real impact on society and the environment.

Last not least, if sustainability concerns are already included in existing financial legislations (PRIIPS, IORP), they now need to be included in the mandate of the European supervisory authorities (ESAs), which could supervise carbon stress tests. I shall propose it in the report on ESAs review.

EU has a major opportunity to take concrete action to manage its transition to a low-carbon economy, meet the COP 21 climate change goals, while making growth sustainable and boosting employment. Let's green the finance! ●

Harald Waiglein

Director General for Economic Policy, Financial Markets and Customs, Federal Ministry of Finance, Austria

Challenges in developing sustainable finance

The Paris Agreement and the UN Sustainable Development Goals mark a new way of thinking in international politics. Coming together on a global scale and agreeing on a common goal is a major accomplishment. Achieving a more sustainable economy undoubtedly requires a cross-cutting political effort. The European Union has seized this momentum to set out a strategy for sustainable finance. In this context, it is important to recognise that sustainable finance is primarily a political project, but market participants should not be forced to allocate capital and loans according to political considerations.

It is undisputed that increased private sustainable investments are needed to reach the internationally agreed climate and environmental goals. In this regard, the introduction of a taxonomy for sustainable finance would lead to a common understanding, raise awareness and provide for clarity as well as efficiency in markets. This taxonomy should ensure the inclusion of existing standards while providing a flexible framework for the future development of sustainable finance.

For a profound discussion of the effects of sustainable measures, more efforts to clarify the characteristics of sustainable products like green bonds are required. At present, the possible implications are still theoretical. To be accepted by markets, sustainable products need a sound analytical basis.

From the perspective of a regulator, financial stability has to be the main focus. A functioning financial system is crucial to facilitate adequate support for sustainable initiatives. A risk-first approach is necessary to allow for an effective transition of financial institutions to a more sustainability-oriented business model. The often-quoted "tragedy of the horizon" should not be addressed by prudential regulation but by developing a framework that allows for adequate adjustments by financial markets.

"Financial stability has to be the main focus."

- HARALD WAIGLEIN

Any introduction of specific prudential regulations which could run counter to risk reduction measures in the banking sector must be avoided. Firstly, there is no evidence that sustainable investments are less risky in financial terms. Secondly, sustainability could be used as a loophole to circumvent regulation. Adapted capital requirements for financial institutions holding sustainable investments could be an example of the green-washing of risk.

Lastly, the Basel Committee on Banking Supervision has not foreseen specific rules regarding sustainable finance. European supervisory rules should not deviate from the Basel standards. ●

Felicia Stanescu

Head of Financial Services Policy and International Affairs Unit, DG Financial Stability, Financial Services and Capital Markets Union, European Commission

Financing sustainable growth

It has become clear in recent years that public policies need to be adapted to the new reality of climate change, resource depletion, environmental degradation, and social pressures. The financial challenge posed by these issues goes beyond the capabilities of the public sector and will continue to grow if we do not act now. The scale of investment needed to succeed means that the financial system has a crucial role to play when reorienting capital towards sustainable investments. The financial system is being reformed to address the lessons of the financial crisis, and can be part of the solution towards a more sustainable economy. This requires a comprehensive shift in how the financial system works.

For this reason, the Commission appointed a High-Level Expert Group on sustainable finance at the end of 2016. On 31 January 2018, the group published its final report arguing that sustainable finance is imperative both to fund society's long-term needs, and to safeguard the stability of the financial system.

On this basis, the Commission adopted on 8 March 2018 an Action Plan on 'Financing Sustainable Growth' to set out an EU strategy for sustainable finance.

What are the changes needed in order to favour sustainable finance that can only be achieved by market forces and market-driven initiatives?

Finance can be a powerful force to redirect capital towards financing sustainability challenges. But this will not be possible without triggering behavioural change and a change in mind-set to ensure sustainability becomes enshrined in all policies and investments. Moreover, sustainable finance cannot be developed as a niche: to make an impact, sustainable finance must be integrated into financial decision-making at every level of the investment chain and horizontally across geographies.

But involving the private sector in this effort will require a systemic change in investment culture and will require policy interventions.

What are the priorities of the Commission Action Plan on Sustainable Finance?

The policy agenda laid out in this Action Plan combines a number of legislative and non-legislative measures.

The first step is to define what is sustainable and establish an EU classification system (taxonomy) for sustainability activities. This taxonomy will ensure market consistency and clarity. The Commission will table a legislative proposal in May that will ensure the progressive development of an EU taxonomy.

Also in May, the Commission will propose to clarify the duties of asset managers, pension funds and insurance companies to make sure they consider environmental, social and governance factors and risks in their investment decision process and are more transparent towards end-clients.

Of course this will not be possible without the right transparency by issuers. This is why the Commission will evaluate the current reporting requirements for issuers to make sure they provide the right information to market participants.

The Commission Action Plan will be instrumental to help deliver on the Paris Climate Agreement and the Sustainable Development Goals. Europe is well-placed to become global leader in sustainable finance and the chosen destination for sustainable investments. ●

Contributors: Antoine Begasse, Elia Trippel

Michael Leinwand

Chief Investment Officer,
Zürich Beteiligungs-AG

Improving the sustainable investment climate for institutional investors

The 2016 Paris agreement on Climate Change underlined the challenges the global community faces in keeping global warming within the safe limits of a 2c increase and the prominent role the private sector must play in funding the investments needed to ensure the long-term transition to a low carbon economy. While investors are increasingly allocating larger pools of assets to investment strategies integrating Environmental, Social and Governance (ESG) factors, several obstacles remain.

Disclosure and transparency

For any investor to make informed investment decisions, access to the right data and information is a necessary pre-condition. Ensuring that investors redirect their capital allocation towards sustainable investments and companies will require enhancing the breadth, depth and quality of ESG data. The EU Non-Financial Reporting Directive (NFRD) will already provide additional information to investors. It should be further complemented >>>

>>> through the integration of the recommendations from the Task Force on Climate-related Financial Disclosures (TCFD) into the NFRD. It will be critical for policymakers, together with investors and issuers, to design a disclosure regime that ensures quality of information over quantity, delivering the right information for investors while not overburdening issuer with unnecessary disclosure.

What is sustainable? The need for a common language

While critical, data flows alone will not be sufficient in ensuring different capital allocation. A common and shared taxonomy of what is considered sustainable will be necessary to introduce a common language to markets that will allow investors to analyse and compare different investment opportunities on ESG criteria. The taxonomy should seek to assist market participants in determining what "green", "social" or "sustainable" means. It is critical that the taxonomy is underpinned by an appropriate governance regime: institutions and market participants with the expertise and scientific know-how should be closely involved to ensure the taxonomy delivers on results and does not become merely a 'tick-the-box' exercise. The taxonomy and its governance structure will have to perform a careful balancing act between dynamism and predictability. It will have to be dynamic to evolve when scientific research evolves and new technology or processes emerge that achieve more sustainable outcome, while providing tools and metrics to measure the impact to ensure investments have a tangible impact (e.g. significant reduction in CO_2 emissions). It will however also have to provide long-term institutional investors with sufficient predictability and certainty to invest in long-term projects.

Sustainable finance alone is not the panacea

There is no doubt that access to better quality data and a common sustainability language will improve the functioning of European markets for sustainable investments. However, truly ensuring a rapid and well-managed transition to a low-carbon economy will require a broader overhaul of public policies, such as taxes and subsidies on energy, a 'real' Carbon price integrating all externalities and other incentives for industries to move their production- and supply chains towards more sustainable models and for consumers to respond to price signals by adjusting their consumption. These policy changes will impact far more investors' investments, forcing them to price in these changes in their investment decisions. This will also allow insurers to play a more important role in this transition process by gradually integrating and reflecting sustainability challenges in the pricing of their insurance policies as well as in the way they manage claims. Measures to make capital allocation more sustainable are necessary to deal with climate change, but they are not sufficient on their own. ●

Dominic Rossi

Senior Advisor, Fidelity International

Challenges to investing in the sustainable economy

There is little doubt that over the last decade "sustainability" has entered the mainstream of the asset management industry. The shift has been largely driven by institutional investors from northern Europe demanding more of their asset managers. As a consequence, asset managers have signed up to numerous protocols on climate change and, gradually, have dedicated more resources to newly formed in-house ESG teams. Practice across the industry remains varied however, and asset managers face numerous obstacles when investing in the sustainable economy. I would like to highlight three:

- corporate disclosure;
- the capacity to assess climate risk;
- the need for standards.

Firstly, asset managers need data. Asset managers have become very effective at financial analysis, partly because financial data is routinely available in standardised formats. In contrast, corporate disclosure on climate change risk is nascent. For this reason, Fidelity welcomes and supports the Taskforce for Climate Change Disclosure, led by Michael Bloomberg and Mark Carney. We particularly welcome the focus on "decision-useful, climate related information" and the need for "standard and comparable" corporate disclosure on climate risk. Without progress on corporate disclosure, asset managers will be unable to assess these risks and reflect them in asset prices.

With the availability of comparable corporate disclosure on climate change risk, there will be an expectation that asset managers will have the appropriate skills to assess this new information. There is a genuine question as to whether the current generation of financial analysts are appropriately trained and equipped to field a new set of questions to companies and their management teams. Asset managers are importing some of these skills through specialist external third-party providers and resourcing their in-house ESG teams, but these efforts can be disjointed from the day-to-day efforts of analysts and portfolio managers. The integration of these new skills within the mainstream investment process has to be the goal, and will carry implications for training and development across the industry.

"The asset management industry has failed to develop a standard for the sustainable economy."

- DOMINIC ROSSI

Despite numerous rebranding exercises over 30 years, from green investing to SRI to ESG, the asset management industry has failed to develop a standard for the sustainable economy. As a consequence, different client groups continue to develop their own bespoke benchmarks which are often incompatible with one another. For segregated mandates from institutional clients this poses less of an issue, but for the mutual fund industry where client assets are pooled together, the contradictions can prove insurmountable. The absence of a widely accepted standard or benchmark for the sustainable economy will continue to inhibit the scale and efficiency required to mobilise the investment that the sustainable economy is estimated to need. ●

Florence Lustman

Chief Financial Officer, Head of Public Affairs, Executive Board Member, La Banque Postale

Policy changes at a EU level are required to increase further involvement in sustainable projects

One of the most significant risks that organizations face, and yet one that has proven to be the most challenging to understand, is climate risk. The impacts of climate change on organizations not only affect physical assets (flooded buildings, wasted crops, eroded coastlines…), they also question the viability of existing investments, inducing the risk of potential stranded assets.

Moreover, the horizon which is often associated with such risks tends to get closer and closer. As a matter of fact, recent extreme weather events throughout the world tend to demonstrate that climate risks are relevant starting yesterday, and not in a distant future.

Faced with these threats, the vast majority of the world countries have agreed during COP 21 in Paris in December 2015 to reduce greenhouse gas emissions and to transition towards a low carbon economy. This transition will require significant and disruptive changes in entire segments of our economic and industrial sectors in a short time frame. Political, economic and financial leaders need to grasp the implications for the global financial system, in order to avoid violent crisis and sudden asset value losses.

To get a better understanding of the challenges at stake, in 2016 the G20 asked the Financial Stability Board to create a Task Force on Climate-related Financial Disclosure (TCFD) to provide a voluntary set of recommendations for use by companies in providing information to investors, lenders, insurers, asset managers and other stakeholders. The Task Force considered the physical, liability and transition risks associated with climate change and what constitutes effective financial disclosures across industries. These recommendations received a wide range of support both from the financial community at large and form companies.

Following the same momentum, the European Commission announced in September 2016 that it would establish a High-Level Expert Group on Sustainable Finance (HLEG) to advice on developing a comprehensive EU strategy on sustainable finance. Adopting the TCFD guidelines was among the ambitious 28 recommendations that emerged in December 2017.

France had already paved the way for mandatory climate reporting in 2015 with its now famous article 173 of the Law on Energetic Transition and Green Growth. It is La Banque Postale's opinion that by formally adopting the recommendations of the TCFD and the HLEG in the revision of the non-financial reporting directive, the European Union now has a chance to take over the lead internationally and get in the driver's seat of the fight against climate change. ●

Stephanie Maier

Director, Responsible Investment, HSBC Global Asset Management

Establishing an effective 'market' in delivering on our climate and sustainability goals

The European Commission (EC) High-level Expert Group (HLEG) on Sustainable Finance recently issued its final report to which the EC provided a prompt and ambitious response. We now have perhaps the clearest opportunity yet to develop sustainable finance in Europe, but what are main levers?

Firstly, we need to clarify what we are aiming to achieve. We need to create a policy framework that harnesses existing market mechanisms and establishes an effective 'market' in delivering on our climate and sustainability goals.

Our ambition should be to 'green' the global market for growth, not just grow the global market for green finance. We need to focus policy measures on making a sustainable market the market, not just part of the market.

In this way, we can help the market adjust and mitigate the financial and real economy risks while benefiting from the opportunities that the necessary transition brings.

To achieve this, information is a potent lever.

It is true to say that information is the lifeblood of markets. Market participants use it to drive their investment decisions and regulators use it to oversee the markets. Information needs to cover relevant sustainability factors and over a relevant timeframe. This is true for information directly from the companies we invest in and the research we use to make our decisions. Enhancing the uptake and quality of the FSB Task force on Climate-related Financial Disclosures (TCFD) in particular will be critical to prompt the market to more appropriately price the risks and returns associated with the low carbon transition and influence supply and demand dynamics across the economy.

Three actions from the Financing Sustainable Growth Action Plan therefore stand out – primarily 'Strengthening sustainability disclosure and accounting rule-making' (Action 9) and 'Better integrating sustainability in ratings and market research' (Action 6). These can be supported by 'Establishing an EU classification system for sustainable activities' (Action 1). Developing an EU taxonomy will be helpful but not critical to move ahead with these other actions and will need to be well-defined but dynamic and developed with significant private sector input. While all actions have their role to play, actions that deliver better information to investors have perhaps the largest potential to establish an effective 'market' in delivering on our climate and sustainability goals. ●

Developing fund cross-border distribution

Ugo Bassi

Director, Financial Markets Directorate,
DG Financial Stability, Financial Services and Capital Markets Union,
European Commission

New proposal to facilitate cross-border distribution of investment funds

In the CMU framework the Commission has taken fundamental steps towards deeper and more integrated EU capital markets. Several actions were addressed to investment funds, which are important tools to channel private savings into the economy and increase funding possibilities for companies.

EU investment funds have seen rapid growth, resulting in a total of €14,310 billion asset under management (AuM) in June 2017, of which roughly 60% is invested in UCITS and 40% in alternative investment funds (AIFs). However, although the market is increasingly organised on a pan-European basis, EU investment funds have not exploited their full potential in terms of cross-border distribution.

The EU investment fund market is still predominantly organised along national lines: 70% of the total Assets under Management held by investment funds registered for sale only in its domestic market. Only 37% of UCITS and about 3% of AIFs are registered for sale to more than 3 Member States. Responses to a Commission consultation identified a range of regulatory barriers that, alongside other reasons such as distribution models, national tax regimes, and investor home-bias, cause market fragmentation.

The regulatory barriers are largely due to different approaches adopted by Member States in how the marketing passport may be exercised. The Commission just adopted a legislative package to address remaining sources of friction to cross-border passporting of UCITS and AIFs.

The proposal - adopted last 12th March - consists in a Regulation and a Directive, and is designed to improve transparency, remove overly complex and burdensome requirements and harmonise diverging national rules. The new rules should help asset managers sell funds to a wider range of investors with less cost and complexity. In return, investors should have more and better choice.

>>>

>>> More concretely, the proposed Regulation improves transparency by aligning national marketing requirements and regulatory fees. It introduces more consistency in the way these regulatory fees are determined. It also harmonises the process and requirements for the verification of marketing material by national competent authorities. The Regulation enables the European Securities and Markets Authority (ESMA) to better monitor investment funds, enlarging ESMA's central database to include all management companies, the AIFs and UCITS they manage as well as the Member States where those funds are marketed. This will assist ESMA monitoring and assessing market developments in the investment funds sector.

The proposed Directive – which amends the UCITS and AIFM Directives – modernises the existing requirements regarding facilities for making payments to unit-holders, repurchasing or redeeming units and making information available to investors. The management company will be able to choose how these facilities are provided: either physically, by telephone or electronically. The Directive harmonises the conditions under which investment funds may exit a national market. It creates the possibility for asset managers to stop marketing an investment fund in defined cases in one or several host Member States. It also allows European asset managers to test the appetite of potential professional investors for new investment strategies through pre-marketing activities.

The proposed measures are expected to save up to EUR 440 million annually in costs for existing cross-border distribution. More importantly, easier cross-border distribution is expected to boost competition between asset managers. Removing inefficiencies in the functioning of the Single Market for investment funds will reduce the costs for cross-border distribution and make it simpler and quicker. This will accelerate the growth of cross-border distribution in the EU and will ultimately provide for more investment opportunities in the EU. ●

Massimo Greco

Head of European Funds, J.P. Morgan

The work has just begun on cross-border distribution

J.P. Morgan Asset Management has in past wholeheartedly supported the European Commission's efforts to identify and take down marketing and distribution barriers and improve the functioning of the cross-border market for investment funds. While we still support this objective, we will need to work hard over coming months if we want the new legislative framework to meet the ambitions of the Capital Markets Union.

We have consistently made the point that underlying practical barriers to marketing and distribution is the lack of a common definition of marketing in the EU regimes. We have noted that legal uncertainty gives rise to divergent local interpretations and encourages Member States sometimes to think about these topics in an uncoordinated way. We have called in the past for the allowance of a single point of entry for authorizing of marketing materials and registration of investment funds in one Member State. We have noted that while addressing these issues idiosyncratically is not unhelpful, we believe we should be moving toward a true single market, a common standard for marketing and a "one stop shop", where if a manufacturer's marketing materials are either approved in the Member State of authorization or follow a single EU wide prescribed set of marketing requirements, then they are deemed acceptable across the EU bloc.

We are discouraged by the approach that we understand the European Commission is taking in its upcoming legislative proposals. We are concerned that these proposals 1) do not propose a common, harmonised EU definition for marketing which would bolster a true Single Market for investment funds; 2) do not address individual barriers to marketing/ distribution in a meaningful way; and 3) in some areas may even add additional cost and complexity to cross-border marketing.

In this respect, while we remain grateful for the efforts of the European Commission and still agree with the aims of their work, we are concerned that the draft proposals fall short of the CMU's objectives of reducing costs of going cross border or deepening the Single Market for investment funds. >>>

>>> Furthermore, we would remind policymakers that while these proposals are targeted, we do run the risk of entering the UCITS and AIFMD rules into a political process unnecessarily. This may cause avoidable tension and uncertainty among investors in EU funds, especially those in non-EU jurisdictions who may lack a deep understanding of the EU legislative process. This could negatively affect competiveness of these fund frameworks at a time of increasing competition and where there is already disruption and uncertainty caused by Brexit.

We will be working with policymaker over coming months to try to improve this framework and to help ensure it stays on track. ●

Verena Ross

Executive Director, European Securities and Markets Authority (ESMA)

Improving of cross-border distribution of funds across the EU

The two legislative proposals adopted by the European Commission on 12 March aim at enhancing the EU framework for the cross-border distribution of funds which is still limited within Europe. Even for UCITS – whose brand was created more than three decades ago – available data reveal that only 37% of them are distributed in more than three Member States (for AIFs – which started benefitting from the European marketing passport much more recently – this percentage dramatically decreases to about 3%). This appears clearly unsatisfactory from the perspective of the need to build a Capital Markets Union (CMU).

Against this background, the legislative response is comprehensive. It covers three different stages of the distribution cycle of a fund.

Firstly, it recognises that in the context of the distribution to professional investors (under the AIFMD and EuSEF and EuVECA Regulations) a testing phase may occur where investment strategies or investment ideas are presented to potential investors without having to comply with the marketing notification requirements (so called 'pre-marketing'). Secondly, for the actual distribution phase, various innovations are introduced. Thirdly, the possibility to discontinue marketing in a given jurisdiction when the investor base is reduced to a limited number of investors will be introduced in order not to force an asset manager to keep its presence in a jurisdiction that is no longer economically viable.

One should keep in mind that, as also recognised in the Commission's proposal, there are further limitations to the development of the cross-border distribution of investment funds such as taxation issue, which will have to be addressed by other measures, and cultural preferences for domestic investment products which will take time to change.

From ESMA's perspective the issue of whether the UCITS and AIFMD passports operate effectively is very topical. Last year ESMA published a report on a thematic study it conducted on the operation of home and host responsibilities under AIFMD and UCITS with a view to promoting smooth operation of the EU passports for marketing and management. The study has identified a number of good supervisory practices, but also further issues around the day-to-day functioning of the passporting frameworks. ESMA keeps monitoring these issues with a view to enhancing supervisory convergence among NCAs, clarifying supervisory responsibilities and facilitating administrative procedures around the passporting frameworks.

Looking forward, the cross-border distribution proposals of the Commission also complement the amendments foreseen in the ESAs Review which have a specific focus on certain specialised funds. Under the latter initiative ESMA would be entrusted with direct supervisory powers on EuVECA funds, EuSEF and ELTIFs. While the merit of this proposal will have to be assessed by the co-legislators, centralising the supervision of these funds at ESMA level would be a further step towards more integrated distribution of these products across Europe. In consequence, that could mean creating a single European hub where these funds would be authorised and supervised with the potential of further facilitating their cross-border operations within the single market. ●

Natasha Cazenave

Managing Director, Policy and International Affairs Directorate, Autorité des Marchés Financiers (AMF)

Cross border distribution: a step in the right direction

The European Commission's legislative proposal on cross-border distribution of investment funds, although limited in scope, contains welcome proposals which overall strike a fair balance between investor protection and facilitating an efficient pan-European market for investment funds, thereby enhancing the EU's capital markets union. Building on the existing framework, which hinges on the success of the European passport mechanism, the Commission has put forward a set of pragmatic measures to harmonize marketing practices, provide clarity on the review of marketing materials, and increase transparency for fund managers.

Fund managers will benefit from the introduction of clear conditions governing pre-marketing activities, when seeking to test investor appetite on potential investment strategies. It is essential for them, before launching a fund, to ensure that sufficient seeding capital will be available without triggering marketing requirements. Such practice has already been recognized in France and the AMF published specific guidance clarifying the boundary between pre-marketing and the actual sale of a fund. Some adjustments nevertheless need to be made to >>>

>>> the proposal: for example, pre-marketing should not solely be introduced for AIFMs but also for UCITS managers as professional investors typically subscribe to UCITS funds in significant proportions.

European investors will be better protected by the Commission's proposal as it promotes high-quality standards for the content of marketing materials, and their review by national authorities. The AMF is particularly supportive of such measures, which are consistent with the outcome of recently negotiated texts (e.g. Prospectus Regulation) and usefully acknowledge the pivotal role of host-country authorities in verifying compliance of marketing materials. In practice, host authorities are best placed to perform such checks as they have the language skills and the proper knowledge of local behaviors, distribution networks and local tax requirements.

Finally, there remains areas where there is still scope for additional, more ambitious measures to serve the two overarching goals mentioned previously. For instance, ESMA could be tasked with centralising the notifications for all EU funds and managers. A notification portal run by ESMA could be established to allow asset managers to directly notify each relevant host-country authority where they wish to market their fund. In line with its general stance in the context of the ESAs' review, the AMF sees obvious merits in simplifying existing processes wherever possible and strengthening ESMA's role as a European data hub for the benefit of fund managers and investors. ●

Rodrigo Buenaventura

Director General, Spanish Securities and Exchange Commission (CNMV)

Capital Markets Union and the cross-border distribution of funds

The marketing passports of funds in Europe, especially regarding the UCITS brand, have had a clear success according to available statistics. However, if we look closer at the figures, we notice a concentration in some jurisdictions, so the European Commission is right in proposing measures (namely, a proposal to a Directive and Regulation) to reduce possible barriers that may be hampering the cross-border distribution of funds. Moreover, if we take stock of the new MiFID II framework, which in the chapter of inducements introduces requirements for distribution of third-party products and open architecture, the fewer the barriers to the cross-border flows of funds the better. In this sense, we should not forget that investments funds, because of their characteristics as a diversified investment and an entry point to financial markets, are widely distributed financial products.

Two of the barriers identified by the European Commission are worth considering: marketing and notification requirements.

Regarding marketing or distribution of funds, we should first take into account that it is a completely cross-sectoral activity which is addressed in several pieces of European legislation, more eminently MiFID, but also the UCITS directive and AIFMD. Additionally, the Member States have, since long, set up their own national requirements on marketing (i.e. rules on advertising). In this regard, a holistic approach is needed so the new Commission proposals for setting minimum requirements to marketing suit this objective. In this framework, a common definition of "grey areas" such as premarketing looks like a solid premise for having a harmonized approach to marketing. Notwithstanding this, in the Commission proposals there are no evident references to reverse solicitation and marketing online, which are two issues which would merit further attention from a regulatory perspective.

As regards the second issue, notification requirements, in spite of the Commission proposals for setting precise timeframes, the process of notification is not as smooth as it should be: the passports are communicated by way of e-mails and attached files and sent from one authority to the other. The CNMV has been for a while in favor of a different approach, namely the use of specifically designed IT tools. A more robust and centralized process for the notification of passports would improve the current system. In this regard, ESMA, which has been developing successfully IT projects on similar areas, looks like the natural hub for a centralized system of passport notifications.

"Two of the barriers identified by the European Commission are worth considering: marketing and notification requirements."

- RODRIGO BUENAVENTURA

In short, more legal certainty in marketing and a more intense collaboration by ESMA and the local authorities for the overhaul of the passport notification system may constitute two important building blocks for strengthening the cross-border distribution the funds. In this sense the proposed Directive and Regulation go in the right direction. The final goal should be to help to build a true Capital Markets Union where investors find issuers through widely distributed and liquid products and investment vehicles. ●

Dr. Adam Lessing

Head of Central & Eastern Europe, Fidelity International

Reducing regulatory barriers to cross-border distribution of investment funds

While cross-border distribution of investment funds in the EU has become easier since the early days of UCITS, the market is still predominantly organized along national lines. From a Capital Markets Union perspective we must thus ask ourselves, what are the constraints preventing an investment fund manager from registering funds in an otherwise attractive market in another Member State?

Key countervailing considerations include (a) regulatory cost, such as the cost of local agents and registration fees charged by local regulators, (b) marketing cost, including cost for translating existing KIIDs and other marketing material into local languages, (c) tax related costs, such as when local tax rules require special calculations or filings to make the funds fit for local distribution, and (d) regulatory risk where local regulations require specific filings or notifications to the local regulator, impose specific constraints on marketing material or are vague on pre-marketing. Where regulations are incomplete, unclear or not easily accessible legal fees to even partially mitigate this risk may be significant.

The Commission's recent legislative proposal, aimed at some of the barriers to cross-border distribution set out above, seeks to address some of these issues. It can always be discussed exactly how rules should be framed or at what level they should be adopted, but regulatory risk would clearly be reduced by the establishment of a complete database of local laws, regulations and administrative provisions governing marketing and other aspects of fund distribution. Cost aspects would at least be easier to determine once local listing fees are clarified and published.

However, a key question is if rules are still too much rooted in the 20th century and if they are fully fit for the 21st century. The concept of submitting marketing material to local approval is clearly not adapted to social media marketing. How do blog entries or tweets fit into the old regulatory and marketing model? How do rules prescribing that marketing material must be produced in local languages square with the fact that social media have made information flow global?

While the recent legislative proposal is a step towards further EU harmonization and integration, more will have to be done at legislative and industry level to meet the needs of our clients and the younger generation in the world of the 21st century. ●

Stéphane Lapiquonne

Managing Director, BlackRock

Investment funds: imagining the future of European distribution

The flexible strategies and diversified nature of investment funds make them a cornerstone of any form of financial planning. However, cash holdings dwarf the assets held in investment funds by European investors. BlackRock's periodic Investor Pulse surveys show that the majority of European end investors still save in cash to meet future financial goals. By doing so consumers miss out on the medium and long-term returns offered by investing in capital markets which, in turn, miss out on a regular source of funding. Investment funds offer an ideal way of investing to meet future retirement and other needs in a diversified and risk-controlled way.

We find operational, structural and behavioural barriers to increased take up of investment funds by consumers. In all cases technology provides new ways to solve these issues. We welcome the European Commission's recent legislative initiatives to encourage greater cross-border distribution of investment funds by reducing administrative barriers through the use of digital communication tools and minimising the costs borne by consumers. This is one of a number of initiatives which should help increase the attractiveness of investment funds.

"New technologies offer many opportunities to meet the array of consumer needs."

- STÉPHANE LAPIQUONNE

The sales of the vast majority of funds are intermediated. Changing consumer preferences and the increasing rate of branch closures are leading to fundamental changes to the traditional structure of branch-based bank and insurance salesforces. Distributors are increasingly looking to technology and outcome-based product solutions to service their clients, thereby maintaining scale

and consistency while improving client service. Recent legislation has accelerated these moves: MiFID 2 aims to address many structural issues through enhanced requirements on suitability, product governance and full transparency of costs and charges throughout the distribution chain. While these changes do much to provide consumers with the information they need to make informed decisions it is still far from certain that consumers feel they are getting value for money when choosing >>>

>>> investment funds. Regulators and industry need to work together to show how the new framework can empower consumers rather than submerging them with multiple and confusing data points. In addition, the new PEPP proposals could increase the acceptance of investment funds by consumers who are new to investing, especially when combined with the use of risk-controlled lifecycling strategies.

While a strong regulatory system is a prerequisite, consumers need far more support if they are to fully embrace investment funds as the solution to their needs. Behavioural finance teaches us that consumers have many different and sometimes conflicting reactions, including inertia, to savings and investment. New technologies offer many opportunities to meet the array of consumer needs far more quickly and in a scalable way which meets regulatory requirements. Here it is essential that regulators allow the developments of dynamic approaches to communication between consumers, manufacturers and distributors tailored to individual needs using digital tools. ●

Stéphane Janin

Head of Global Regulatory Development, AXA Investment Managers

Developing fund cross-border distribution: improving it in Europe... and beyond!

To date, the EU has achieved the most performing legislative framework at worldwide level to facilitate the cross-border distribution of funds, progressively built from the initial 1985 UCITS Directive until UCITS V and AIFMD: nowadays, more than half of UCITS are registered in at least 2 Member States, and more than a third in at least 3 Member States. In the case of AXA Investment Managers, our funds sold in at least 3 Member States represent more than half of our fund assets. And they are sold across 16 Member States.

Of course, some practical improvements should take place at pan-European level:

- Setting positive and negative lists of "pre-marketing" examples, to reduce the uncertainty of asset managers when they organize an event in a Member State – knowing that currently the same action can be qualified by one local regulator as a "marketing" action while it would be considered as mere "pre-marketing" by another local regulator;
- Banning the necessity of local paying agents: in 2018, the appointment of a local paying agent should depend on the decision of the asset manager;
- Levelling down the fees taken by regulators in case of local registration of cross-border funds, knowing that fees are already paid in the home country of the fund;
- Common criteria for being allowed to locally deregister funds which are not marketed anymore might be helpful to avoid undue remaining costs.

However, such practical improvements should be directly tackled by ESMA – and not at Level 1. We have to keep in mind the significant change in the legislative process introduced by Baron Lamfalussy in the early 2000s – with the central contribution of David Wright: Levels 1, 2, 3 and 4.

The clear objective of the Lamfalussy comitology approach was to reduce the frequency of revisions of Directives at Level 1 (setting the "essential principles"), in order to let European technical committees adapt and update over time the "technical details". Let us then ESMA work and update, instead of having permanently to cope with revisions of Levels 1 which generate a lot of efforts and costs within firms.

Last but not least, the Commission should tackle distribution from a global competitiveness perspective:

- Enhancing the dialogue between the EU and the main fund markets in the world - e.g. the US, Asia, Latin America - is key, to get more open markets for EU-based asset managers. 64% of the global fund market is NOT in the EU. And in all these regions, it is very difficult for EU-based players to get access to the local markets with EU funds[1];
- Another key element for selling funds is cost-competitiveness, including the cost of regulation. As for instance the US administration issued in October 2017 an official Report on Asset Management[2], wouldn't it be the right time today for European institutions to launch a similar action, on finding practical and competitive solutions, at ESMA level, instead of intending to launch the production of new provisions at Level 1? ●

1. See for instance the PWC Global Distribution Poster (March 2018) https://www.pwc.lu/en/fund-distribution/docs/pwc-publ-gfd-march-2018.pdf: out of 64,255 Luxembourg fund registrations at global level at end 2017, only 11% had taken place out of the EU; out of 26,928 Irish fund registrations at global level at end 2017, only 7% had taken place out of the EU.
2. https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf

Index investing

Wolf Klinz

MEP,
Committee on Economic and Monetary Affairs,
European Parliament

The index investing invasion - if it ain't broke, don't fix it

Following the financial crisis, the scepticism towards banks and investment experts has led to an increased interest in financial products without active management. As a result, funds designed to passively track the performance of indices have invaded the markets and become a growth industry. They have allowed for a democratisation of financial investing and led to a new era of low risk and low cost investment, which may sound the death knell for many actively managed funds.

The benefits of index investing are wide-ranging and significant: Without noteworthy management and transaction costs, the fees and expenses of passively managed funds are substantially lower than those of their actively managed competitors. In addition, they are more transparent and tax efficient. What is more, research shows that most of the actively managed funds underperform the benchmark indices even before factoring in the annual management costs. And it goes without saying that passive funds also allow for dividend pay-out or reinvestment.

Index funds, though attractive in several aspects, should nevertheless be handled with caution. The speed and range of financial innovation in the index investment market has been extraordinary. With the evolution of the industry, the investor base of index funds has expanded and the products on the market have become more complex in their structure.

Initially, an exchange traded fund (ETF) was a stock index-tracking fund that included all index constituents according to the relative weightings defined by the index. In recent years, these funds have become more diverse and have grown substantially in asset classes and market relevance: There are synthetic ETFs, which, instead of physically holding each of the securities of the corresponding index, rely on derivatives such as swaps to execute their investment strategy. There are now also so-called "smart beta" funds, which track indices based on investment strategies usually used by actively traded funds. But there are also inverse ETFs that try to achieve the opposite performance of the indices they track as well

>>>

>>> as leveraged ETFs, which seek to magnify the performance of the tracked benchmarks. While offering similar exposures, these products can vary greatly in their risk profiles, bringing additional counterparty or conflict of interest risks to the underlying market.

A further issue of concern is market liquidity: As index funds are price-takers and not price-makers, the larger the relative share of passive investments of the overall market becomes, the more the relative impact of the remaining active managers on the development of the market increases. Several analysts have therefore warned that a significant "ETFisation" of relevant stock indices may erode the real liquidity of the markets, leading to a crowding of investments and to a potential distortion of valuations.

Legislators and regulators in the European Union have followed these developments closely. So far, the legislative frameworks of UCITS and AIFMD and specific guidance by the European Securities and Markets Authority (ESMA) have ensured a substantial margin of safety.

Immediate action is therefore more required on the supervisory than on the regulatory side: In recent years, there have been several cases where funds have not published all required data or where so-called "closet index funds" have pretended to offer active management, while actually being passive, in order to charge higher fees to their investors. These activities have clearly highlighted the need for stronger supervision and enforcement, also from the European side.

When it comes to further legislative and regulatory action, ESMA is planning to conduct a peer review on its guidelines on ETFs and other UCITS issues in 2018. Beyond that, the introduction of a common classification scheme that better distinguishes among several types of ETFs, and helps investors identify less complex and less risky so-called "plain vanilla" funds, may one day become an issue of discussion. But for the time being, the markets are thriving and product safety is sufficient, consequently, the saying "if it ain't broke, don't fix it" continues to apply. ●

Guillaume Prache

Managing Director, Better Finance

Low cost and broad index investing must be brought to Main Street in Europe

In Europe, index investment products are 90% sold to institutions, and only 10% to individuals (i.e. about € 80 billion in assets), contrary to the US where 50% are sold to individuals (i.e. € 1650 billion or 20 times more). Indeed, Mystery shopping by NCAs confirms that retail intermediaries rarely inform and promote low cost index funds to EU citizens.

Depriving EU savers of index funds is unfortunate as:

- Index products are usually a low cost, relatively simple, and diversified investment product (especially if replicating "gross return" and broad market indices), which is particularly appropriate for long term and pension savers with limited amounts, and for those who can't afford to pay for advice.
- Research shows that over the mid and long term, a majority of actively managed funds underperform the market benchmarks; this is even more true for "retail" ones which charge higher fees than institutional ones.

"Mystery shopping by NCAs confirms that retail intermediaries rarely inform and promote low cost index funds to EU citizens."

- GUILLAUME PRACHE

- Low cost index funds such as ETFs are a driver for more competition and lower prices in the retail investment markets: fund fees are much higher in the EU than in the US, and several funds priced as "active" can be in fact "closet indexers" as ESMA found that up to 15% of the funds it surveyed are "potential" closet >>>

>>> indexers, and the UK financial supervisor recently forced 64 of those funds to indemnify their clients.

This is why the emerging robo advisors generally base their entire offering on low cost index products.

How to fix this European problem? Mostly by improving investor information and protection in the following ways:

- In 2015, at the inception of the "CMU", BETTER FINANCE asked that the European Supervisory Authorities (ESAs) must better comply with their legal duty to analyse and report the actual past performance and fees of all retail long term and pension products. The EC has now (October 2017) requested the ESAs to do it.
- However, at the same time, the EU has eliminated the standardised disclosure of long term past performance and compared to market benchmarks: it will now be impossible for investors to know how much the fund performance differs from the benchmark. The PRIIPS KID must be urgently reviewed to restore this very necessary improvement obtained in 2010 for UCITS funds.
- Authorize direct investments into low cost index funds in the future PEPP: this is the best tool to do it for EU pension savers and for the economy.
- Better Enforce MIFID rules on advice and inducements: retail intermediaries who do not clearly inform clients about index products and ETFs are not compliant: NCAs should act upon the findings of their mystery shopping investigations to ensure EU individual investors have full access to low cost index funds.
- The ESAs should make full use of their new product intervention powers and move against toxic investment products, such as closet index products, or – even worse – a self-proclaimed "index" fund with annual charges of 2.5% or more, which generate a hugely negative deviation of the fund's performance from the index.
- More than 90 % of UCITS equity funds are benchmarked: providers must disclose the past performance of their benchmark alongside that of the fund. Our research shows that this legal requirement is poorly enforced by several NCAs.
- Index funds must get the whole net profit from securities lending. ESMA guidelines on this practice seem inconsistently implemented. ●

Noel Archard

Global Head of SPDR Product,
State Street Global Advisers

ETFs can be instruments to enhance market stability

Index investing is the broad term referring to the approach whereby an investment manager seeks to track and provide returns in line with an underlying benchmark. It comes in many forms, encompassing collective trusts, separately managed accounts and exchange traded funds (ETFs). It is the latter which is the topic du jour and has increasingly attracted regulators' attention, to some extent driven by its success and growth. While the growing discussion in this area is mostly to be welcomed, there appears to be a degree of misunderstanding, including with respect to 'market stability'.

A key differentiating factor of ETFs relative to other investment funds is liquidity. Unlike traditional open-end mutual funds, ETFs benefit from having both a primary and secondary market, making it possible to trade the shares of an ETF often without impacting the underlying securities. While the liquidity in both markets is intrinsically linked, the presence of a secondary market can help during periods of market volatility, enabling investors to more efficiently adjust their exposures without triggering a sell-off of the underlying assets. This is reinforced by the 'in-kind' redemption and issuance mechanism utilised by most ETFs. In addition, the role of Authorised Participants (APs) and liquidity providers should be noted. These entities will 'make markets' in the ETF units when a market opportunity presents itself.

While size in itself is not a proxy for risk, it is also worth noting that ETFs constitute a relatively small section of the market. Despite an annual growth rate of over 20% in the past five years, globally ETFs represent approximately 13% of the investment management market.

Looking ahead to future developments, index funds and in particular ETFs, continue to be characterised by a high level of innovation, further increasing investor choice and market accessibility. Alongside 'traditional' core equity and fixed income investments, there is increasing interest in exposures that were traditionally the domain of active managers, including factor, thematic or smart beta strategies. This may help demystify more traditional 'active strategies' into simple, rule-based investment funds at lower cost.

Similarly, there is scope for passive strategies to be incorporated into more active models, as investors further explore how index products can be used in their portfolios. For ETFs specifically, while they are traditionally seen as passive instruments, they can be used alongside active strategies to complement an existing active exposure, whether to place a tactical position in a sector or asset class or simply to manage cash.

"A degree of misunderstanding, including with respect to 'market stability'."

- NOEL ARCHARD

The benefits of index investing can also help deliver broader objectives, including those related to the EU's Capital Markets Union (CMU). Given the variety of indices that can be constructed and utilised, it can help direct capital across borders and those sectors where there is potential for growth. For investors, it has democratised the investment process through a low-cost, transparent approach, putting more power into the hands of the investor and offering them more choice. ●

Joanna Cound

Head of Public Policy, EMEA, BlackRock

Index investing delivers patient capital to Europe's capital markets

Index investing – via index mutual funds or Exchange Traded Funds (ETFs) – has been much discussed in industry and regulatory circles. While differentiating between active and index strategies is a useful shorthand, in practice the investment landscape is a continuum of strategies, ranging from the more active to the more index driven. As a manager of active and index based investment solutions, BlackRock sees important roles for both.

Index investing is well aligned with the objectives of the Capital Markets Union (CMU), in providing solutions for investors, patient capital for companies, and a focus on investment stewardship.

> *"Index investing has lowered the barriers to investing in diversified portfolios."*
>
> - JOANNA COUND

The simple value proposition at the core of index investing is the tracking an index to provide low cost, sector or market-wide diversification. For individual savers, increasingly responsible for funding their own retirement, access to opportunities to put capital to work is essential. Index investing has lowered the barriers to investing in diversified portfolios for all. Meanwhile active investment remains a robust proposition for those seeking the potential to profit from individual stock price changes, and the expertise of an active manager. The patient capital provided by index investors supports the ability of companies to focus on long-term value creation and sustainable growth.

Finally, index investing is helping to raise the bar for corporate governance, and ESG issues more broadly, by driving increased focus on investment stewardship. While engagement and voting on behalf of clients has always been a part of an asset manager's responsibility, it is particularly important for index managers, who cannot express disapproval simply by divesting from a stock included in an index they track.

Despite its growth in recent years, the relative scale of index investing is still small – index funds and ETFs represent 7% of the global equity universe[1]. The pace of adoption has triggered questions from the global policy community, which is seeking to ensure the features and dynamics of index investment have been well understood. When volatility occurred in equity markets in early 2018, investors, ETF issuers and policy makers alike repeated calls for a classification system that clearly distinguishes 'plain vanilla' ETFs from more specialised Exchange Traded Products. A consensus appears to be emerging around the benefit of ensuring that leveraged or inverse products, which may respond differently to market events, are clearly distinguishable.

Index investing has come a long way since the launch of first index funds nearly 50 years ago, and today reflects the spirit of the CMU, by connecting millions of investors with European companies seeking capital to innovate and grow. ●

1. Source: ViewPoint: Index Investing Supports Vibrant Capital Markets, 2017

Martin Moloney

Special Advisor, Regulatory Policy, Central Bank of Ireland

Index investing

Asset management regulation should try to be neutral between different investment strategies. But some strategies can throw up issues that need to be considered carefully. In the past, index investing usually aimed to get exposure to the whole of a geographical segment of an asset market, by buying securities in proportion to their capitalisation on the market. The rules were simple. The goal was to capture 'beta' and thus to give up on any ambition to do better than the market average.

This traditional index investing threw up its own concerns, mainly around price discovery and herding. The success of low cost index investing with its significant economies of scale also contributed to the growth of very large asset managers who now hold voting rights for very many investors. But if there was harm done by traditional index investing, it was difficult to spot because that impact was either dispersed or was very occasional.

Perhaps most worrying was the growing dependence of the industry on index providers. In this regard, the Benchmark Regulation is welcome because it tackles conflicts of interest and outsourcing by index providers, but will not be fully implemented until 2020.

To balance these concerns, the benefits have been significant: there is much greater transparency about what strategy you are buying into and, while trading

costs could be high, management costs could be very low. It has particularly suited a low interest rate environment where competition on management fees >>>

>>> and scrutiny of returns on active strategies has been intense.

ESMA did have to intervene through its ETF & Other UCITS Issues Guidelines (2014) to prevent intra-day rebalancing and to require that every iteration of an index over its lifetime should be traceable by reference to its underpinning methodology. But generally speaking, traditional index investing is a tried and trusted feature of the market.

Perhaps every investment cycle throws up new strategy fashions. If so, the most significant fashion in the current cycle is the new forms of index investing based on 'factors' other than market capitalisation, such as Environmental, Social and Governance ('ESG') factors or 'smart beta'. This contrasts with the old fashioned way of doing index investing because it does try to do better than the market average within a 'passive' strategy.

Industry statistics put assets in what are called 'smart beta' ETFs and ETPs increasing by 5.78% in the period of a month, reaching a global high of US$696bn at the end of January 2018 (Source: ETFGI).

This is throwing up some new issues:

- Firstly, some 'smart beta' indices can be less clear-cut and more complex than others. Sometimes there seems to be so much discretion built into the index methodology (in the form of index committee decision making power, for example) that some index providers may be acting in an investment manager capacity, without being regulated as such.
- Secondly, 'rebalancing' trading activity becomes less predictable because the rules for these smart beta strategies are more complex. Could it be that the traditional stickiness of investment fund holdings in stressed or volatile market conditions could be undermined as the rules of passive investing become more complex?

"Perhaps every investment cycle throws up new strategy fashions."

- MARTIN MOLONEY

A close watch needs to be kept on episodes of market volatility and on the implementation of the Benchmark Regulation to ensure that the growth of index investing does not undermine any of the assumptions from previous investment cycles as to how the funds sector behaves and interacts with markets. ●

Natasha Cazenave

Managing Director, Policy and International Affairs Directorate, Autorité des Marchés Financiers (AMF)

ETF risks remain limited in Europe, but regulators should remain on the look out

The popularity of passive investing through index mutual funds and exchange-traded funds (ETFs) has grown substantially over recent years, raising questions on potential risks for markets and investors. The sizeable growth of ETFs assets under management, as well as their very specific nature - they can be traded intraday on the secondary market – has logically led to increased regulatory scrutiny.

The scale of ETFs' expansion is impressive. They have experienced a 20% average annual increase in assets over the last four years globally. In the second quarter of 2017, total assets under management reached EUR 3 506 billion (+ 35% yoy) amounting to 8% of all assets managed through collective investment vehicles. If the US represents 74% of this total, European ETFs are also growing, they have reached 16% of global assets.

Clearly these figures reflect the strong investor appetite for such products. There is no doubt ETFs represent a significant innovation in the fund industry and a trend that is here to stay. But ETFs' development both in terms of size and types of investment strategies comes with a number of questions: Should there be limits to the potential discount / premium to the NAV? Is there is a risk of misunderstanding of the liquidity it can actually offer? Does the arbitrage mechanism function in all circumstances? What is the appropriate degree of transparency? What about price formation? More recently questions have been raised on the impact on corporate governance and investor engagement. In that context, IOSCO's work will be critical.

From an investor protection perspective, European rules provide strong safeguards: the vast majority of ETFs in Europe are structured as UCITS and are therefore subject to the corresponding constraints in terms of eligible assets, portfolio asset diversification and risk management. However, some of the risks mentioned above can be of concerns. The AMF examined these risks looking at regulatory data collected on the French market[1], and the study shows that:

- the total take-up rate of ETFs in the Paris market appears insufficient to have a significant impact on underlying markets;
- circuit breakers applied by Euronext contain the risk of significant divergences between the traded price of an ETF and the value of the underlying basket;
- subscriptions and redemptions of ETF units appear counter-cyclical, thus serving to dampen major price movements rather than amplify them.

However, the AMF is of the opinion that if investors continue to be drawn to ETFs, sustained vigilance is required to prevent the materialization of risks especially in periods of market stress. ●

1. AMF (2017), "ETFs: characteristics, overview and risk analysis — the example of the French market," Risk and Trend Mapping, February.

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First Deputy Governor, Banque de France

Developing equity financing is key for growth and innovation in European economies

In the Euro area, against the background of aggregate savings in excess of investment, of around 350 bn euros per year, corporate financing sources are largely dominated by debt, especially bank credit: at the end of September 2017, own funds represented 121% of the United States GDP, whereas this ratio was only 78% in the Euro area. The gap was already significant before the crisis (118% in the United States and 82% in the Euro area at the end of 2006) but it has widened since then. Accordingly, debt is lower in the United States (45% of GDP) than in the Euro area (72%). In other words, European companies favor debt, and especially bank loans, over equity to finance their investments and working capital needs.

This situation results from supply and demand conditions for equity financing that reflect savers' home bias, along with preference for safety and liquidity. It might be suitable for catching-up economies, such as post-war Europe or emerging countries, as growth is then usually strong, allowing to repay debt with a high degree of certainty. But it is an issue in developed countries which fund innovation with debt because in such case repayments may not await the proceeds of investment or be compatible with the uncertainty which goes along with new projects. Developing equity financing is thus key for the growth of European economies if they are to operate at the technological frontier.

To that end, the reviews of the European Venture Capital Funds Regulation (EuVECA) and European Social Entrepreneurship Funds (EuSEf) provided in the Capital Market Union action plan are a step in the right direction, but more is needed to strengthen the supply of equity financing. Some existing regulations on financial intermediaries might be reviewed following the example of Solvency 2 where some adjustments are considered. to enhance insurers' key role in the long-term financing of the economy, notably SMEs, through private-equity investments.

Beyond financial regulation, other policy areas could be touched upon to foster equity investment, including on a cross border basis. For instance, the fiscal bias that favors debt financing, via a tax-deductible interest expense, may contribute to economic distortions resulting in high and inefficient debt-to-equity ratios. This fiscal bias should be >>>

>>> tackled in a harmonized manner throughout the EU. The lack of comparable accounting reporting for smaller firms is also a hurdle to cross-border investments. Harmonised standards would facilitate the assessment by foreign investors of financial statements and may have a positive impact on the cost of capital. In parallel, more efforts could be dedicated to improving the financial literacy among individual investors and households to channel available savings towards equity financing and long-term financing products.

Succeeding in that endeavor requires an integrated approach combining and coordinating the Juncker Investment Plan, the Banking Union and the Capital Markets Union to achieve a true "Financing Union for Investment and Innovation". ●

Lee Foulger

Head of International Department, Financial Conduct Authority (FCA)

Stronger equity markets for the EU

Equity finance has a vital role to play in providing risk capital to European companies, supporting the real economy, promoting economic growth and job creation. The European Commission's Capital Markets Union (CMU) project identified that Europe has traditionally been more reliant on bank finance. Whilst bank finance is important, the EU needs to be able to finance the full range of companies at different stages of their development with a diversified range of funding mechanisms. Strengthening equity based finance will be crucial in achieving this.

The depth of EU equity markets relative to GDP has increased by a fifth over the past five years and the value of IPOs has tripled relative to GDP[1]. However, public and private equity markets remain roughly twice the size in the US, and overall, EU capital markets are only around one third as deep as in the US[2]. We have observed in our role as the UK Listings Authority that fewer smaller companies are accessing equity markets and are doing so only at later stages of their development. This is an important factor because equity funding allows companies to take a longer-term approach to their growth and to raise the sorts of funds that can propel expansion into new markets.

There are a number of key areas which need to be addressed if more companies are to see a public listing as a viable and efficient route for raising capital.

We must do what we can to reduce barriers to entry to capital markets. Raising capital by issuing equity involves high transaction costs, additional listing requirements and more complex legal and regulatory requirements. The CMU review in mid-2017 proposed the introduction of more proportionate rules on SME listing and has pledged to review costs and complexities for small and mid-cap companies looking to access public markets. This is a welcome development.

It is also important to ensure investors have confidence in equity markets. Investors need appropriate information and transparency. An FCA study into investment and corporate banking examined the availability of information during the UK IPO process and found that there was scope for a broader range of investors to receive final approved prospectuses earlier. To remedy this, we have introduced a number of new rules governing the timing and sequencing of information during the IPO process.

There may also be cultural, tax and wider business environment factors where reform could support equity market development across the EU.

Improvements on all these fronts can lead to lower barriers to entry and increased investor confidence to support European companies to grow.

The EU has already put in place a number of measures such as tailoring Prospectus requirements more appropriately for SMEs, and rules to promote venture capital in the EU such as expanding the ability of EuVECA funds to invest in SMEs listed on SME growth markets.

These are a welcome first step with which we can build momentum. And more momentum is needed. If we can get it right, the result could be greater growth potential for hundreds if not thousands of EU businesses. ●

1. "A Decade of Change in European Capital Markets", New Financial, February 2018
2. ibid.

Niels Lemmers

Managing Director,
European Investors' Association

Three extra measures to enhance equity investment

Academic research show that (access to) the equity market is an important variable in corporate financing decision making and in attaining long term economic growth. The capital-raising function of the primary equity market proved to be of equal importance as the liquidity function of secondary equity market in obtaining this. European Investors' Association ('European Investors) believes that ensuring EU citizens can contribute to and benefit of well-functioning equity markets and perceive the associated economic growth, should be the priority for legislative initiatives, regulators and market participants. Improvements made in this respect are the implemented regulation on prospectuses and MiFID II. However, some obstacles remain to overcome.

Barriers

In the European Investors' annual survey 2017, individual investors address four key issues about cross-border equity investment and more engagement with equity markets:

(i) easy and free access to (foreign) equity markets;
(ii) greater harmonisation in the areas of financial reporting (including on ESG-factors) and taxation;
(iii) digitalisation of exercising shareholder rights and engagement;
(iv) enhancing investor protection by an EU collective redress mechanism.

One third of the 2017 respondents mention difficulties with procedures for withholding tax as being one of the main barriers to cross-border investment in equity. Annually, investors lose out around six billion euro by not claiming their refunds. The Code of Conduct on Withholding Tax published by the European Commission ('EC') in December 2017 is a step towards lowering this barrier. However, the Member States ('MS') should adopt the measures, particularly those stressed in paragraph 10. European Investors calls upon the MS to act swiftly and ensure investors that by 2019 'relief at source' is available throughout the EU.

One fifth of the respondents indicated that legal obstacles are reasons for not investing cross-border. Investors believe they do not benefit from the same level of investor protection when investing abroad and they are afraid that no proper (collective) redress mechanism is available. Respondents see insufficient opportunities to professionally engage with foreign listed companies. European Investors advocates that in this digital era online tools for exercising shareholder rights and engagement should be available. For example, participating and voting at annual general meetings from a remote location as well as regular online communication with boards should be available.

"Fostering cross-border equity investment requires three extra measures."

- NIELS LEMMERS

Challenges

Consequently, fostering cross-border equity investment requires three extra measures: adequate shareholder engagement, tax relief at source in all MS and an EU collective redress mechanism.

European Investors keeps encouraging the EC to monitor closely whether the MiFID II measures deliver on their objectives. More transparency, optimized best execution and accessible, free and comprehensive data from all trading venues come at our fingertips.

Together, these three measures and the new regulation will increase the willingness and confidence of individual investors to step into (foreign) equity investment, supporting economic growth and the emergence of a genuine European equity market. ●

Anthony Attia

Chief Executive Officer of Euronext Paris and Global Head of Listing Member of the Managing Board, Euronext

Exchanges have an essential role to play in accelerating the growth of capital markets

EU Member States have made it a priority to accelerate the growth of European companies by reinforcing investor protection, fostering transparency and facilitating access to capital markets.

A considerable number of steps in the right direction have been made. Prospectus rules were reviewed to simplify access to growth capital on financial markets. MiFID II introduced SME Growth Markets and stronger safeguards for retail investors when it comes to transparency and best execution. The PRIIPs framework is expected to strengthen retail investor confidence by shedding light on dedicated investment vehicles. Moreover, further progress should be made towards building a proportional regulatory framework for SMEs through the upcoming Small Listed Company Act. >>>

>>> Beyond these examples, EU regulation covers a larger scope and bring benefits in the form of stability and fairness. However, more remains to be done and Exchanges clearly have a pivotal role to play.

In this regard Euronext has been very active and invests considerable time and effort in helping European SMEs access capital markets. We believe education to be a foundational element of our overall action to further the development of equity markets. It is critical that European SMEs understand the mechanics and dynamics of capital markets to be able to navigate and leverage them.

TechShare is a good illustration of our education focus. TechShare is a leading pan-European pre-IPO programme that gathers selected Tech SMEs from our domestic countries and provides them with strong education including lecture-like sessions, personalised coaching, networking opportunities and connections to capital markets experts. The now 144-strong alumni community will be extended as we roll out the programme in Germany, Switzerland, Italy and Spain later this year.

Yet providing European SMEs with the tools to understand capital markets mechanics alone will not be enough to accelerate capital markets' utilisation. While the regulatory initiatives mentioned earlier have brought several benefits to equity markets, more could be done to build visibility amongst the investor community, which remains the vital constituent of equity market utilisation.

"Building visibility amongst the investor community remains the vital constituent of equity market utilisation."

- ANTHONY ATTIA

Equity research, a key pillar of this visibility, is at risk of being undermined in a post-MiFID II world that is transforming the current research funding model. Anticipating the likely significant impact on SMEs, Euronext has - since 2015 - partnered with Morningstar to produce equity research covering 60% of its listed SMEs.

In parallel, more needs to be done to empower issuers. Euronext's Trade & Leverage programme - that we have just rolled out in Germany, Switzerland, Italy and Spain - facilitates access to investor relations services such as equity research, investor events and investor outreach solutions.

Moreover, Euronext has recently reaffirmed its focus on addressing hurdles issuers face when interacting with investors by launching a suite of corporate solutions, on the top of offering personalised advisory services and solutions to regulatory evolutions.

Finally, the development of equity markets also relies on accommodating investors. Dealing with regulatory changes can therefore mean simplifying product access for investors, as we have recently done by creating dedicated bond segments further to changes brought in by PRIIPs. ●

Sophie Barbier

Head of European Affairs,
Caisse des Dépôts et Consignations (CDC)

Developing investment and financing in the EU to the benefit of the European citizens

Developing investment and financing for the benefit of the European citizens is a crucial issue for the future. This will allow our fellow citizens to improve their daily well-being in areas as health and care, affordable housing or long-life education.

Aging population, technological developments, current lack of investment in hospitals, schools, universities and social housing will require considerable financial efforts in all EU Member States over the next decade. Each year, €170bn are spent on social infrastructure, mainly by local, regional or national public authorities. Given the foreseeable developments, Europe needs the same annual amount of additional investment to adapt its social infrastructure to future needs. In a constrained public resources environment, this additional effort can only be achieved by mobilizing public and private investors.

The report presented on January by the "High Level Task Force on Social Infrastructure" chaired by former President Romano Prodi and former Minister Christian Sautter with the support of the ELTI association[1], underlines the major role of NPBI and their availability to emphasize their efforts in these areas which are key for the development all over Europe.

These investments are mainly financed by public bodies and offer limited risk for investors, their volatility being generally decorrelated from that of other assets. Major obstacles could be removed by making the investment easier to access, by improving technical assistance as well as financial and non-financial regulation of these assets. In any case, the mix of funding sources (private funds, public funds or social impact bonds for example) appears appropriate.

NPBI play an important role in financing the real economy and are designed to provide medium and long-term capital for productive investment. Historically, they have played an important role by funding social infrastructure and in cross-border initiatives.

They played an important countercyclical role in recent years and were part of the new financial balance since the financial crisis. They have created new financial instruments and new guarantee schemes; provided significant additional resources to support the economy during the crisis, and set up new European and domestic long-term equity funds to invest in infrastructure projects.

For all these reasons, NPBI will be at the heart of the financing of the real European economy and partners of all for the benefit of so many. ●

1. https://ec.europa.eu/info/sites/info/files/economy-finance/dp074_en.pdf

Jean-Jacques Bonnaud

Member of the Board and Treasurer, EUROFI

Current challenges require accelerating certain priorities

The relative weaknesses of the financing of European firms have been well identified in the context of the Capital Markets Union initiative. These include the fragmentation of EU capital markets, the lack of equity financing particularly concerning SMEs, the preference of individual savers for domestic markets and for risk free savings rather than long term investments and also the reduction of long term equity investments from insurance companies over the last 15 years.

Many of these issues have been addressed in the Capital Markets Union (CMU) action plan and the related legislative texts are in the process of being adopted and implemented. Several measures could in particular help to further develop equity financing and investment, such as the review of the EU Venture Capital Fund (EuVECA), proposals for developing the cross-border distribution of investment funds, the review of prospectuses, initiatives to develop local capital market ecosystems for SMEs and the intention to adjust the current fiscal bias in favour of debt issuance. MiFID II moreover aims to improve transparency, price formation and investor protection in EU securities markets and to foster the development of SME growth markets, which should all contribute to the further development of EU equity markets.

But reaping the benefits of these different reforms will take time, which Europe may not have when considering the different challenges that it is facing in the near term: notably the departure from the EU of the UK, its most important and sophisticated capital market; the increase in volatility that may result from the planned gradual increase of interest rates; the numerous acquisitions of innovative firms by non-European (mainly Chinese) investors that are happening all over Europe; and in addition the reduction of growth prospects if the recent threats of a possible "trade war" between the US and some other economies materialize.

In light of these different challenges, it is likely that the European Member States will have to accentuate their priorities and reconsider how to take advantage in the relatively near term of the significant savings potential in Europe (a significant part of which is invested outside Europe), of the strengths of European financial players and of new opportunities offered by technology.

First, we should (re)develop all possible incentives for the insurance industry and pension funds to increase their allocation to long term equity investments through an appropriate calibration of their capital charges concerning these investments. Although strengthening retail investment is essential, institutional investment is faster to develop and is more likely to quickly kick-start European equity markets which currently lack liquidity and depth in many cases.

Second, tax incentives are needed to encourage individual savers to direct more savings towards long term and sustainable investments. This should be considered in the context of the PEPP project in particular. Improving withholding tax procedures building on the recently published Code of Conduct would also further facilitate cross-border investment.

Third, the establishment of a European passport for crowdfunding platforms may help to complement rapidly the lack of listed capital especially in the SME sector.

Finally, strong banks are also necessary for developing equity markets (e.g. supporting the issuance process, market liquidity etc.). Accelerating the implementation of STS securitisation and addressing NPL issues (e.g. with guidelines to improve their prudential provisioning and proposals to develop a secondary market in the EU) would help European banks to rebuild their balance sheets. Moreover, further integrating banking markets within the Banking Union seems essential to support the development of cross-border capital markets. ●

NEXT EUROFI EVENTS

5, 6 & 7 September 2018
Vienna - **Austria**

3, 4 & 5 April 2019
Bucharest - **Romania**

September 2019
Helsinki - **Finland**

Regional and SME market ecosystems

Benjamin Angel

Director for Treasury and Financial Operations,
DG Economic and Financial Affairs, European Commission

Measures and instruments proposed and being implemented at EU level to support the financing of SMEs

SMEs are the engine of the European economy. There are 23,8 million enterprises in the EU. They employed 93 million people in 2016, accounting for 67% of total private-sector employment and generated 57% of value added in the EU-28 non-financial business sector.

Despite their crucial role in the economy, European SMEs face challenges when accessing finance. Compared to larger enterprises, they have access to a more limited set of financing sources: they typically do not issue bonds, have only limited access to stock exchanges or large institutional investors, and are not rated. Consequently, European SMEs rely heavily on banks and debt financing in the form of bank overdrafts, bank loans or leasing. Market-based instruments like private equity are only considered relevant by 12% of SMEs[1] although in many cases equity is more suitable than debt finance, as small companies often lack collateral or have irregular cash-flows. Equity could also help SMEs bridge times of economic stress as it does not impose specific repayment schedules.

Providing more diversified sources of funding is necessary for increasing the ability of SMEs to finance their growth and development, withstand economic downturns, and for making the economy and the financial system more resilient during economic shocks. This is one of the key objectives pursued under the European Commission's Capital Markets Union flagship priority.

As part of the policy response, the EU – through the EIF as an entrusted entity – has been operating centrally managed instruments since 1998 providing guarantees to financial intermediaries for SME lending. Studies on the economic impact of SME guarantee schemes[2] have found that such schemes have, on average, a significant positive effect on firms' growth in terms of employment and turnover. However, certain evaluations and audits, including a recently finalised audit of the European Court of Auditors (ECA) on portfolio guarantees[3], point to the opportunity to further enhance the financial additionality and EU added value of the current instruments.

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>>> Moreover, recent surveys[4] point to an improvement in SME access to finance: the percentage of SMEs stating that access to finance is their biggest problem has dropped to 9%, and 79% of SMEs report obtaining all or a part of the loan requested. While the fourth generation of EU SME support instruments is currently being implemented, the next MFF provides an opportunity for the EU to focus, with the budget available for SME financing, on specific, more targeted guarantee instruments with higher additionality and EU value added.

The upcoming Commission Communication on EU support for local capital markets aims at expanding the financing sources of SMEs, in particular with long-term equity funding. Better-functioning capital markets also attract international investors, thereby helping companies to create jobs and growth within the European Union. ●

1. Survey on the Access to Finance of Enterprises in the euro area April to September 2017, section 3.1: https://www.ecb.europa.eu/pub/pdf/other/ecb.accesstofinancesmallmediumsizedenterprises201711.en.pdf?beb1832df4af9efa9945a5a1f7b99eeb7
2. Asdrubali and Signore: The Economic Impact of EU Guarantees on Credit to SMEs - Evidence from CESEE Countries, July 2015, as well as a 2017 study commissioned by the ECA on the impact of SME guarantee schemes in France.
3. ECA: EU-funded loan guarantee instruments: positive results but better targeting of beneficiaries and coordination with national schemes needed, Special Report 20/2017.
4. E.g. the most recent SAFE studies: Survey on the access to finance of enterprises (covering EU28), November 2016, and the ECB's Survey on the Access to Finance of Enterprises in the euro area, October 2016 to March 2017.

Bas B. Bakker

Senior Regional Resident Representative for Central, Eastern and Southeastern Europe, International Monetary Fund (IMF)

Capital Markets Union and SME financing in the EU New Member States in CEE

The Capital Markets Union is being established to address the problem that financial systems in the EU are too bank-based. Companies have largely been financed through banks, with little stock market and corporate bond financing, and little financing for startups or through venture capital. The role of institutional investors has been limited, and household financial assets consist in large part of money in bank accounts. The dominance of banks has been a particular problem in the post-2009 period, as banks have been reluctant to lend, and may have been factor behind the post-crisis weakness of corporate investment.

Many of these problems CMU seeks to address are even more pressing in the EU New Member States than they are in Western Europe. Investment in the New Member States is relatively low; and equity and bond financing are even lower than Western Europe. If we exclude bank deposits, household financial assets are very limited. Institutional investors are much smaller than in Western Europe, and venture capital is even more underdeveloped than in Western Europe.

Moreover, the New Member States face some additional problems. In the pre-crisis boom years, there were large capital flows from parent banks to local subsidiaries. Between early 2003 and late 2008, exposure of Western Banks vis-à-vis non-CIS CESEE increased from $144 billion to $571 billion. Post-crisis these capital flows have partly reversed, and exposure fell back to $341 billion by late 2016. In addition, capital markets in the New Member States are very small in absolute size. The stock market capitalization of all the New Member States together is only 2 percent of the >>>

>>> EU aggregate; for corporate bonds markets it is only 1 percent. Corporate bond market capitalization in Hungary is less than 3 billion, compared with 800 billion in France!

Indeed, survey evidence suggest that domestically owned SMEs are even more finance constrained relative to large firms than their counterparts in Western Europe. Developing a capital market union may, therefore, be as important for the New Member States as it is for Western Europe. However, the underdeveloped nature of capital markets and their small size pose additional challenges. It is therefore imperative to have an optimal sequence for developing capital market union by matching investors with the right issuers through the right instruments.

- The CESEE government bond market is a good place to start. Large corporates will go offshore anyway. To develop private bond markets, some covered bond and securitized SME/Household debt could be listed locally.
- International experience suggests that bond market finance may not be the best solution for family-owned SMEs. This may be even more an issue in the New Member States, where capital markets are small. In considering the best way to meet the SMEs' funding needs, we need to take into account the cost and size of funding.
- Besides developing the domestic investor base (e.g. pension funds and insurance companies), attracting foreign investors should be a key focus based on the experience of other emerging markets.

Each country should have its own strategy based on the structure of the real sector (e.g. SME dominance, economic scale) and financial sector (banks, non-bank financial institutions, debt composition) to choose the right instruments. Some countries might not have a critical mass to have their own full-fledged capital markets; for them, a more limited, specialized, version is more realistic.

In short, many of the problems Capital Markets Union seek to address are even more pressing in the EU New Member States than they are in Western Europe. The small size and underdeveloped nature of capital markets in the region makes implementing capital market union more challenging, but the potential rewards for them from CMU are even greater than for large countries with well-developed equity and bond markets. ●

Levon Hampartzoumian

Chairman of the Management Board and Chief Executive Officer, UniCredit Bulbank

Bulgaria: the peak of economic expansion is ahead of us

UniCredit's economic forecasts predict that economic growth is likely to reach a cyclical peak of around 4.4% in 2018, before easing marginally to 4.2% in 2019. As research shows last year, growth was supported by two main drivers: exports and private consumption. This year and next, however, they are likely to be joined by investment, given signs that, after a prolonged period of stagnation, it has gained momentum recently. With its composition more balanced, the expansion will become more sustainable as well, predicts the latest CEE Quarterly analysis of UniCredit.

All components of private investment are expected to rise in 2018. Private residential construction contributed the most to the investment expansion last year. Stronger growth is forecasted this year as well, underpinned by rising house prices, a surge in >>>

>>> new construction permits and continuing improvement in financing. Private construction is also likely to draw support from rising demand for commercial real estate for logistic, leisure and particularly for administrative purposes. UniCredit Bulbank expects investment in machinery and equipment to increase too. The manufacturing sector, which will benefit the most from the ongoing expansion of production capacity, includes basic and fabricated metals, medicine and cosmetic products, and manufacturing of spare parts for the automotive industry.

The economic environment within which Bulgarian banks operate continued to improve in 2017, as GDP growth recovery took a stronger hold, while labor market improvement helped the number of jobs in the economy to increase to their highest level since 2008.

Increased competition on the market helped push the spread between interest rates on loans and deposits further downward. The contraction in the loan-to-deposit interest rate spread last year (48bp) was almost twice as much as in 2016 (26bp). As deposit rates were already close to zero in the start of 2017, spread contraction almost entirely reflected a decline in lending rates, which further supported ongoing strong economic recovery. Meanwhile, capital buffers remained at comfortable levels of 20.9% for Tier 1 Capital adequacy ratio and 22.0% for Solvency ratio in September 2017, or slightly below where they were one year earlier.

In 2017 the Bulgarian economy showed signs of gradual recovery, where the lending conditions were also improving, helped also by a favorable combination of abundant liquidity and the falling cost of borrowings. In this environment UniCredit Bulbank successfully retained its existing clients and further focused on new businesses. The commercial initiatives were addressed to providing a comprehensive range of Bank financing products supplemented also by factoring and leasing products to fully meet customer needs.

In 2017 the award winning International Center of the bank also continued to serve as a driver and facilitator of international businesses in Bulgaria, while more new international clients were attracted. The various meetings and events during the year promoted further the Center as a distinguished business matching hub.

As the bank with the largest market share in Bulgaria in terms of loans, deposits, assets and capital and as a main participant in the economic activity of the country, UniCredit Bulbank recognizes its role for the development and support of both Bulgarian and international enterprises operating on the local market. Addressing the financing needs of the enterprises is key element of our core banking activities, but it is complemented by other initiatives. Among them investing in financial education, fostering entrepreneurship, digitalization and innovation efforts of the enterprises, by which the bank strives to deliver higher customer value. ●

Roger Havenith

Deputy Chief Executive Officer, European Investment Fund (EIF)

Supporting European business: next-generation financial solutions

Despite positive developments, one in four European SMEs still consider access to finance a significant problem. This affects particularly microenterprises, start-ups, and highly innovative firms that lack sufficient collateral and have fewer resources to prove their credit-worthiness.

In cooperation with the European Commission, EIF has developed a broad toolkit of financial instruments covering both equity and debt to facilitate access to finance in the EU and address market failures. These instruments are delivered in partnership with financial intermediaries on the ground, sharing risk and thus leveraging scarce resources.

But we can do more. In the context of the new EU budget, we see a key role for financial instruments in achieving more with less. In particular, EIF is proposing an integrated approach through the creation of a single Equity Flagship and a single Guarantee Flagship. In both cases, the aim is to create a single platform pursuing EU policy objectives through a harmonised delivery mechanism and a unique coordinated set of streamlined rules. >>>

>>> On the guarantee side, this will reduce implementation costs and address the current fragmentation reflected in a multitude of initiatives at EU, national and regional level. A centralized governance structure and a harmonised rulebook will facilitate alignment of stakeholder interests and ultimately be more conducive in attracting private funds.

But the real challenge is on the equity side, where we want to tackle investment gaps at both the early-stage and the growth-stage. Europe still lags behind the US, China and other major actors in the global VC scene. VC investing as a percentage of GDP is ten times lower in Europe compared to the US and Israel. At the same time, European companies face a significant growth-stage trap, when VC financing is less readily available: The US invested 20 times more than Europe in later stage companies, while global leaders like Facebook have raised on average USD 7.3bn – around five times more than European leaders like Spotify or Zalando.

"We cannot let the EU become an incubator for other industrialised countries."

- ROGER HAVENITH

European entrepreneurs need to have access to the support they need here in Europe, to commercialise their ideas, but also to expand and scale-up, and not find themselves obliged to seek funding elsewhere. We cannot let the EU become an incubator for other industrialised countries. This is why we need an ambitious project to back innovative companies throughout their entire lifecycle. The European equity gap requires around EUR 4-5bn per year. EIF is proposing an integrated approach, blending various funding sources to create a single instrument to enable larger investment amounts and catalyse private investment. The next budgetary period will be challenging. We need to be ambitious in offering the much needed support to Europe's innovative entrepreneurs and most creative minds. ●

Christophe Bourdillon

Chief Executive Officer, CDC Entreprises Valeurs Moyennes, Caisse des dépôts Group

The fight for financial information: a critical challenge for SMEs

The European Parliament has passed a reform package aiming to promote a single market for capital capable of meeting the needs of the European economy: the MIFID and the Capital Markets Union texts are the most emblematic. The Capital Markets Union Mid-term Review prioritises access to finance for small and medium-sized enterprises (SMEs): SME Growth Market, more flexible growth requirements, etc. Yet, weaknesses persist—regarding, notably, the processing of financial data—and risk undermining the progress already made.

How to Aid SMEs in the fight for financial information?

SMEs, a critical source of growth and employment, are an essential link in the fabric of our economy, especially in central and southern Europe, but their ability to engage in initial public offerings (IPOs) remains hindered (only 3,000 out of the recorded 20 million SMEs). Beyond a young and often fragile national ecosystem, this limit also stems from the obligation for investors to undergo a high-quality financial analysis for evaluating risk. And yet, in the context of MIFID II, quality research can imply unbearable costs for specialised brokers due to their modest size. By separating execution and research services in the legitimate interest of transparency, the directive puts financial information at risk in a sector widely subsidised by large-cap companies. To invest in these stocks, however, long-term investors need independent and diversified research activities. This problem has raised worries of a major market flaw. Having been alerted, the Commission has decided to launch an impact assessment on this subject in early 2019.

It appears urgent to reconsider our economic model for financial analysis of SMEs by mobilising all actors, including issuers, brokers, and regulators, with the goal of exploring different ways of reform, for example:

1. The recognition of a unique regulatory status for research activities adapted to SMES that are listed or are candidates for access to a regulated market;
2. The use of new technologies (e.g. big data) for making information more accessible at a lower cost;
3. The possibility for professionals to mobilize public or private funds to facilitate the mergence of innovative research activity;
4. The creation of specialized pan-European funds supported by long-term investors (EIB, NPBs, etc.) aiming to encourage entrepreneurs to list their companies on the stock market. ●

Fernando Navarrete

Chief Financial Officer, Instituto de Crédito Oficial (ICO)

The versatility of development banks supporting SMEs: the Spanish case (ICO)

Small and medium enterprises represent the overwhelming majority of Spanish productive fabric and, within these, the large proportion of the smaller ones stands out. This average size, much smaller than the European average, determines their way of acting in many respects, including their funding strategies, where bank credit is the predominant source.

The past financial crisis caused a contraction of bank credit that affected particularly the most bank-leveraged

companies, that are, the smaller ones. ICO, as a promotional bank, contributed to relieve the effects of these credit restrictions, always under the principle of complementarity with the private sector. This contribution was carried out in two ways: first, injecting funds into the economy when such need was detected and, secondly, encouraging the diversification of businesses' financial sources through the promotion of private equity.

In order to inject liquidity into the economy, ICO increased by more than threefold its balance sheet size mainly though second-floor lending, aiming to reduce the credit shortages to companies in a period when the banking sector itself was immersed in a restructuring and deleveraging process. After this quantitative effort, and following the recovery of the Spanish economy, ICO's activity has gradually retreated, shifting from volume to specialization in segments that are deemed to be promoted and acting as a catalyst for the private sector. In this regard, ICO's support to the internationalization of Spanish companies should be pointed out, as well as its resolute commitment to the "Juncker Plan" or the determination of the institution to promote alternative funding sources.

Regarding the diversification of financial sources, ICO acts through its fully owned venture capital subsidiary –AXIS-, whose activity has contributed significantly to develop the private capital market in Spain. Fond-ICO Global, a fund of funds aimed to boost this sector, was launched in 2012 and, after nine calls for proposals, its success is unquestionable, having committed in 64 new private funds for a total investment of 1.42 billion euros. The funds participated by Fond-ICO Global have invested more than 1.68 billion euros in 330 Spanish companies employing more than 100,000 workers. ●

Ludwig Nießen

Chief Technology Officer &
Chief Operating Officer,
Vienna Stock Exchange

CCP as a standard element of modern financial systems and an opportunity to develop capital markets

Central Counterparties (CCP) and regulatory requirements are a broadly discussed topic in the financial world. Following the global financial crisis in 2008 and 2009, CCPs have increasingly become a standard for most developed capital markets. It's the regional and smaller capital markets who currently need to decide if introducing a CCP has the potential to unlock access to international trading activity. This might provide a chance to establish a more modern market infrastructure, an increase of liquidity and access to capital to fuel the financing of future growth.

Exchanges which already implemented a CCP underline its importance to ensure that the capital market meets future requirements of clients and investors. These exchanges confirm that the utilization of the CCP was a key factor in the positive development of the capital market. In most cases, markets with a CCP have seen an increase of memberships at the exchange, especially from internationals directly participating. Also trading volumes and market quality have increased in the years following the CCP introduction.

Large international trading houses confirm that direct membership at any trading venue and exchange requires a CCP.

The rationale is both based on actual risk management considerations as well as on a general drive to standardize procedures in the trading activities across the companies.

The process to catch up with Western European peers will require massive investments in the development of modernization of the Eastern European countries infrastructure. This investment will have to be largely financed internationally. In order to be able to attract international banks and allow them to more effectively engage

"Large international trading houses confirm that direct membership at any trading venue and exchange requires a CCP. "

- LUDWIG NIEßEN

in the local market, local exchanges will have to position themselves with a modern capital market infrastructure which complies with international standards and offers a trading friendly environment.

All Western European, but only selected CEE economies have adopted CCPs in compliance with EUR regulation. For smaller capital markets and exchanges, the introduction of a CCP poses challenges - organizationally, financially and in terms of its impact on today's trading members and future business potential. Therefore, it needs to be embedded in a set of carefully drafted measures to improve its chances for success. A positive development in the exchange's core function of equity trading will depend on a number of factors. Some of them can be positively influenced by the exchange, such as providing a modern infrastructure; others require external events and can at most be indirectly influenced. Research proves: The thoughtful introduction of a CCP is a strategic necessity and an opportunity for an exchange - it is one of the key elements for a potentially promising development.

The full study is available under: https://www.wienerborse.at/en/trading/clearing-settlement/ ●

Impact of bank prudential rules

Andreas Dombret

Member of the Executive Board,
Deutsche Bundesbank

NSFR and FRTB: it´s all about implementation now

The global financial crisis, which prompted the Basel III reforms, erupted more than ten years ago now. And in the EU, another four or five years are likely to pass before the FRTB and NSFR are implemented and applied. This is partly due to the relatively complex legislative procedure by which Basel recommendations are transposed into EU law, involving the European Commission, the European Council and the European Parliament. The revised version of the relevant EU rulebook, the Capital Requirements Regulation (CRR) including translations in all official EU languages, is expected for mid-2019. This will be followed by appropriate and reasonable deadlines for implementation that will give banks and supervisors sufficient time to prepare for applying the new regulations. This is one reason why the implementation of the NSFR and the FRTB is behind the original schedule set out in the Basel framework.

However, delays are also a general phenomenon and have occurred in a number of member countries of the Basel Committee worldwide. Regarding the NSFR, these delays may be explained by the ongoing discussions in the Basel Committee on the adequacy of the treatment of derivatives liabilities, which led to a limited adaptation of the related provisions in October 2017. The additional national discretion introduced in the Basel NSFR framework at that time and the resulting uncertainty about how it will be used by other jurisdictions have also acted as a brake on implemen-tation. Indeed, some authorities have even stopped their NSFR implementation to await developments in other coun-tries. Finally, it needs to be recognised that the NSFR, which captures the entire balance sheet, may have a stronger im-pact on markets and banks' business models than the Liquidity Coverage Ratio. Thus, a limited delay may be justified to provide sufficient time to adjust to the new rules.

The same holds for the FRTB, which is one of the most complex standards in the Basel III package. For the FRTB, delays could furthermore occur following the GHOS' announcement that certain specific issues related to the market risk framework still need to be addressed. Against this background, delays in NSFR and FRTB implementation are explicable and are per se no cause for concern – as

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>>> long as they are not interpreted as unwillingness to adhere to the reforms. In that case, and if implementation phases are extended again and again, the reputation and credibility of the Basel pro-cesses could suffer significant damage.

Despite the technical challenges presented by the high level of complexity, implementation needs to progress as quick-ly as possible. Banks will only step up their implementation efforts materially if deadlines are officially set and are given a legally binding character. A rigorous schedule is therefore key for an orderly and largely timely implementation pro-cess. Banks would likely cut back their project budgets for new system infrastructures if the Basel timeline were relaxed further. In estimating appropriate timeframes for implementation, national authorities need to assess how structural peculiarities in the respective banking systems and markets ought to be taken into account.

I have confidence in all the Committee members' firmness to push through the Basel III post-crisis reforms and their willingness to implement the rules in line with the agreed Basel standards. This is crucial to ensure that the prudential purpose of the rules and the global level playing field are not compromised. Consequently, the EU approach to imple-menting the NSFR and FRTB has to follow the relevant Basel frameworks as closely as possible.

Changes to the Basel rules, in particular as an early response to anticipated implementation in other Basel Committee member states, are not adequate. It would be desirable if the EU signalled a timely and consistent implementation. ●

Shunsuke Shirakawa

Vice Commissioner for International Affairs, Financial Services Agency, Government of Japan (JFSA)

Finalization of Basel III and its implication for Asia

On 7 December 2017, the Group of Central Bank Governors and Heads of Supervision (GHOS) endorsed the final piece of post-crisis regulatory reforms – known as Basel III. This is certainly an important milestone to strengthen the global banking system. If so, however, can we safely conclude that it should lead to more prosperous economic growth and more vibrant financial markets particularly in Asia?

In terms of overall impact of the finalization of Basel III, capital requirements on Asian banks tend to be lessened because many of them use standardized approaches (or less advanced models) for risk weighted asset calculations and do not heavily rely on internal models, while those on major Japanese banks will significantly increase.

Basel III has introduced additional constraints such as an aggregate output floor and input floors on the IRB approaches in order to address excessive variability of risk weighted asset calculations. These measures may have a different impact on each bank depending on its adopted business model. Asian banks, most of which are regarded as commercial banks, usually hold loan assets on their balance sheets until repayment and put more emphasis on internal credit assessment than investment banks. Thus, we need to carefully monitor whether these measures may unduly affect commercial banks vis-a-vis investment banks and may affect SME financing.

Basel III may also affect trade finance which supports sustainable growth of Asian economies. Under Basel III, capital requirements for exposures to banks, which provide guarantees for international trade, will be increased by removal of both the AIRB approach and a certain standardized approach based on the creditworthiness of the sovereign of its incorporation. Since trade finance usually relies on other banks' guarantee, these measures could in turn negatively affect trade finance in the Asian region. In addition, people are concerned about the impact of possible revisions to the treatment of specialized lending, for which banks play important roles in long-term infrastructure financing in Asia.

The new risk-sensitive framework of the standardized approach concerning real estate financing (i.e. risk weight tables using LTV ratios) would probably increase the overall capital requirements >>>

>>> for those exposures, while they are expected to promote banks' robust risk management and to help prevent overheating of Asian property markets. Also, the heightened risk weights for equity holdings (i.e. 250% risk weight) would lead to a significant increase of capital requirements for Japanese banks, while they are expected to help reduce cross-shareholdings between banks and large corporations.

In addition to the risk-based capital requirements, the non-risk-based leverage ratio, which became a Pillar 1 minimum capital requirement in January 2018, might induce banks' behavioral responses leading to a contraction in market activities. The introduction of liquidity and funding requirements (i.e. LCR, NSFR) has also necessitated banks to preserve sufficient high-quality liquid assets in anticipation of a significant liquidity stress and to reduce funding risk over a longer time horizon by maintaining a stable funding that meets the composition of their assets and off-balance sheet activities. Supervisors should carefully monitor whether and how the market liquidity could be affected by these regulatory changes.

"We need to achieve not only financial stability but also economic growth."

- SHUNSUKE SHIRAKAWA

Therefore, it is important for us to evaluate effects of Basel III as well as its combined effects together with other post-crisis reform measures. The JFSA has been claiming that we need to achieve not only financial stability but also economic growth by post-crisis reforms. In this respect, we are encouraged by the fact that both the Basel Committee and the FSB already embarked on impact assessment exercises and expect them to cover the aforementioned areas. We should not hesitate to make necessary adjustment if we find any unintended consequences. ●

Burkhard Eckes

Partner, PwC Banking & Capital Markets Leader, EMEA, PricewaterhouseCoopers

More "ex post" cumulative impact assessment needed for calibration of reforms

In calibrating future reforms to bank capital rules, it's important to explore the effects of post-crisis reforms made up to now. In a study for AFME, we have undertaken an 'ex-post,' data-driven study of how banks have actually responded to regulations.

The main body of the post-crisis regulations has been known for some time and has been influencing banks' strategic decision making - their choices of businesses and products. We examined changes in banks' balance sheets, identified and via statistical analysis accounted for other potential drivers of changes such as commercial performance, macroeconomics and wider financial sector trends, technological change and individual banks' positions.

The study draws on granular, business line data across of 13 global banks, based on the years 2005, 2010 and 2016 (the latest full year of data available at the time).

"Regulatory drivers have been the biggest contributor to balance sheet shrinkage."

- BURKHARD ECKES

Our key findings were: There has been significant asset deleveraging in capital markets activities since the crisis and regulatory drivers have been the biggest contributor to balance sheet shrinkage. Aggregate capital market assets fell by 39%, and even more in rates, credit, commodities and equities.

Broad trends of deleveraging are global in nature, and not limited to individual firms or regions. Aggregate annual regulatory costs on capital markets activities is estimated to be c. US$37bn (or 39% of banks' total expenses in 2016). Capital and leverage requirements account for almost 90% of the total regulatory impacts and will rise further Basel rule implementations. Regulation is responsible for a 14 percentage point reduction in ROE - (pre-tax) capital markets return on equity (ROE) declined from (from 17% in 2010 to 3% in 2016), before banks' mitigating actions - deleveraging, cost reductions or repricing are taken into account.

Policy actions and areas for further assessment

Our analysis of data demonstrates an empirical connection between regulations, the size of regulated banks' balance sheet capacity, and transmission impacts to both clients and to markets intermediation activities. These impacts are particularly significant for regulations designed to impact capital and liquidity requirements. This suggests caution about reforms still under consideration, or yet to be implemented.

Additional ex-post cumulative impact studies should be undertaken and complemented by ex-ante analyses to enable better calibration of coming reforms, in particular the NSFR, FRTB, Leverage Ratio and SA-CCR. Further assessment of the effects of regulations on products, instruments and asset classes are important. For EU policy effectiveness, impacts on the functioning of funding markets for less liquid asset classes will be particularly useful for the financing of SMEs.

And further assessments of impacts to the important credit and rates/repo activities which underpin the interbank market will also be important for those with responsibility for improving financial stability. ●

Olivier Guersent

Director General for Financial Stability, Financial Services and Capital Markets Union, European Commission

Fundamental review of the trading book: ongoing review and implementation in the EU

During the financial crisis, trading book losses for some banks worldwide were substantial and, in certain cases, the level of capital required against those losses proved insufficient. As a result, the Basel Committee initiated in 2009 a review of the market risk framework which is known as the fundamental review of the trading book (FRTB) to address a number of structural weaknesses in the prudential treatment of trading book positions. This work led to the publication in January 2016 of a revised market risk framework with a proposed implementation date on 1 January 2019.

The European Commission considers the FRTB as one of the essential measures needed to further reduce risks in the banking sector while working on the completion of the Banking Union. Because of this, the FRTB was included in the banking package published in November 2016. The Union co-legislators, the Council and the European Parliament, are still considering the Commission's proposal before adopting their respective approach to implement the FRTB in EU law.

In December 2017, the Group of Central Bank Governors and Heads of Supervision (GHOS) endorsed a package of amendments to the Basel framework with the intention to finalise the post-crisis reforms known as the "Basel III" reforms. At the same time, the GHOS extended the implementation date of the revised market risk framework to 1 January 2022, in order to allow banks additional time to develop the necessary systems infrastructure but also for the Basel Committee to address certain specific issues related to the framework. This includes a review of the calibrations of the standardised and internal model approaches to ensure consistency with the Committee's original expectations.

The Commission remains committed to the implementation of the measures that have already been agreed upon at international level. Therefore, if the ongoing review performed by the Basel Committee results in changes to elements of the FRTB, the Commission will naturally consider how to introduce them in EU law. To a certain extent the Commission's proposal already provides some degree of flexibility to incorporate certain of the elements currently under review via level 2 measures. Nevertheless, the Commission is now considering together with the co-legislators whether this flexibility is sufficient to ensure that all the elements under review in Basel could be reflected in a consistent and timely manner. This includes the extension of the implementation date to 1 January 2022.

"It is essential that all major jurisdictions implement all the key elements of the Basel agreement, including the FRTB."

- OLIVIER GUERSENT

In order to maintain a level playing field for banks at global level, it is essential that all major jurisdictions implement all the key elements of the Basel agreement, including the FRTB. In the December 2017 agreement by GHOS, all the Basel member jurisdictions have committed to such implementation. The Commission intends to deliver on this commitment for the EU and expects other jurisdictions to do the same. ●

Craig Goldband

Managing Director, EMEA & Investment Bank Treasurer, UBS

International alignment on implementation of the Basel framework is key

Coordinated regulatory reforms since the crisis have made systemically important financial institutions more resilient, markets safer and addressed too-big-to-fail. With the legislative framework approaching completion, consistency in implementation across jurisdictions becomes increasingly important.

In practice we see political pressures driving a more fragmented regulatory approach, threatening to undermine progress. In the US, the Basel framework has become less central to policy which is increasingly focused on stress-testing while the Foreign Banking Organization concept requires global banks from outside the US to adhere to US enhanced prudential standards.

The revised Basel III framework leaves in place a number of areas for national discretion. It is important that those options do not result in significant divergence because of conceptual differences in approach or lack of trust among supervisors. In this regard, the ECB's approach to removing options and

discretions within the Banking Union is to be welcomed. Going forward, alignment is needed at the global level to >>>

>>> ensure a level playing field and comparability between banks.

One element of the Basel framework that is key in determining banks' capacity to support liquidity in the capital markets is the Net Stable Funding Ratio. A level playing field in implementation, on substance as well as timeline, is important to avoid competitive distortions. One of the national discretions agreed by the Basel Committee is that jurisdictions may lower the Required Stable Funding for derivative liabilities. While the lower calibration likely to be adopted by the EU would help to minimize the impact on markets, the optimal solution would be to avoid fragmentation by adopting the recalibrated approach at the international level.

Besides, the industry strongly encouraged the Basel Committee to simplify and recalibrate the market risk standard that emerged following the Fundamental Review of the Trading book. It is essential that this framework supports market liquidity. The current consultation on a revised approach is therefore welcome.

A level playing field is important for the market risk framework too. A number of jurisdictions are considering postponing their implementation of this outstanding initiative. EU policymakers have yet to decide on precisely how much of the market risk framework to include in the CRR2 package currently under negotiation and the US commitment to implement that standard is yet unproven. If this leads to delay in implementation beyond 2022, the internationally agreed timeline should be revisited. ●

Kim Laustsen

Chief Analyst, Nykredit

Proportionate treatment of covered bonds in NSFR and FRTB

A lot of important work has been done in recent years by international and EU-level authorities to develop new frameworks for the regulation of liquidity and market risk. On the liquidity side, the NSFR has been finalised by the BCBS and is being implemented in the EU through the CRR2 proposal. On the market risk side, the BCBS is recalibrating the FRTB and the full implementation in the EU of FRTB is consequently being delayed.

"Nykredit generally supports strengthening the liquidity and market risk frameworks."

- KIM LAUSTSEN

Nykredit generally supports strengthening the liquidity and market risk frameworks. However, as the largest covered bond issuer in Europe it is important for us to ensure a proper treatment of covered bonds in both frameworks. This is also in line with the CMU project and the push to further strengthen covered bond financing of the real economy. The recent Commission proposal will ensure a strong harmonised framework for covered bonds in the EU and will be a strong reference point when discussing a proper treatment of covered bonds in the NSFR and FRTB.

Specifically, on NSFR it is very important that conditional pass-through funding models are recognized as stable funding and that an appropriate treatment of specialized covered bond issuers is ensured in relation to the definition of encumbered assets. Failure to do so would be very detrimental to many covered bonds issuers, in particular specialised institutions like Nykredit. It is therefore encouraging that the Commission proposal and the subsequent Council discussion to a large degree take these concerns into account.

As regards the FRTB the picture is more complicated following the ongoing discussions in the BCBS. The original BCBS standard was in our view overly conservative as regards the stress of covered bond exposures employing a stress four times higher than the largest observed stress in many countries, including Denmark, even during the crisis. Such overly conservative approach would disturb well-functioning covered bond markets as well as increase capital requirements significantly when combined with the Basel output-floor. Again, a more proportionate approach was included in the Commission proposal on CRR2 and especially in the Council discussion. However, the postponement of FRTB implementation in the EU risks undermining these positive developments. It is imperative that the progress made in the EU on this point is not forgotten when the final FRTB standard is to be implemented in the EU. ●

FOLLOWING EUROFI EVENT

3, 4 & 5 April 2019

Bucharest - **Romania**

Insurance groups in the CMU context

Gabriel Bernardino

Chairman, European Insurance and Occupational Pensions Authority (EIOPA)

Sustainable investment needs to be based on sound risk/return considerations

With the implementation of Solvency II in 2016, (re)insurers in the EU have benefited from more freedom regarding their investment policies. Solvency II requests insurers to invest all their assets in accordance with the "prudent person principle", hence to ensure the security, quality, liquidity and profitability of the portfolio as a whole.

In implementing a sound and prudent investment framework, insurers need to consider the structure and the duration of their liabilities. In fact, an appropriate asset liability management is the foundation of the insurer's investment process. Furthermore, elements such as the insurer's risk appetite and, ultimately, the strength of their capital position, are also important in the design of the investment strategy.

From a risk management perspective, the insurer's objective is usually to reach an optimum balance between risk and return, knowing that, as in all investment activities, higher expected returns have higher risks attached to them. From a solvency perspective, with Solvency II being a risk-based regime, when insurers hold more risky investments, they must hold more capital. These two considerations should continue to guide insurers' investment strategies, in the interest of policyholder protection and financial stability.

Granular capital requirements for individual investments should reflect the underlying risks and be calibrated to the overall confidence level in Solvency II. EIOPA developed a pioneer approach, with the creation of a separate asset class under the Solvency II standard formula for investments in infrastructure projects, allowing a specific treatment and lower risk calibration for qualifying infrastructure project debt and equity. The qualifying infrastructure investments need to satisfy conditions relating to the predictability of the cash flows, the robustness of the contractual framework and their ability to withstand relevant stress scenarios. >>>

>>> In a next step, EIOPA recommended extending the new asset class to certain infrastructure corporates.

The recent EIOPA investment survey points to a search-for-yield behaviour of insurers, which is a natural reaction to the low interest rate environment. The increased exposure to more illiquid investments and to non-traditional asset classes, such as infrastructure, improves asset diversification, providing significant risk mitigation, but also demands new risk management capabilities from insurers and closer supervisory scrutiny. At the same time, the first observations from the impact of the Solvency II point to an increase in long-term investment and a stable allocation to equity.

The first data available on the infrastructure asset class shows an ascending trend for infrastructure investments and one can observe that the share of qualifying infrastructure in total investment assets is growing each quarter, suggesting that qualifying infrastructure is becoming more attractive for insurers.

This year, EIOPA thoroughly analysed the treatment of unrated debt and unlisted equity and finally, recommended objective criteria, such as financial ratios, that would allow these important asset classes to be given the same treatment as rated debt and listed equity.

Within the Capital Markets Union (CMU) project, an important element is the proposed regulation on the Pan-European Personal Pension Product (PEPP), which is based on EIOPA's advice. It should not only provide a safe, transparent and cost-effective long term retirement savings option, but equally create the appropriate type of liabilities to allow long-term investment. I am confident that the co legislators, the European Parliament and Council, will recognise the strategic importance of this initiative for EU citizens and the long-term competitiveness of the EU economy.

Finally, a new challenge is to properly introduce Environmental, Social and Governance (ESG) factors into the investment decision processes in the financial sector. The insurance sector can be part of the solution towards a more sustainable economy, by maximising long-term, sustainable financial value and creating non-financial value. To achieve these objectives, ensure policyholder protection and preserve financial stability, sustainable investment needs to be based on sound risk/return considerations. ●

Burkhard Balz

MEP, EPP Coordinator, Committee of Economic and Monetary Affairs, European Parliament

CMU without insurance won't be successful

The Capital Markets Union still remains to be a piecemeal approach. More legislative initiatives are in preparation, but still require thorough analysis and proper consultation, before the law-making starts. Unlike the Banking Union, the creation of a CMU affects all financial sectors and builds on all financial sectors to contribute. Without doubt, a CMU will need more time to develop. Nonetheless, the aim to achieve continuous progress shall be pertained. The goals of the CMU, such as facilitation the cross-border investment in capital markets and the financing of the EU economy, have to guide the co-legislators through existing and upcoming legislation.

The co-legislators and the Commission should do their best to make use of the insurers' lending and investment capabilities to continue with the build-up of the Capital Markets Union. With regard to Solvency 2 the amendments to the delegated acts on infrastructure corporates and on securitization rightly brought some impetus to refine the risk weighting of some asset classes. The pending revision of parts of the standard formula should be used to enhance the risk sensitivity of e framework, to reduce pro-cyclicality, and to avoid a distortion in asset allocations. The European Parliament agrees with envisaging relevant changes on >>>

>>> the level of delegated acts, as long as the mandate from the co-legislators is respected by the Commission and by EIOPA and as long as early and comprehensive involvement of the co-legislators is ensured throughout the whole process.

At the same time, it is crucial that the positive efforts currently pursed are not offset by regulatory constraints, which are counterproductive to the goals of the CMU. A substantial concern is the early amendment to the risk free interest rate term structure as pursued by EIOPA. A stand-alone approach on the UFR without the co-legislators' agreement surely has to be rethought by the Commission, Council and Parliament.

The impact of a change of the UFR cannot be properly evaluated if detached from the long-term guarantee package. The same concern exists with regard to a stand-alone review of the interest rate risk sub-module which has been initiated by EIOPA as part of the advice to the standard formula review.

"Stability in legislation, in particular where legislation facilitates the maintenance of long-term insurance business, also adds positively to the implementation of the CMU."

- BURKHARD BALZ

The co-legislators chose the timeline for the Solvency 2 review deliberately. Long-term measures require a long-term perspective, also with regard to review cycles. Stability in legislation, in particular where legislation facilitates the maintenance of long-term insurance business, also adds positively to the implementation of the CMU.

It is obvious that any substantial change in regulation has to be preceded by an impact assessment evaluating both quantitative and qualitative aspects of the existing rules as well as of potential adaptations, including their contribution to the CMU. The EU Institutions should therefore work on a common strategy in terms of timing and of content to ensure that any future revision of the long-term guarantee measures will remain to be regarded as a package and is able to add to a positive investment culture in Europe. ●

Tobias Bücheler

Head of Regulatory Strategy,
Allianz SE

Targeted changes in insurance regulation and accounting needed to unfold full potential in supporting CMU

The CMU initiative of the European Union seeks to develop a pan European capital market to support growth and employment. At the same time, the Pan-European Pension Product as a key element of the CMU aims to help closing the pension gap and to further develop the long-term financing of the real economy in Europe.

This is where the long-term insurance business model could perfectly bridge long-term savings and long-term investment and thereby helping to fulfill the promise of the CMU – if not thwarted by off target regulation. Although Solvency II is a modern and fundamentally solid regulatory framework, it is still suffering from relevant shortcomings – especially the preferential treatment of sovereign risks and the disregard of the specifics of a long-term business model are relevant here.

With respect to the latter, current regulation is premised on a trading perspective where long-term insurance portfolios are treated as if they have to be sold tomorrow placing too much focus on short-term market fluctuations. While a risk-sensitive regulation is necessary, the focus should be on those risks that really matter. For buy-and-hold investment strategies typically employed by insurers, the most relevant risk would be default risk rather than spread volatility triggered by short-term market fluctuations. As a result, the existing Solvency II volatility adjustment should - for long-term illiquid insurance portfolios - be amended to mitigate unwarranted solvency volatility due to short-term spread movements. A relevant solution to this issue has been proposed by industry stakeholders in the context of the development of an Insurance Capital Standard by the International Association of Insurance Supervisors, which could serve as benchmark for the further development of Solvency II.

"The CMU initiative of the European Union seeks to develop a pan European capital market to support growth and employment."

- TOBIAS BÜCHELER

Notwithstanding the above, the impeding introduction of IFRS 9 and 17 will add a further challenge. In order to reduce unnecessary complexity and avoid potentially divergent risk management implications, both frameworks should be aligned to the largest extent possible. This would also create a consistent basis for communication with investors, supervisors and policyholders thereby increasing transparency for all relevant stakeholders.

Against the background above, we believe that the work on relevant issues should start in a coordinated manner already now. We have an unique opportunity to improve the availability of long-term financing while increasing financial market stability for the benefit of consumers, capital markets and the real economy – let's not waste it. ●

Frédéric Hervo

Director for International Affairs, Autorité de Contrôle Prudentiel et de Résolution (ACPR)

How does regulation affect insurance contribution to the CMU objectives?

The insurance industry has a key role to play regarding the achievement of an effective capital market union (CMU). The savings in the European Union (EU) exceed 350 billion €. At the same time, the UE is faced with structural challenges like the needs of an aging population or the adequate allocation of savings to investments. In this context, insurers and pension funds play a crucial role in pursuing long-term investment.

The existing prudential framework already contributes to the CMU objectives. Strengthening the financial regulatory framework in the post-crisis context, which includes an adequate capitalization of undertakings, is necessary to support a long-term and sustainable growth.

The design of Solvency 2 is aimed at ensuring both financial stability and support to long term investment. For instance, the shock of 39% applying to equities does not translate into an equivalent cost in own funds, especially thanks to diversification effects. Moreover, the so-called "long-term guarantees measures" aim at decreasing the impact of volatility of financial markets on solvency ratios and therefore dampens pro-cyclical effects. Thus, there is no evidence of a decrease of equity investments in insurers' assets since the entry into force of Solvency 2.

Long-term investment was also further encouraged by subsequent Solvency 2 revisions, chiefly with the lowering of capital requirements for infrastructure assets. The upcoming reviews of Solvency 2 aim at detecting potential unjustified restrictions to economy financing: EIOPA has advised to align the capital charges for unlisted equities and unrated debt on the treatment of listed and rated ones, provided they meet some defined criteria.

Other venues to bolster investment could be considered. Especially in a context of low interest rates, insurers should be incentivized to diversify their investments by the use of other adjustment potentialities of Solvency 2, to improve the capacity to hold equities over the long run.

Finally, one should bear in mind that other factors have often a more prominent impact than prudential regulation regarding the achievement of the CMU, including the lack of legal or tax harmonization in the EU. New initiatives at the EU level which encourage product innovation and cross-border reach pave the way for long-term investment. However, policyholders' protection must be closely considered: this would clearly be a prerequisite for the success of the pan-European pension product (PEPP) initiative. Last but not least, a genuine single capital market would imply an increased cooperation between national supervisory authorities in terms of supervision of cross-border activities. ●

Felicia Stanescu

Head of Financial Services Policy and International Affairs Unit, DG Financial Stability, Financial Services and Capital Markets Union, European Commission

The role of insurers within the CMU initiative

One of the aims of the CMU is to reduce reliance on bank lending and diversify funding sources. The European insurance sector, with investments worth more than €10 trillion, is a cornerstone of this initiative. Insurers' long-dated insurance liabilities make them natural investors over a long-term horizon.

The Commission is committed to ensure that no undue regulatory barriers exist to insurers' long-term investment, and seeks to create incentives to channel funds towards long-term investments that benefit growth in Europe.

Infrastructure investments are a perfect example of this. They are typically long-term in nature and studies have shown that, especially over a longer period, they present less risk than investments in corporates. The Commission, therefore, decided to reduce the Solvency II risk charges for infrastructure corporates and infrastructure project finance by an average of 25% to a more risk-adequate level.

"Create incentives to channel funds towards long-term investments that benefit growth."

- FELICIA STANESCU

Another important building block of the CMU is the "simple, transparent and standardised" (STS) securitisation which is expected unlock up to €150 billion of additional funding to the real economy. The Commission will therefore amend Solvency II capital requirements, involving a tailored treatment for STS securitisations with the aim of having the changes in place on 1 January 2019 when the STS framework becomes applicable.

A recent report from EIOPA has shown that most insurers are, on the one hand, planning to allocate more investments into less liquid >>>

>>> long-term assets, including infrastructure and privately placed debt. On the other hand, insurers' investments in equity have remained stable and the overall asset allocation seems to be driven by market practice in the individual countries.

The report also concludes that insurers have increased the maturity of their bond portfolios over the past years. While part of this can be attributed to the introduction of Solvency II, the CMU initiative will support and accelerate observed trends.

Under the CMU action plan, the Commission is currently assessing whether the Solvency II framework contains any unintended obstacles discouraging insurers' investments in private equity or privately placed debt. In its response to the Commission's call for advice, EIOPA has developed a detailed proposal to identify higher quality unrated debt instruments and high-quality private equity investments. Taking EIOPA's advice as starting point, the Commission aims to adopt an amendment to the quantitative framework of Solvency II by the end of the year. ●

Contributors: Nathalie Berger, Stephen Ryan, Robert Hintze, Hadrien Maillard, Filip Zrile

Cyril Roux

Chief Financial Officer, Groupama

Insurers and CMU: never the twain shall meet?

European Insurers are leading institutional investors - they should naturally be at the forefront of the capital markets union project. Yet they are not. Insurers' investment policies are shaped by any number of factors, but the CMU: asset liability management, the course of financial markets and markets for real assets, local gaap accounting and IFRS accounting, solvency 2 treatment of asset classes, tax considerations, dividend policy.

The CMU project aims at a number of microeconomic and macroeconomic goals: removing impediments to the flow of capital across EU jurisdictions, harmonizing listing rules, facilitating the access of firms to capital markets, rebalancing the financing of growth and investment in the EU away from its over-dependency on bank credit, declogging banks' balance sheets with the recourse to STS securitizations. Absent from these worthy goals are the needs of institutional investors in general, and those of European insurance companies in particular.

"The CMU project and insurers' investment policies have limited ground on which to meet."

- CYRIL ROUX

There is thus little surprise in the outcome: the CMU project and insurers' investment policies have limited ground on which to meet.

Insurers of a sufficient size do not need to restrict themselves to listed assets - Solvency 2, removing the shackles of Solvency 1, has given the insurers free rein to invest in assets whether or not they can be exchanged on capital markets. Insurers hold massive amounts of listed securities. But they can and do invest as well in private debt and private equity, illiquid assets and real assets. They can be indifferent to the CMU and bring their wealth to bear across the whole spectrum of asset classes.

Some attempts to increase insurers' interest in the CMU have focused on Solvency 2 cost of capital incentives: The review of the SCR standard formula will take into consideration long term investment promoted by CMU. However, these attempts fail to address in full impediments to the CMU: high sensitivity of solvency 2 eligible own funds to mark-to-market (only partially addressed by the volatility adjustment), liabilities constraints induced by local regulations, accounting constraints (especially under IFRS 9). A good place to start is to embrace all those constraints and identify the main drivers that have led insurers to underweight some asset classes or short-term behavior in their investment decisions.

The forays made by EuVECA and EuSEF are based in part to trying to bridge the needs of individual investors with those of smaller companies. An approach tailored to the needs and constraints of institutional investors, and in particular insurers, should also be developed.

There is scope to bring the CMU into greater relevance for European insurers. In order to achieve it, insurer specificity as investors and the diversity of insurance products in the EU should be taken into account better. Only then will the CMU reach its stated objective of "a more competitive and innovative European financial sector". ●

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IV. REDUCING FRAGMENTATION IN EU FINANCIAL MARKETS

Issues at stake

More integrated banking and capital markets would foster more effective capital allocation and private risk sharing across the EU, which are essential to absorb potential asymmetric economic shocks and move towards a genuine Economic and Monetary Union.

The completion of the Banking Union with EDIS and a backstop to the SRF would improve financial stability. However further integration of the EU banking sector is hindered by the lack of recognition of banking groups in EU legislation and a persistent national approach regarding the regulation underpinning bank resolution and liquidation. Further integrating EU capital markets also remains challenging with inter alia the maintenance of legal and fiscal barriers, despite considerable efforts made to lift these obstacles.

Content

Addressing fragmentation issues in the Banking Union

Sylvie Goulard

Second Deputy Governor, Banque de France

Enhancing and consolidating the Banking Union to support European integration and growth

Over the last decade significant progress has been made towards deepening and fostering the integration of the financial and banking sectors. The Banking Union has been a corner stone in providing a sound, stable and harmonized regulatory and supervisory framework. Its first two pillars are fully implemented: the Single supervisory mechanism (SSM) is ensuring consistent supervision practices and the Single resolution mechanism (SRM) guarantees harmonised orderly resolution of failing banks at the Eurozone level.

Nevertheless, as underlined by recent communications from the European Commission, the banking sector still suffers from fragmentation. A number of Member States host subsidiaries that hold such a market share that if one of these subsidiaries was to experience difficulties, their national economy could be impacted. This explains their willingness to hold powers to retain loss-absorbing capacities and liquidity on a solo basis, despite the free movement of capital within the single market and Banking Union. Therefore, it is critical for these Member States to be confident that banking groups would support the losses of their subsidiaries.

Their concerns need to be acknowledged and addressed. But going back to national approaches and increasing fragmentation would be a historical and economic mistake. Opting for the status quo would also leave the Banking Union incomplete and would dramatically limit its benefits.

Instead, in the Brexit perspective where Members States might be tempted to race to the bottom in order to attract the relocation of financial institutions, we must express clearly that there is no other way forward than further integration to deliver the benefits of the single market.

On-going legislative proposals to complete the Banking Union (permanent backstop to the Single Resolution Fund, EDIS) as well as the efforts to reduce NPL should help to increase the confidence of host countries regarding foreign banking groups operating in their jurisdiction. In addition, adopting a progressive and comprehensive

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>>> approach towards an enhanced solidarity between parent entities and subsidiaries coupled to minimum proportionate national requirements seems sensible. Subsidiaries should have some internal loss absorbing capacity, calibrated and composed in such a way to ensure the implementation of the resolution strategy and this should be done in a framework that ensures that host financial stability concerns are dealt with.

We also believe that obstacles to cross-border acquisitions should be lifted. The EU banking system is clearly less concentrated that the US one: the market share of the top five US banks within the United States was more than 40% in 2016, whereas the market share in the Eurozone of the top five European banks stands at more or less 20%. Against this background, there may be room for further consolidation of the European banking industry, and particularly within the Eurozone.

In a truly unified market, pan-European banking groups and a more developed capital markets union would improve the diversification of risks across Member States and investments would be more effectively channelled across borders. Financial needs and resources will thus be better matched at Union level.

To this end, regulatory and supervisory obstacles to cross-border activities within the Eurozone must be completely removed. For example, the calculation of systemic scores of banks as per the methodology used by the Basel Committee to identify Global systemically important banks includes cross-border lending at country level. Therefore, it is more costly for a bank located in a given Euro area country to expand its activity in another Euro area country than in its domestic market. However, the rationale of the Banking Union should lead to consider the Euro area as a single jurisdiction in the context of this regulation.

This should be a top priority for European regulators. ●

Levin Holle

Director General, Financial Markets Policy,
Federal Ministry of Finance, Germany

Fragmentation and the banking sector in Europe

As the financial crisis began to unfold almost 10 years ago, the assumption that a single financial market existed in Europe with similar conditions and risks everywhere was corrected. This was reflected in a growing fragmentation in financial and banking markets, with diverging credit spreads along national borders and a reorientation of banks towards core businesses and markets, which were often domestic.

Since then, fragmentation has been gradually reduced by far-reaching policy measures such as banking union, structural reforms in many Member States, and a favourable macro-economic environment. Also, fragmentation in Europe is receding as bank capitalisation improves and non-performing loans (NPLs) are being reduced. Nevertheless, countries still differ in terms of infrastructure, institutions and economic trends. Furthermore, NPLs across Europe of about €900bn are still very unevenly distributed and some Member States continue to have high levels of public debt.

Integrated financial markets do contribute to a better credit supply and economic growth, provided that the right framework conditions are in place. From this point of view, fragmentation of financial markets is regrettable. But to some extent it merely shows that financial markets are more responsive and efficient in processing information than they were in 2007. Accordingly, we should worry less about the symptoms but rather >>>

>>> concentrate on addressing the fundamental issues exposed by fragmentation, in order to strengthen stability and convergence in the euro area.

With regard to the banking union, risks in the banking sector have to be reduced before further risk-sharing can happen. As set out in the Ecofin roadmap, risk reduction requires lowering excessive NPL levels, improving insolvency regimes, building sufficient bail-in buffers and addressing sovereign exposures and with them the link between sovereigns and banks. If we are to fully restore the confidence of our taxpayers, we need clear, effective and convincing results. From this perspective a clear sign for progress is that legacy problems are solved first. The current good economic recovery offers us a window of opportunity to do this now.

Cross-border consolidation could also contribute to reduce fragmentation, and with a single supervisor and a single resolution regime, cross-border mergers are easier than in the past. This being said, mergers are not good or bad per se. In the 1990s and early 2000s, many bank mergers were motivated by the aim of internalizing an implicit "too-big-to-fail" subsidy, which obviously would be undesirable. The track record of mergers in improving bank profitability is also mixed. In understanding the relatively low level of cross-border activity, one should take into account the institutional and cultural differences in banking between Member States. The relatively low cross-border activity may also have to do with limited value-added. Currently, other activities may appear to be more profitable.

To sum up: A true single financial market will improve efficiency and foster economic growth to the benefit of European citizens. It is therefore a goal worth pursuing. In doing so, however, it has to be acknowledged that financial markets are not only influenced by financial regulation, but also by many other regulatory, institutional and market factors, which are largely domestic. Such differences exist and are likely to last for some time. With the banking union the Eurozone has started on an ambitious journey to stabilize and integrate the banking market. A lot has been achieved already and more needs to be done. ●

Jean-Jacques Santini

Head of Group Public and Regulatory Affairs, BNP Paribas

The Banking Union is an extremely ambitious achievement but EU banking markets are still fragmented

Faced with an acute sovereign debt crisis, Europe has embarked in an extremely ambitious journey to create the Banking Union. The set-up of the Single Supervisory Mechanism, after an unprecedented Asset Quality Review, was followed by a recapitalization exercise of identified banks. Via a critical transfer of sovereignty, it has allowed to reinforce the strength of banks directly supervised by the SSM, and to harmonize their supervision. The Single Resolution Board has been put in place and has started to handle a number of distressed situations. The Single Resolution Fund is being financed by the industry, with hundreds of millions being contributed every year by large banks, with the goal to end using tax-payer money to rescue ailing banks.

Despite such game-changing institutional architecture being now in place, the Banking Union is still, six years later, not fully functioning as an internal market for financial services with associated costs for end-users.

The ECB has repeatedly called for restructuring of the European banking Sector, including the development of pan-european banks, in order to forster private risk sharing, and contribute to absorb asymmetrical shocks. But in practice, despite the massive efforts put by the supervisory community and the industry, in human and financial resources, the "single banking market" still does not exist, and there major issues still have to be tackled:

- Whereas supervisory convergence has been broadly achieved for directly supervised banks and despite the removal of dozens of national discretion, it is still a work in progress in other banks, perpetuating the perception that the European banking system has not yet fully dealt with the crisis legacy. >>>

>>> This is a huge impediment for the investment of other jurisdiction funds and asset managers. This is why some form of asset quality review is needed for all banks, notably before their risks might be shared in an EDRIS framework. This is also why proportionality, if applied beyond legitimate reporting burden alleviation, would be contrary to the financial stability objectives.

- Whereas the link between bank and sovereigns has been drastically cut as regards supervision and resolution, bank holding of sovereign debt has not decreased, due to the massive accumulation of HQLA buffers, not only at consolidated level, but in each subsidiary, as LCR requirements are applied at solo level. This situation is likely to prevail as the waiver reform proposed by the Commission is still not accepted by a majority of Member States.
- Whereas the main goal of the Banking Union was to curtail the increasing risk of fragmentation of EU banking markets[1], integration has actually decreased according to ECB studies. Indeed, for the largest 67 banks in the Euroarea (7 G-SIIs and 60 O-SIIs), expanding business beyond the "home" country is more expensive than within their home market, due to penalizing systemic scoring method, and the need to preposition capital, liquidity, and now TLAC/MREL, in each country where banks operate.

"Barriers to the free flow of capital and liquidity must be dismantled. "

- JEAN-JACQUES SANTINI

Although one can understand that at this stage of the Banking Union host countries are reluctant to accept full liquidity and capital waivers, it should not mean that no progress is possible, and we strongly support the proposals expressed in the EUROFI paper, aiming at fostering private risk sharing.

At least, Member States should recognize the reality of parent financial support. As the FSB does in the context of internal TLAC, the CRR2 could, for example, before the Banking Union is completed, reduce the LCR and capital requirement for host subsidiaries to 75% / 90% of the solo requirement.

And, at least, Member States should not implement additional obstacles to free flow of liquidity, compared to those already existing. In particular, the NSFR should be implemented at Group level, to avoid long term debt to be issued in each Eurozone subsidiary. If such measures were not implemented in the short run, cross-border mergers within the Euroarea, and development of subsidiaries in "host" countries, which are necessary to reduce fragmentation and favour sovereign risk diversification, would continue to be blocked.

This would mean not only a drag on EU banks profitability and sustainability, but also a structural unlevel playing field in the Euroarea financing conditions, with major differences in credit provision trends from one country to the next, both in quantity and cost, despite the unicity of monetary policy, and to the detriment of borrowers and depositors.

Barriers to the free flow of capital and liquidity (a freedom guaranteed in the Treaty) must be dismantled. European political will is now needed to tackle this issue, and deliver to individuals and corporates the benefits of a genuine EMU. ●

1. Roadmap towards a Banking Union, May 2012, European Commission

Andrea Enria

Chairperson,
European Banking Authority (EBA)

Cross-border risk sharing in the EU: priorities on the way forward

Available evidence on the degree of integration of banking markets in the European Union is far from satisfactory. Cross-border bank consolidation, in particular, is on a declining trend, with M&A transactions reaching record lows in 2016. Cross-border risk sharing promotes resilience and productivity. For this reason, cross-border consolidation should rank high in the EU agenda on economic policy. Institutional and regulatory factors play a decisive role and the EBA stands ready to provide valuable input on various fronts. The way forward is threefold.

First, institutional risk sharing needs to be taken forward. A European Deposit Insurance Scheme must now be phased-in and a common backstop standing behind it and the Single Resolution Fund should complete a truly European safety net. Both private investors and host authorities need to be confident that, in case of local shocks, the available support does not exclusively rely on local (i.e. national) resources. The safety net must be credible, also in presence of systemic events. In the absence of such arrangements, private investment decisions will likely refrain from crossing borders and national considerations will continue to affect regulatory and supervisory decisions. Within the current debate, the requests that risk sharing and risk reduction proceed hand in hand are legitimate and grounded on solid arguments. It is precisely in that perspective that the substantial progress being made in reducing the stock of legacy risk, as well as in harmonising the recognition, provisioning and management of non-performing exposures, justifies steps towards a more common safety net.

"Institutional risk sharing needs to be taken forward."

- ANDREA ENRIA

Second, EU authorities should engage in a holistic review of the Single Rulebook and supervisory handbook aimed at identifying rules and practices that may unjustifiably stand in the way of cross-border banking. Regulation and supervision should be neutral in relation to the way cross-border banking >>>

>>> is organised, i.e. they should not incentivise any specific group structure. Rules and practices should not lean against the 'single point of entry' type of business model, whereby the institution chooses to centralise the management of capital and liquidity resources, treating them as fully fungible. Ring-fencing rules and practices preventing this fungibility may undermine EU institutions' incentives to operate cross-border. The review will need to cover both the going concern and gone concern frameworks including, without being limited to, rules on the solo application of capital and liquidity requirements, the design of capital buffers, internal MREL as well as the broader treatment of groups in a resolution context.

Third, in the medium term, the EU should aim at a higher level of harmonisation of national regimes that play a role in cross-border consolidation. Corporate law and tax regimes are two frequently mentioned examples. Given the progress made on bank resolution at the EU level, and the critical implications of the differences in national liquidation decisions, an EU regime on bank liquidation should also be introduced.

As progress is being achieved in completing the architecture of the Banking Union, EU authorities could move closer to considering the Euro Area a single jurisdiction for banking business. With the due adjustments, the same approach could be extended to the whole Single Market. ●

Edouard Fernandez-Bollo

Secretary General, Autorité de Contrôle Prudentiel et de Résolution (ACPR)

Achieving risk reduction and risk sharing to foster a European approach of financial supervision

In the aftermath of the 2008 global financial crisis, European institutions and governments have undertaken bold and comprehensive action to strengthen the banking sector, especially at the Euro area level with the establishment of the Single Supervisory and Resolution Mechanisms and the convergence of deposit guarantee schemes. After nearly five years of functioning and several actual tests including the orderly winding-down and the resolution of some financial institutions and strong measures to address non-performing loans, the Banking Union is now fully confirmed as the most adequate approach for enhancing financial stability on the continent.

The national competent authorities have played a key role in those first achievements, since cross-fertilization among national supervisors and the ECB has contributed to build a common supervisory culture for the Banking Union. Although the sensible way forward is through more integration and convergence, the European Commission and the ECB have noted in recent communications that our banking sector is still, at this stage, fragmented. This means that financial needs and resources are not yet matched at Union level, which is detrimental to the Single Market and results in significant inefficiencies for the real economy.

"The development of cross-border groups at Banking Union level is necessary for achieving financial integration, which is also desirable from a financial stability perspective."

- EDOUARD FERNANDEZ-BOLLO

The development of cross-border groups at Banking Union level is necessary for achieving financial integration, which is also desirable from a financial stability perspective. For this reason, in the context of the review of European supervisory agencies, the ACPR has called for a mandate of the European Banking Authority to identify and propose solutions to remove obstacles to cross-border consolidation.

In our view, the exercise of current micro and macroprudential supervisory powers to retain loss-absorbing capacity (e.g. capital buffers and eligible liabilities) and liquidity at national level should be carefully assessed against these objectives. EU regulation should provide for the application of waivers of some requirements at the individual level on a cross-border basis. Nevertheless, the reasons why these proposals are met with reluctance by some Member States should also be clearly understood. Regulators and supervisors currently stand at a crossroads where they can assume the overall banking risks are under control, but all do not feel they are sufficiently or evenly shared at the Banking Union level; thus, they fear national authorities may be on the hook in the case of a local stress.

As the challenging implementation of the European Deposit Insurance Scheme shows, full risk-sharing at Union level will not be achieved in one day. However, some possible solutions could be explored. For instance, on the resolution side, while we acknowledge the need for internal loss-absorbing capacity, we think credible guarantees provided by the resolution entity to its subsidiaries should be eligible as internal MREL to count towards this capacity, and the aggregation of internal MREL requirements should not exceed the MREL amount determined at the consolidated level. In the same way, the capital and liquidity frameworks should now take into account the Banking Union level of supervision by the ECB-SSM. One promising first step would be the possibility to waive Pillar 2 at the individual level while maintaining simple requirements which would ensure some capital and liquidity remain immediately available at the national level to absorb losses or face liquidity outflows: one could imagine an 8% own funds requirement and a liquid assets buffer covering outflows from deposits subject to the national guarantee scheme. These requirements could be adjusted upwards by the relevant supervisor to take into consideration a deterioration of the risk profile, ahead of any other supervisory actions that have to be taken in a situation of a failing or likely to fail institution.

Such solutions would ensure intragroup solidarity while allowing more efficient management of financial resources at the consolidated level: in other words, progress towards risk and resource sharing, essential conditions for durable growth and stability in Europe. ●

Korbinian Ibel

Director General, Directorate General Micro-Prudential Supervision IV, European Central Bank (ECB)

A single rule set for the Single Supervisory Mechanism

Numerous studies show that risk sharing has positive effects on welfare. Cross-border risk sharing can better balance the needs of customers in different locations and stages of the economic cycle. And the establishment of true cross-border banks is a major facilitator of well-functioning cross-border markets.

The Banking Union was an important step in this regard. At the SSM, we work every day to add value by supervising financial institutions at a consolidated euro area level. A lot of progress has been made in ensuring a level playing field among euro area banks. Despite this progress, we know that there is still potential for cross-border banking in the euro area to develop further. The European banking market remains mostly domestic measured in terms of the top 3 players by country and their origin.

To promote more cross-border banking and accordingly more cross-border risk sharing, we need to reduce regulatory fragmentation. The ECB has already harmonised the application of over 130 options and discretions (ONDs) in the euro area. But a substantial number of ONDs are granted to Member States, where the ECB has no competence. Some ONDs directly reduce the attractiveness to institutions of engaging in cross-border banking.

One of the most important areas of national discretion outside the remit of the ECB is constraints on large exposure limits. Member States can place constraints on fund allocation within groups by putting national limits on how exposed one part of a group can be to another part of the same group, even though the ECB has a policy of removing these large intragroup exposure limits if certain prudential safeguards are met. As a consequence, large exposure limits can undermine some of the benefits of a possible liquidity waiver that would otherwise allow banks to move liquidity flows freely within their banking group across the euro area. This is particularly problematic as intragroup cross-border lending accounts for around 70% of total cross-border bank lending. The execution of this and similar ONDs should be assigned to the relevant competent authority – for the euro area, the ECB – to achieve a harmonised policy on waivers.

This is not the only area of fragmentation, e.g. the approach to the fit and proper assessment of banks' board members varies because national law applies. The framework provided by the CRDIV and EBA guidelines alone is not enough.

Similarly, the ECB is required to adopt early intervention measures on the basis of national transpositions of the BRRD. This means that 19 different frameworks have to be taken into account. Early intervention powers should be directly applicable as set out in Union law, providing a unified approach.

Finally, we also need to make sure that banks can be trusted to provide beneficial cross-border services. Robust prudential requirements play a big role. It is important to implement key regulation such as the finalisation of the Basel package. The SSM will continue to enforce and complement these requirements with effective supervision.

In summary: The SSM is promoting a level playing field as the basis for further cross-border activities, but more progress in integrated banking could be achieved if legislators reduce fragmentation and complete the Banking and Capital Market Union. ●

Koos Timmermans

Chief Financial Officer Executive Board, ING Groep N.V. & Vice Chairman Management Board Banking, ING Bank

Pan-European banking groups: what are we waiting for?

Conceptually, it is very clear that the creation of the Banking Union (with the ECB - not NCAs - in charge as single supervisor for all eurozone banks) has the potential at some stage to drive intra-regional consolidation. Despite all the progress to arrive at one Banking Union in the eurozone, there are still challenges to overcome. Traditionally the retail market, in terms of process and products, has been created and developed per country. So, before any cross-border merger can take place, operational efficiency and harmonization have to be achieved. Digitalisation and innovation are also important new developments. Increasingly digitalised banking technologies are not only key to survival but can also be major synergy drivers. At the same time, uncertainty about the future direction of a fundamentally changing banking landscape is holding back investment in traditional ('old style') banking. Fintechs and Bigtechs offer technological solutions that banks cannot always match. Banks are also slowed down by the fact that existing clients do not always take quickly to new solutions. The combination of the above developments works against traditional consolidation in the banking sector.

The political landscape is also not very conducive to pan-European banking.

Whilst a lot of efforts are being undertaken to complete the Banking Union, there is a continuing resistance from 'host' authorities within the Eurozone, hampering the free flow of funds. This is also reflected >>>

>>> by the fact that the third pillar of Banking Union, EDIS, has not been established yet. As a consequence, capital and liquidity within the SSM and the eurozone economy is usually trapped at the national level, limiting financing of the broader economy. The existing limits to fungibility of deposits across jurisdictions and remittance of capital from subsidiaries to the parent should be lifted as a matter of priority. We also observe an asymmetric use of macroprudential tools by competent authorities across core eurozone countries that is distorting the level-playing-field. Higher capital buffer-requirements negatively impact opportunities for loan growth, adequate capital returns and the ability for to play a role in European banking consolidation. The same concerns exist with respect to future internal MREL requirements. All of this results in substantial inefficiencies and additional costs for banks and their customers.

Finally, there are also internal considerations for banks to consider. Important risks in a merger are the execution risk (e.g. system and IT integration require a lot of management attention) as well as the impact on the fulfillment of the banks own strategic objectives. ●

Kalin Hristov

Member of Governing Council,
Deputy Governor, Issue Department,
Bulgarian National Bank

Why the Banking Union is not a reasonable option for non-euro area countries?

The creation of the Banking Union was a response to the banking and sovereign crisis in the euro area. While impossible to prevent occurrences of future banking crises, a well-designed Banking Union should minimise their likelihood or their systemic impact for the EU banking systems.

The Banking Union was launched in the euro area but, being based on EU law and needing to respect the integrity of the Single Market, was left open for participation of the non-euro area Member States. The latter, however, have so far shown no interest. A summary of reasons explains why.

A primary objective of the Banking Union was to intensify integration of banking supervision and thus reduce market fragmentation. Another key motivation was to ensure more efficient supervision at the national level, unimpeded by non-prudential considerations stemming from industry pressure on domestic supervisors.

However, these expected merits of the Banking Union invoke different perspectives from the non-euro Member States.

First, a degree of market fragmentation/differentiation may be "healthy". Such differentiation, among other things, reflects risks associated with a particular national economy or banking system. Country-specific risks always remain. They need to be differentiated, not blurred, to let market forces play their disciplining role.

Second, the argument against regulatory capture can also extend to a unified supervision. Whereas a banking entity of only domestic significance may hardly influence a supranational supervisory authority, this may not be the case with big cross-border banks.

In addition, there are clear disincentives embodied in the "close cooperation", the mechanism devised for Member States whose currency is not the euro to join the Single Supervisory Mechanism.

A country with "close cooperation" will face hugely asymmetric treatment:

- It will remain excluded from the ultimate decision-making on supervisory issues in the ECB Governing Council.
- The supervisory decisions of the ECB, which are not legally binding outside the euro area, will have to be replicated by acts of the domestic supervisor. The latter will be held responsible and liable in case of disputes.
- It will remain without access to ECB liquidity assistance.
- It will have no access to the ESM as a potential source of funds for direct or indirect bank recapitalisations.

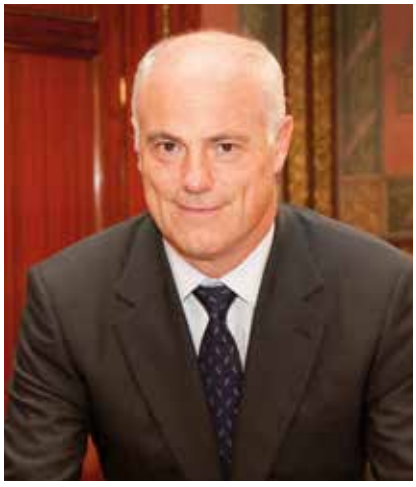
The asymmetries and inequalities between euro area and non-euro area Member States are further exacerbated in the Single Resolution Mechanism, which is automatically joined if a country joins the Single Supervisory Mechanism with "close cooperation".

The above provides reasons why it is risky to join the Banking Union with "close cooperation" before becoming a member of the euro area. ●

Jose Manuel Campa

Global Head of Regulatory Affairs,
Grupo Santander

Complete the Banking Union to have European banking



Since the outbreak of the financial crisis, important steps have been achieved and risk reduction measures are being implemented.

Banks are now more prepared to face crisis situations. We have seen the successful implementation of the Single Supervisory Mechanism and the Single Resolution Mechanism, stronger prudential requirements for banks under CRDIV/CRR and a final agreement on Basel III, the new loss absorbency requirements push beyond the resilience of financial institutions, and the Deposit Guarantee Scheme Directive harmonised their coverage. All these measures have fostered risk reduction, contributing to reduce financial fragmentation and the link between banks and their sovereigns.

The European Deposit Insurance Scheme is the missing piece to complete the Banking Union and we need to >>>

>>> move forward to achieve this goal. As long as DGSs remain purely national, the vicious circle is not completely broken, and Member States and financial institutions will continue to be exposed to financial instability. Both depositors and national authorities clearly understand that although supervision is European, national treasuries remain the backstop for national deposit insurance schemes. Retail depositors must feel the same level of protection irrespective of their location.

"The European Deposit Insurance Scheme is the missing piece to complete the Banking Union."

- JOSE MANUEL CAMPA

We welcome the Commission's proposal for a European Monetary Fund. In the absence of such a backstop, there is a risk in the case of "large local shocks", national authorities themselves would have to support banks established in their jurisdictions leading to the reemergence of the sovereign-bank risk nexus. We need a credible liquidity backstop that allows the implementation of resolution plans. It also has to give confidence in the stages previous to resolution.

This helps to explain the still low level of cross-border consolidation in the Banking Union. However, broader issues also need to be addressed. The Banking Union is still incomplete due to very heterogeneous national legal frameworks, as national product diversity and insolvency laws illustrate, and differences in national supervisory practices still remain despite the progress achieved by the SSM. These differences result in retail banking markets that continue to be aligned along national borders. As a result, there are limited synergies available to gain in a cross-border transaction inside the Euro zone. Banking consolidation also demands more transparency and market discipline must apply to all euro-area financial institutions. This requires significant changes in corporate and ownership structures among European banks. Some relevant data are: 58% of European significant entities in the EMU are unlisted and more than 31% of Euro area significant entities are in control of the public sector.

In a context of political momentum among key Member States to further advance in the Economic and Monetary Union, completing risk reduction and addressing risk sharing measures should help push the banking union forward. ●

Nicolas Duhamel

Head of Public Affairs, Member of the Executive Committee, Groupe BPCE

Let's reinforce the Banking Union while acknowledging diversity

It is striking to note that today many of us would agree that fragmentation in banking remains a fatality inherent to the renewal of banking regulations.

This, however, only paints a partial picture. We have made significant progress since 2009. Regulatory and supervisory harmonisation at EU level is today a reality. One just needs to think about the CRDIV/CRR, the creation of the ESAs, the development - from scratch - of the Banking Union, the SREP or the launch of the Capital Markets Union.

We supported all these reforms. Initially they had one single goal: avoiding another crisis and ensuring financial stability. Later we added fostering economic growth. Both goals can be compatible. But distrust between Member States now creates clear gaps in the Banking Union, especially at cross-border level.

On essential point to address this distrust is to have workable banking resolution framework whereby host competent authorities are fairly associated to all the supervisory and resolution decisions in the same way as their home colleagues. Moving in this direction would leave open the door to ending the "solo approach" of the EU banking regulatory and supervisory framework which does not consider transnational banking groups in the EU at the consolidated level, but as a sum of separate subsidiaries.

However, this would not address all of problems. We could be lacking proportionality as well. A one-size fits all approach could play part in fostering more distrust than necessary. Surely, there have been national reactions against EU harmonization (gold-plating in home jurisdictions and conversely the persistence of less stringent options and national discretions). Moreover, we should not forget the tendency to confuse harmonisation with uniformisation and apply to all banks or to all portfolios the same set of criteria, despite the diversity of business models and corresponding risks. This in turn could exacerbate national reactions.

It could therefore be interesting to consider recognizing different banking ecosystems across the EU, with the consequences that specific markets (such as real estate or specialised lending) need a different treatment when finalising Basel III. This is how proportionality could help the Banking Union.

Doing so could also help us set the first steps for a unified voice when negotiating at the BIS, IOSCO or FSB. This in turn would allow us to develop our internal market within a fair competitive environment while not weakening at all the need to ensure financial stability. ●

EDIS and SRF backstop : expected benefits and success factors

Sabine Lautenschläger

Member of the Executive Board
& Vice-Chair of the Supervisory Board,
European Central Bank (ECB)

Risk reduction in the euro area – how low can you go?

The financial crisis demonstrated that risks need to be kept in check, both at bank level and at systemic level. To that end, the euro area has taken many steps over recent years. It has grown closer together and this has helped to reduce risks.

The European banking union is the centrepiece of these efforts. The first pillar, European banking supervision, was set up in 2014 to ensure that banks across the euro area are supervised to the same high standards. To that end, we have harmonised the supervisory approach applied to the 118 largest banking groups. In the process, we made use of the discretion contained in both the European and the national frameworks. This enabled us, for example, to move in 2014 from 19 different Supervisory Review and Evaluation Processes to a single harmonised one. This and many other changes in day-to-day supervision help to reduce risks and ensure that banks remain both safe and sound.

The second pillar of the banking union was established in 2016: the Single Resolution Mechanism. This ensures that banks can fail in an orderly manner. The failure of a bank must not pose a threat to financial stability or to public funds. Recent bank failures have shown that the new system works; supervisory and resolution authorities have cooperated smoothly and effectively.

This new institutional set-up is a good basis for reducing risks, but it needs further refinement. Regulation, for instance, needs to be further harmonised. To reap the full benefits of the banking union, we need a harmonised regulatory framework.

First, there is the issue of options and national discretions (ONDs). While some of these ONDs have been harmonised by supervisors, others lie in the hands of national legislators. Waivers for large exposure limits, for instance, are still fragmented across the euro area. This in turn affects other cross-border waivers, such as that on liquidity requirements. More generally, it stands in the way of a truly European banking market, as do the other ONDs that fall within the competence of national legislators. >>>

>>> Second, recent bank failures have shown that we need to further harmonise the tools for crisis management. We need to remove the overlap between standard supervisory measures and early intervention measures, for instance. As we are obliged to apply the least intrusive tool, the overlap often prevents us from taking early intervention measures. We also need to expand our toolbox to include a harmonised moratorium tool. Finally, national insolvency laws need to be aligned. All this would make the Single Resolution Mechanism even more effective.

These measures will help to better contain risks in the future. However, we also have to reduce the risks we face today. Non-performing loans (NPLs) currently pose one of the biggest risks to the European banking sector. They need to be dealt with first and foremost by the banks themselves. Some progress has been made on this front, although more needs to be done. In addition, supervisors need to play their part. European supervisors closely monitor how banks approach NPLs, and in 2017 and 2018 the ECB published guidance on the subject. The aim is not only to resolve the current NPL problem, but also to keep it from recurring in the future. Finally, legislators also need to address the issue of NPLs. Across the euro area, legal and judicial systems differ substantially in terms of effectiveness and efficiency when it comes to dealing with NPLs. The time and resources required to resolve NPLs thus differ from country to country. National legislators should strive to improve legal and judicial frameworks. In the end, tackling NPLs requires a joint effort by banks, supervisors and legislators.

To sum up, there are still things we can do to reduce risks in the euro area. In doing so, we will grow closer together, and that in turn will help to reduce risks further; European banking supervision is a prime example of this. We must thus be careful not to reach a point where we neither reduce risks nor grow closer together. We have to keep moving on both fronts; only then will we reach our destination of a more stable and prosperous European Union. ●

Esther de Lange

MEP, Committee on Economic and Monetary Affairs, European Parliament

A healthy lifestyle or effective medication

Now that the euro area is experiencing a period of economic upturn - despite its modest nature and downside risks stemming from external developments - it is important to continue to strengthen the foundations and the architecture of our financial system and our banking sector. Europe's Banking Union and its Single Rulebook are not yet finished and therefore work on creating a European deposit insurance scheme needs to continue. On the other hand, in every Member State deposit guarantee schemes are already active and the safety of citizens' deposits would be helped more - at least at this point in time - with national DGS funds actually being filled and with banks cleaning up their balance sheets rather than with mutualisation of national deposit insurance funds into a fully mutualised European fund. The latter, in any case, should never be an excuse not to do the former.

Healthy banks and thus a healthy Banking Union start with a sound foundation and future-proof balance sheets. Take non-performing exposures, for example. Granted, for many reasons Europe has always had slightly higher NPL rations than, for example, the Unites States. Also, on an aggregate level, the reduction of NPLs is clearly taking shape. However, NPL ratios in the euro area are still nowhere near to historical or pre-crisis levels. The immense divergence between Member States is furthermore striking. The recently published Commission proposals on the issue will give co-legislators more options to address this problem and are to be welcomed.

Secondly, look at sovereign risks. Breaking the bank-sovereign nexus is extremely important. Tax payers should never again foot the bill for the failure of credit institutions. A European deposit insurance scheme, funded by banks, to provide immediate liquidity support and - if conditions are met - loss cover, is a vital element to addressing the issue. But why are we not tackling the issue of the enormous amount of sovereign debt on the balance sheet of banks? Some credit institutions have multiple times >>>

>>> their amount of CET1 capital of sovereign debt of only one sovereign on their balance sheet and very often that sovereign is the Member State the bank is operating from. A sovereign debt problem in that Member State will automatically constitute a major problem for many of its banks. For the stability of our Banking Union and towards breaking the bank-sovereign nexus, addressing this issue is just as important as EDIS.

The different opinions on EDIS can thus be characterised by a medical metaphor. Do we (first) want to make sure the patient is healthy or is it fine not to care much about its general health, but rather ensure that effective medication is available should the patient fall ill? Sure, sick patients need to be treated with good medicine. But let's also try living a healthy lifestyle. The two have to go hand-in-hand, there is no other way.

The Commission Banking Union Communication provides a possible way to make progress already now. Co-legislators could try, for the moment, to focus on a system based on full and immediate liquidity support and leave the sharing of losses for a later moment, after enough risks have been reduced and more health has been restored. The fact that DGSs and EDIS are shielded by credit institutions' higher MRELs and by the super priority of deposits, will make sure that the liquidity will also easily be repaid, without extra levies on the national banking sector or intervention from the Member State. A repayment plan giving enough time for recoveries from the insolvent estate to materialise should be part of the liquidity support.

Deposit insurance is above all about confidence-building. Let us give our citizens that confidence in the safety of their savings: let's make sure currently well-functioning systems continue to operate, let's make sure our banks live a healthy lifestyle by reducing risks and let's continue work on good medication in case we do get sick by starting with the liquidity phase of EDIS as soon as possible. ●

Olivier Guersent

Director General for Financial Stability, Financial Services and Capital Markets Union, European Commission

Getting ready for future unforeseen risks

In the debate regarding the reduction of risks in the banking sector it is sometimes assumed that the regulator (the Commission) should intervene continuously to get rid of all possible risks. This reasoning is however not correct since it doesn't take into account two main aspects: the first is that there will never be – and hopefully so – a banking sector where there are no risks. Banks are made to take risks and by doing that they have an extremely important role in the economy and the society because they lend money to the people and allow them to set up businesses, invest or simply carry out their daily activities.

The second is that not all risks can be foreseen in advance. You can try to put in place rules that mitigate or reduce the risks you know on the basis of past experiences but what about the new risks that might arise in the future? Financial services evolve rapidly and even more so now with technology. As a regulator what you should do is twofold: ensure that the banks and crucial financial infrastructure are resilient enough to withstand shocks and, create a sound framework able to limit contagion. The Banking Union was conceived to provide such a framework with its three pillars: Single Supervisory Mechanism (SSM), Single Resolution Board backed by a credible backstop (SRB) and European Deposit Insurance Scheme (EDIS).

We have done a lot in the last years to reduce risks in the banking sector and the fruits of this work are visible. Since the onset of the financial crisis, the EU has adopted over fifty proposals aimed at increasing the resilience of the financial sector. All these measures have contributed to a strong improvement in European banks' capital and liquidity positions, ensured better governance and supervision of the banking sector and set in motion a process of significant enhancement of banks' resolvability. This work will continue in the future but rules on banking activity cannot make up for the absence of a completed institutional framework.

The Banking Union must be completed without delay if we don't want the EU banking system to be still vulnerable in case of crises. An important cornerstone, the European Deposit Insurance System (EDIS), is still ahead of us. EDIS would underpin stability in the banking sector by providing strong and uniform insurance coverage for all such depositors, independent of their geographical location in the Banking Union.

The Banking Union also still lacks an effective common backstop to the Single Resolution Fund (SRF) to reinforce the overall credibility of the bank resolution framework within the Banking Union. SRB (with its single resolution fund) and EDIS (with its deposit insurance fund) are complementary tools and both needed to minimise the consequences that failing banks may entail for the economy and the people in the Banking Union.

The SRB is deemed to intervene to ensure the orderly resolution of significant banks and other cross-border groups, whilst EDIS would be the mechanism to be used when smaller banks are put into liquidation. It should equally not be forgotten that both EDIS and the SRB are also risk reducing tools, because by contributing to the overall stability of the EU system they reduce the likelihood of future crises. Exposure of banks to their sovereign is an area where workable solutions should be found taking also into account the international dimension. However, this should only be done once the Banking Union (with a functioning backstop to the Single Resolution Fund and a common deposit insurance) is completed, sufficient progress on Capital Market Union have been achieved and suitable common European safe asset is introduced to avoid introducing in the EU system more risks. ●

Fabrizio Saccomanni

Chairman, UniCredit S.p.A.

Completing the Banking Union is necessary to reduce systemic risks and foster stability

For years, the EU has de facto accepted the idea that a Single Currency was possible without the remaining elements of the institutional architecture needed to support it, a genuine Economic and Monetary Union (EMU). However, the financial crisis put an end to this illusion.

The first step in the process of completing the EMU was the launch of the Banking Union (BU). However, after more than six years, the BU has yet to be completed to deliver its full potential. While much has been done in terms of guaranteeing that banks are supervised and, in case of failure, resolved according to the same standards thanks to the establishment of the Single Supervisory and the Single Resolution Mechanisms, two further crucial elements are still missing. In terms of bank resolution, in the event that several banks were to experience a near-to-default crisis, the Single Resolution Fund (SRF) might not be enough.

A common backstop would reinforce the credibility of liquidity sources available to resolution authorities in case of systemic crises. As the backstop would only be activated as a last-resort, the chances that it would ever be needed are very low. Yet, its existence would send a strong signal that, even in a worst-case scenario, the Eurozone stands united and would also allow more time for banks to replenish the depleted national resources that support the Single Resolution Fund; thus lessening the capital impact of a single bank resolution on the national banking system. In terms of deposit insurance, finalising the BU would mean avoiding differences among DGSs which could lead to fragmentation and thus limit banks' appetite for cross-border banking. With a strengthened BU, cross-border banking groups should be able to transfer excess capital and liquidity across their groups and across borders, with supervision at a consolidated level.

This would foster the stability of the Eurozone's banking groups, promote growth and, by reducing risk premiums across the BU, facilitate the transmission of monetary policy impulses by the ECB. Moreover, banks would be in a better position to serve the real economy and extend credit where it is most needed. Not only would banks be able to offer more services to their large corporates or help SMEs to expand their businesses across borders, but they would also be able to achieve economies of scale. All this would help them become more profitable.

The completion of the BU should now be considered priority again: it should not be deemed a "risk sharing" measure to be compensated by "risk reduction" in other areas. Completing the BU would actually reduce the risks of systemic crises and strengthen the resilience of the EMU. With the EU economy enjoying a recovery and with the end of the European Parliament's term approaching, now is the right time to act. ●

Dr. Karl-Peter Schackmann-Fallis

Executive Member of the Board, Deutscher Sparkassen- und Giroverband (DSGV)

EDIS – Why centralization threatens today's level of depositor protection

Play to your strength. What applies to each of us in our daily challenges also applies to depositor protection in Europe. Understand the strength you have. Use it effectively. And do not give it up while you need it.

A source of strength is the diversity of the EU Member States' market structures. Today, depositors in all Member States are already protected up to 100.000 Euros under the Deposit Guarantee Scheme Directive (DGSD) of 2014. Hence, we face a harmonized European Deposit Guarantee Scheme (DGS)-landscape. The additional European Deposit Insurance Scheme (EDIS) is not a tool of harmonization but of centralization. In sharp contrast to the DGSD, EDIS eliminates justified options of national discretion, thereby ignoring existing differences in market structures. But diversity is a strength and its retention a political EU-objective. EDIS on the other hand aspires unification through centralization without regard to costs.

To give examples: credit institutions in highly concentrated markets, like France, have only 60 % contributions to national DGSs when compared to other Member States. The DGSD justifies this convincingly. Nevertheless, EDIS eliminates this option without being itself justified by changes of the French market.

The same problem applies to alternative measures. The DGSD explicitly allows DGSs to use their funds for

alternative measures in certain cases. EDIS eliminates this option without justification. This is not trivial, as it could mean the end for Institutional Protection Schemes (IPSs) that are officially recognized as DGS in accordance with DGSD. Under >>>

>>> EDIS, they will have to transfer all funds to a European Fund in Brussels. It is very doubtful if they will be able to raise lost funds a second time through additional contributions from their member institutions.

Pushing for a centralized European deposit insurance with mutualized funds breaks the bond between risk and liability. It introduces the danger of moral hazard. Risk and liability should not be separated.

Another word of caution, when looking at today's discussion of a statistical reduction of Non-Performing Loans (NPLs): Let this not make us rush into EDIS. Legacy risks are not restricted to NPLs. Moreover, we do not have a harmonized insolvency law within the EU. And a coerced European centralization could very well be the missing link that will allow risks to leap from one Member State to the other, endangering financial stability.

Enhancing trust and depositor protection within the framework of the Banking Union needs a well-conceived construction. A pure centralization of DGSs is not the adequate approach. Instead, elements of European and national facilities, as well as different means of protection and stabilization should be taken into consideration. Small and regional credit institutions, such as the German Savings Banks, have been making use of IPSs for decades. Their IPS has more than 40 years of experience protecting depositors. To promote financial stability and to encourage local banking, EDIS needs to incorporate existing IPSs. ●

Ricardo Gómez Barredo

Director Accounting & Supervisors, Banco Bilbao Vizcaya Argentaria (BBVA)

EDIS is the main challenge for a credible fully–fledged Banking Union

After the consolidation of the economic recovery in Europe and the electoral cycle, the debate on the future of the Euro is regaining strength. In that sense, completing the Banking Union with a common backstop for the Single Resolution Fund (SRF) and the creation of a European Deposit Insurance Scheme (EDIS) are now crucial in order to finalize the Banking Union.

The Banking Union was designed to be based on three pillars: Single Bank Supervision, Single Bank Resolution and Single Deposit Insurance, all of them crucial to address the bank-sovereign negative feedback loops which were at the heart of the crisis. As of today, the two first pillars (supervision and resolution) are fully operational in the Eurozone thanks to the Single Supervision Mechanism and the Single Resolution Mechanism. However, the new resolution framework needs a backstop for the Single Resolution Fund to be credible. In other words, this pillar needs appropriate funding and also a large enough public backstop in order to be able to fund the resolution of large banks and play its role as an effective resolution tool.

Already in June 2015 *The Five Presidents' Report* set out a number of steps to further strengthen the European Monetary Union (EMU), stating that a single banking system was the mirror image of a single currency. As the vast majority of money is in bank deposits, the report stated that currency could only be truly single if confidence in the safety of bank deposits was the same irrespective of the Member State in which banks operated. Nowadays, the Single Deposit Insurance is still not in place, so there is a pillar missing. It is time to move towards EDIS as a further step for a fully-fledged Banking Union, as this scheme would be a milestone in the construction of the European Single Market and in order to reinforce EU financial stability: it would improve confidence in the safety of retail bank deposits, regardless of a bank's location in the Union and thus weaken the current link between banks and their national sovereigns debt. This in turn would ultimately enable more lending to the economy, and therefore higher growth and more jobs.

To achieve this goal the Eurozone must put in place a fully mutualized EDIS following a process of gradual increase in risk-sharing, that must go hand in hand and in parallel with risk reduction in a reasonable timeframe to finalize the Banking Union project. Giving up on this objective would imply giving up in achieving a complete Banking Union, and therefore on the potential economic growth it would entail and on the European common project. ●

Elke König

Chair, Single Resolution Board (SRB)

Design of Deposit Insurance in the EU as compared to the US

Given the importance of coordination for managing the failure of international banks, the SRB will strive to work with international authorities to make banks resolvable. In the European context, the SRB supports completion of the Banking Union and this includes the finalisation of EDIS and the backstop to the SRF. Work on EDIS has been ongoing since November 2015, and the SRB has since engaged on this important file. Recently the European Commission has suggested new ideas to break the political deadlock. We hope that these ideas are successful in moving the issue forward as soon as possible. >>>

>>> Since the beginning the SRB has advocated to consider the DGS – be it national or European – as more than just as a paybox. We also view it as important that the eventual EDIS proposal provides for the use of alternative measures, so that the authorities retain the discretion which is currently provided for in the Deposit Guarantee Scheme Directive, although this is not implemented in all Member States.

The FDIC is able to undertake purchase and assumption transactions, which can be compared to the alternative measures provided in the Deposit Guarantee Scheme Directive. Of course, this must be conditional on constraints but also on having the necessary funding available. If we look across the Atlantic, we can see that the US has a Deposit Insurance Fund which is pre-funded and managed by the FDIC, which has adopted a 2% Designated Reserve Ratio each year since 2010.

"Implementing EDIS would centralise deposit guarantee funds and align the EU and US more closely."

- ELKE KÖNIG

By comparison, in the EU we have two prefunded facilities to address bank failures: Deposit Guarantee Funds at the national level and the Single Resolution Fund. Implementation of EDIS could ultimately centralise the deposit guarantee funds and would therefore align the EU and US more closely in this regard (even though the EU would still retain two separate pre-funded facilities).

The backstop to the SRF should also be completed. For this, the SRB has been clear about the principles on which the backstop should be based. Access to the backstop should be aligned with the rules for the use of the SRF and it should take full advantage of synergies with the existing framework. It will be critical that the provider of the backstop is able to make funds available within a short timeframe and that the conditions around access are clear and simple. A duplication of tasks between the SRB and the backstop provider should be avoided. By following these principles, we can ensure that the backstop will be able to support the resolution authority's actions effectively as a last resort. ●

Felix Hufeld

President, Federal Financial Supervisory Authority, Germany (BaFin)

Enhancing the stability of the Eurozone banking system - things can always get better

Oscar Wilde once said, "Everything is going to be fine. If it's not fine, it`s not the end." Although he certainly wasn't thinking about financial crises, this quote describes the efforts of regulators to restore financial stability after a crisis particularly well. Despite the many achievements that have been made, their work never really ends and remains in progress.

If we look back at the financial crisis in 2007/2008, considerable improvements have certainly been made since then. In the European banking sector, we have built resilience by significantly improving the quantity and quality of own funds requirements for banks' balance sheets. In addition, risk management and governance structures are now subject to more stringent requirements. And we are in a much better position to resolve systemically important banks without damaging the public interest. And yet no one can rule out that other financial crises will erupt – because crises unfortunately tend to spread in places where nobody expects them.

At European level, the focus is currently on the risks arising from high levels of non-performing loans (NPLs) in a number of Member States. The favourable macroeconomic climate should be used in order to further mitigate these risks. Last year, the European Central Bank (ECB) issued a guidance document with supervisory expectations for addressing non-performing loans. An addendum to this guidance was also published on 15 March, setting out the prudential provisioning expectations for new NPLs. Institutions should shift towards timely provisioning in order to avoid another excessive increase in NPLs. The European Commission, too, has presented measures to sustainably reduce NPLs.

Germany supports all efforts to develop a consistent and effective supervisory approach.

Another project is a common backstop which would facilitate borrowing by the Single Resolution Fund (SRF) should the funds from contributions from the banking sector be insufficient. According to the roadmap of the Economic and Financial Affairs Council (ECOFIN), this backstop is to be established by the end of 2023 at the latest. However, this issue should not be rushed, and the focus should be on quality. And, in line with ECOFIN's roadmap, the backstop should be set up early only if the risks for the banking sector have been significantly reduced beforehand. The role of the European Stability Mechanism (ESM) is yet to be determined. If the backstop is to be financed by the ESM, this would require amendments to the basic treaties. Both a sovereign debt restructuring mechanism and improved crisis prevention would then have to be on the agenda.

Despite all the issues that are yet to be resolved, we are on a completely different level in financial regulation compared to the situation ten years ago. And if the status quo is not yet good enough, our work as regulators – to loosely quote Oscar Wilde – has not yet come to an end. ●

Resolution and liquidation of EU banking groups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Elke König

Chair,
Single Resolution Board (SRB)

MREL: stocktaking and way forward

As the SRB keeps saying, MREL is a journey. It is a journey with a clear destination – to ensure banks' resolvability, thereby strengthening financial stability and safeguarding taxpayers' money. The SRB is not alone on this journey. Alongside the national resolution authorities (NRAs), we engage closely with the industry to illustrate the envisaged methodology, seek feedback and define step by step the final policy.

In December 2017 the SRB published its MREL policy for 2017, detailing the progress made and the work awaiting us. The SRB has taken a gradual, multi-year approach to MREL, that takes into account the specificities of the banks under its remit, with the goal of maintaining proportionality in the system while preserving a level playing field and upholding high resolution standards across the Banking Union.

The SRB, together with the Banking Union NRAs, started to develop its MREL approach in 2016, with informative targets that sought to enable banks to prepare for their future MREL requirements. For the 2017 resolution planning cycle, the SRB moved from informative targets to bank-specific, binding consolidated MREL targets for the majority of the largest and most complex banks in the euro area, including all global systemically important institutions (G-SIIs).

As in 2016, the 2017 MREL is calculated at consolidated level as the sum of a loss absorption amount and a recapitalisation amount, complemented by a market confidence charge. As a new feature, some bank-specific adjustments were introduced for the recapitalisation amount and the market confidence charge, by referring to the effect of balance sheet depletion, the use of recovery options, or restructuring plan divestments and sales.

The SRB has also moved forward with respect to the quality of MREL, by introducing a first subordination benchmark for other systemically important institutions (O-SIIs) in addition to the subordination for G-SIIs introduced in 2016. In concrete terms, G-SIIs will be required to meet a minimum subordination level equal >>>

>>> to 13.5% RWA plus the combined buffer requirement (CBR); for O-SIIs, the benchmark is set at 12% of RWA plus the CBR.

Regarding the eligibility of liabilities, the SRB has clarified that non-covered non-preferred deposits are excluded unless there is evidence that they cannot be withdrawn within a one-year period. The SRB also took a cautious approach towards liabilities governed by the laws of a country outside the EU, which are generally excluded, unless there is evidence that the write-down or bail-in of those liabilities by the SRB would be recognised by the courts of that country.

For other banks within its remit, the SRB considered that an iterative process, without taking an immediate binding decision on MREL, is preferable. For the less significant institutions that are not within its remit, the SRB will act through its oversight function and assess the conformity of draft resolution measures for LSIs that NRAs notify us, in accordance with the SRM Regulation. These include resolution measures to be adopted, such as draft resolution plans, MREL and resolvability assessment, as well as decisions to apply simplified obligations.

MREL will continue to be one of the key areas of work for the SRB in 2018. To underpin resolution planning, the SRB will develop guidance for the Internal Resolution Teams on solo/internal MREL and MREL calibration under transfer strategies. Internal loss-absorbing capacity is crucial to ensure that, within a group, losses are passed from the entities where they originate to those entities where resolution action is coordinated. The SRB will also work further on defining the need for subordination, not least in light of assessing any challenges from the NCWO principle.

The SRB will develop its approach based on the current legislative framework, and strive to implement internal MREL for banking groups with resolution colleges during the 2018 planning cycle. At the same time, we are following closely the ongoing negotiations on the revision of the BRRD and SRMR to prepare for a revision of our MREL policy, including on bank-specific targets and transition periods.

MREL is a crucial tool to improve banks' resolvability. No responsible management should take a 'wait and see' approach – the direction of the journey is clear. ●

Fernando Restoy

Chairman, Financial Stability Institute, Bank for International Settlements (BIS)

The EU bank resolution framework: the challenge of the middle class

The resolution framework in the EU, as set up in the Bank Recovery and Resolution Directive, is quite stringent. It not only heavily restricts the availability of public funds to assist weak financial institutions, it also prescribes that a minimum of 8% of total liabilities must be bailed in – as a necessary but not sufficient condition – before the Single Resolution Fund can start deploying the resources required to execute the resolution strategy. Banks may also be required to hold on their balance sheets a minimum volume of liabilities that could be bailed in in the event of resolution (MREL).

The Single Resolution Board (SRB) has already hinted at the adoption of a relatively demanding approach for institutions under its remit. MREL requirements would normally imply around 25–27% of risk-weighted assets, on average, for institutions under the SRB's jurisdiction.[1] As a consequence, the European banking industry will need to make up a large shortfall of eligible liabilities that could be between €130 billion and €285 billion.[2] Moreover, the shortfall may be disproportionally high for significant medium-sized institutions that are predominantly financed by capital and deposits – to the point of challenging the sustainability of their business model.

It seems therefore that the effectiveness of the new resolution >>>

>>> framework could require the banking system to be organised into two well defined segments. The first one would be composed of systemic financial institutions with active participation in capital markets that would be subject to the resolution procedures, including bail-in, in case of failure. The second segment would be composed of truly unsystemic institutions that would be subject to regular insolvency procedures. There is therefore no clear room for a "middle class" of institutions whose failure – and eventual liquidation – could be considered systemic but whose business model appears incompatible with the satisfaction of stringent MREL requirements.

In any event, as not all banks could be subject to effective bail-in under a resolution framework, it is natural to expect that in the future a higher proportion of failing banks will be subject to insolvency procedures. That suggests working on developing a specific – and ideally common – regime for failing financial institutions that could help insolvency processes to become swifter and more able to preserve the remaining value of the institutions.

In addition, in the context of the discussions on the creation of a European deposit guarantee scheme (EDIS), it would make sense to provide this fund with receivership functions, following the US FDIC model. EDIS could thus facilitate the winding-up of insolvent institutions not subject to resolution using tools such as the creation of bridge banks, the sale of business or the purchase and assumption formula. That would certainly provide an alternative way to facilitate the orderly management of the crises of small and medium-sized institutions that help mitigate the impact of the new resolution framework on the structure of the banking industry. ●

1. See D Laboureix, Sixth industry dialogue: 2017 MREL policy, Single Resolution Board, November 2017.
2. See EBA, Quantitative update of the EBA MREL report, December 2017.

Bernard de Longevialle

Managing Director, Head of Financial Services & Sovereign International Public Finance Ratings for EMEA region, S&P Global

Europe's crisis management framework: ready for the next downturn?

S&P Global Ratings shares the widely held view that the EU has achieved much in a short time by strengthening its crisis management framework for the financial sector. It has had a positive impact on our ratings on European banks.

The EU framework casts its net wider than other frameworks. A material share of EU banks are subject to ECB supervision and all banks are subject to MREL requirements. Europe has many midsize banks, and in a systemic crisis the default of even small banks could have ripple effects on investor sentiment. Its wider scope reduces the cliff-edge effect that could result from focusing on the largest banks only.

The EU approach to resolution is also more flexible and understandably more cautious, in our view, than in the U.S. Specifically, it acknowledges that large systemic banks are very difficult to liquidate, and that their resources are finite. Therefore, unlike the U.S., the EU provides a backstop for deserving cases through the Single Resolution Fund and allows for banks to tap central bank emergency liquidity assistance. Even government support remains an option in the EU under certain, limited circumstances.

"A key weakness of the framework is the lack of urgency about finishing it."

- BERNARD DE LONGEVIALLE

A key weakness of the framework is the lack of urgency about finishing it. More than two years after bail-ins have become mandatory under the BRRD, banks in many countries still cannot issue senior non-preferred debt. Further, how authorities wish to ensure funding in resolution remains fuzzy. As long as banks lack properly positioned bail-in capacity or sufficient stressed liquidity resources, the authorities will continue to face tough choices and be forced into pragmatic solutions.

Resolvability cannot be achieved overnight, and we do not underestimate the scale and complexity of the task in the Banking Union in particular. Yet, regulators and banks in other countries such as the U.S., U.K., and Switzerland have made material headway in communicating their preferred resolution strategies and issuing sizable bail-in capacity. They are already working on reducing operational obstacles to resolution.

Finally, while the Banking Union has made huge progress in harmonizing and raising prudential standards, it retains a patchwork of regulatory supervision. This could lead to an ineffective response in an emerging crisis.

In 2018, we anticipate substantial issuance of bail-in instruments from major EU banks as they gain greater clarity about their MREL requirement. However, the market for European MREL bonds still needs to develop. In our view, transparency to investors about banks' definitive qualitative and qualitative MREL targets would enable investors to make better informed decisions, given the consequences of breaching MREL requirements. Transparency might also allow insight into the authorities' preferred resolution strategy, which so far remains guesswork, particularly for midsize institutions. It would also shed light on the size and timing of issuance volumes.

The MREL ramp-up is even less clear for banks in smaller markets such as those in CEE with high deposit funding and capital, but limited capital market access. Prepositioning discussions might also raise the familiar tension between home and host regulators that is already well known in the Banking Union. ●

Wilson Ervin

Vice Chairman, Group Executive Office, Credit Suisse

Ring-Fencing – a policy built to backfire

Host authorities should resist the urge to ring-fence bank resources like capital or liquidity within their national borders. A recent Credit Suisse paper demonstrates analytically that such an approach may in fact increase the risk of bank failure by 5 times or more. This doesn't impact just the bystander jurisdictions – it increases risk for the ring-fencers themselves. These results warrant close attention and we believe they could have significant policy implications, both at the international level and within the EU.

In 2008, economic stress pushed major banks like Fortis Bank or Lehman Brothers into an unplanned 'crash-landing' that imposed losses on many entities in both home and host countries. Banks were said to be "international in life, but national in death." Many thought that the smart strategy for host regulators was to move aggressively to protect local operations against these risks, and trap local capital and liquidity by ring fencing. Despite the major reforms enacted since then to increase capital, liquidity and to introduce resolution planning with strong gone-concern bail-in capital, many host authorities still pursue a nationalistic approach.

Does Ring Fencing make banking safer? Our working paper[1] demonstrates that ring-fencing increases the risk of banking for both hosts and home - and that the impact can be large. At first, ring-fencing seems to work - there is an advantage for a single ring-fencer if other jurisdictions do not match that decision. The first ring-fencer benefits from both local capital and the ability to tap a large central reserve in times of need. However, if other jurisdictions adopt countervailing ring-fencing policies, then the benefit of a pooled 'central reserve' is stripped away and ultimately all jurisdictions become worse off. In addition to limiting the available resources to recapitalize a failing subsidiary, trapping capital and liquidity compartmentalizes banking groups reducing diversification, which in turn increases risk.

This is analogous to a 'prisoner's dilemma', an economic paradox where each participant seeks to achieve a local benefit, but ends up worse off when others also pursue their own incentives. But the problems of the prisoner's dilemma can be avoided if the participants can cooperate and build mechanisms to share in the gains from a more enlightened approach.

The trajectory of the Banking Union promises hope for a more cooperative stance. The current nationalistic approaches actually make banks less safe and also prevent banks from capitalizing on the cost, scale and diversification advantages a fully developed Banking Union would bring. This is wholly consistent with the economic logic that has underpinned the growth and prosperity of the EU, and it's important that it be extended – thoughtfully - in critical sectors like banking.

> *"The trajectory o the Banking Union promise hope for a more cooperative stance."*
>
> - WILSON ERVIN

In our paper we propose a bold new solution that protects hosts (and home) jurisdictions in a more robust way, building on the new post-crisis bank resolution architecture. As MREL and resolution plans mature, nationalist approaches become increasingly counterproductive. We hope this prompts a broad new debate. However, in the short-term, there are small but important steps than go in the right direction; capital and MREL waivers similar to those proposed by the Commission should be adopted, and crucially resolution authorities must have the capacity to be able to scale internal TLAC between 75% and 90% per the global FSB rules.

Many people have argued that the solution for cross-border banking is improved 'trust'. We suggest that a better approach is to build that trust on a firm base of enlightened and well-funded self-interest – to protect hosts and home. If we capitalize on this chance, we can avoid the prisoners' dilemma, and build a banking system that is both safer and contributes more to European prosperity. ●

1. For details, see our full paper at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3085649.

Othmar Karas

MEP, Committee on Economic and Monetary Affairs, European Parliament

Stronger banks for promoting jobs and growth in Europe!

When I look at the European banking landscape, I see an incredible amount of diversity. Around 6.600 credit institutions, which differ in size, business model, risk profile, governance and funding structure. I am convinced that this diversity is a source of strength to ensure financial stability, jobs and growth in Europe. We need both, larger globally-active institutions to finance large corporates as well as smaller institutions to finance the local economy. This diversity contributes to less vulnerability to crisis, greater choice for customers and more elaborate financing opportunities.

When implementing agreed global standards into EU law, we must take due account of this diversity and the structural specificities of the European banking sector such as a bank funded real economy which relies much less on capital markets than in the U.S. We need financial markets' legislation which is risk-based and proportionate at the same time. There must be rules for every bank, but not every rule should apply to every bank in the same way.

One key aspect of the ongoing review of the prudential framework is to ensure that institutions have sufficient loss absorbing capacity. As Shadow >>>

>>> Rapporteur of the EPP Group in the European Parliament on the review of the capital requirements framework, I welcome the implementation of TLAC as new requirement for own funds and eligible liabilities. This global standard aims to ensure that banks which get into trouble are well equipped to continue fulfilling critical functions without threatening financial stability or requiring further taxpayer support.

Since TLAC pursues the same objective as the EU minimum requirement for own funds and eligible liabilities (MREL), we need to carefully align both concepts in EU law. TLAC needs to harmonise with MREL, just as the capital requirements review needs to harmonise with the resolution side. To this end, I fully support the principle followed by the Parliament's Rapporteur on the Recovery and Resolution Directive (BRRD), Gunnar Hökmark, to secure legal clarity and market discipline by ensuring that all capital is bail-inable. Consequently, the subordinated capital foreseen for loss absorption must not limit the debt that is bail-inable but rather facilitate a quick and stable process of resolution.

"We need financial markets' legislation which is risk-based and proportionate at the same time. There must be rules for every bank, but not every rule should apply to every bank in the same way."

- OTHMAR KARAS

When it comes to the TLAC application in the Union, I fully subscribe to the notion of a level-playing-field in the competitive landscape. As required by the FSB Term Sheet, TLAC shall be applied by global systemically important banks (G-SIBs) but not impose additional requirements beyond that. Non-G-SIBs shall not be required to comply with the TLAC standard but continue to be subject to MREL. We must ensure that TLAC and MREL do not discriminate against well-capitalised European banks, which increase their level of capital or maintain it at higher levels.

At the same time, this requirement shall be proportionate to the systemic importance of institutions. Just as I support that the requirement to draw up resolution plans shall not apply to institutions which can be liquidated under normal insolvency proceedings, I also support that such institutions shall not be subject to a specific MREL requirement, as under these circumstances the bail-in tool would not be used as such. Finally, it is crucial to foresee an appropriate grandfathering-clause, so that institutions fulfil the requirements for own funds and eligible liabilities as soon as possible to ensure a smooth absorption of losses and recapitalisation in the case of resolution.

When done right, this and the many other aspects of the ongoing legislative review will truly ensure stronger and more resilient European banks for promoting jobs and growth in Europe! ●

Elisa Ferreira

Vice-Governor, Banco de Portugal

Banking Union: closer to or drifting away from original goals?

Post-crisis financial sector reforms aimed at strengthening financial stability, focused on improving banks' resilience, ending too-big-to-fail, breaking the sovereign-bank loop and reducing market fragmentation.

Efforts were put into a harmonized regulatory framework with stricter requirements regarding capital and (private) loss absorption capacity to protect taxpayers, while reinforcing prevention and risk reduction. In the EU, the Single Rulebook and the European System of Financial Supervisors were introduced. The euro area went further, launching the Banking Union (BU) and its institutions.

The firm, cohesive commitment to BU contributed to counter financial fragmentation. However, political willingness to complete it as envisaged waned over time, alongside economic recovery.

Early years of the BU were devoted to the aforesaid goals, paving the way for risk reduction (e.g. SSM, SRM, AQRs, stress tests – resulting in increased solvency levels). Risk sharing initiatives, though, are yet to begin – EDIS and the SRF backstop continue to be postponed, with hurdles emerging as the political discussion evolves. This mismatch has created asymmetry which endangers key BU benefits: supervisory and resolution decisions are mostly European, but the ultimate guarantor of financial stability remains national, with much more limited tools to act. Recent cases prove this asymmetry is marked and that repercussions could have been serious, as decisions were ultimately redirected to national borders.

As fragilities may still arise, the incomplete BU design is jeopardizing all achievements. The bank-sovereign link prevails – it should be a wake-up call for European leaders and authorities. Quoting President Juncker[1], "we must complete the European House now that the sun is shining and whilst it still >>>

>>> is". We should also round up all the builders and assess if construction is proceeding as planned.

Supervisory, resolution and liquidation decisions, usually addressed separately, should be placed into the wider context. Ongoing EMU discussions should reflect on the following:

- Even smaller, traditional European banks are expected to compete in global capital markets to build up MREL – is a rigid approach to the EU level playing field undermining fair competition globally? How does this impact those banks' business models and risk profile?
- Regulatory-driven consolidation is an imminent risk if only larger banks are able to comply with increasingly complex regulation and potentially disproportionate requirements – aren't we risking the comeback of too-big-to-fail?

"Are we moving closer to or are we drifting away from our original goals?"

- ELISA FERREIRA

- EU financial stability still depends on the stability of each jurisdiction, where tools are limited – isn't this an incentive for added national discretions? How well has public interest been assessed? Aren't banks still national in death? Doesn't this impair financial integration?

Europe made significant progress post-crisis, the concrete proof is banks' increased resilience. But challenges remain, not only in design but also as many reforms remain untested, especially altogether. It is crucial to assess if reforms are having the desired effect and hold a frank discussion about the endgame. Are we moving closer to or are we drifting away from our original goals? ●

1. For details, see our full paper at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3085649.

Leena Mörttinen

Director General, Financial Markets Department, Ministry of Finance, Finland

Bank resolution and liquidation – two sides of the same coin?

Authorities have to decide between two alternative approaches when dealing with a failing bank: liquidation or resolution. Whereas resolution is a process regulated by the EU, and led by a single authority in the Banking Union, liquidation regimes are still mostly national and thus vary between Member States. Never-theless, liquidation is the default option for smaller banks – a failing bank is put into resolution only when it cannot be wound up under normal insolvency procedures.

The need for harmonization of bank liquidation procedure is an open issue. In some recent cases, where the banks were put into liquidation under national rules, national authorities provided "liquidation aid" from the taxpayers' pocket. As a result, the senior bondholders did not bear losses as they should have. This raises the question: how can we avoid situations in the future where liquidation may be used to circumvent the agreed rules on dealing with failed banks in the Banking Union? One of the most important lessons taught by the crisis is, after all, that shareholders and creditors should bear the losses of a bank failure to incentiv-ize them to monitor banks properly. Without commitment of both national and European authorities to end the use of taxpayers' funds no harmonization of insolvency regimes will be enough. So how do we strengthen this commitment in implementing a Banking Union truly based on market discipline - thus de-coupling banks from sovereigns?

The first steps have already been taken. The establishment of the new resolution framework and the Single Resolution Board (SRB) in the EU has been an important milestone. However, it is still a work in progress, as the European Court of Auditors pointed out in its recent audit. The authorities are still working hard in set-ting requirements for own funds and eligible liabilities (MREL requirements) as well as making resolution plans and resolvability assessments for individual banks. Resolution authorities will need to ensure that all failing banks, big or small, can be resolved or liquidated in an orderly manner without taxpayers' funds. The liquidation and resolution frameworks need to be aligned to ensure that the most important principles are respected. To this end, the first step is for the Resolution Authorities to set binding MREL requirements for all banks and the banks actually meeting these requirements.

"Without commitment of both national and European authorities to end the use of taxpayers' funds no harmonization of insolvency regimes will be enough."

- LEENA MÖRTTINEN

Resolution authorities have had a lot on their plate during these first years of common resolution rules. And since legislators are eager to revisit those rules, their plates will remain full for a while. We must keep the same level of ambition in revising the rules as we had drafting them. We must give resolution authorities the tools and the flexibility they need to take the last steps in making sure that all failing banks can be resolved in an orderly manner.

Finally, once bank balance sheets have been strengthened, legacy NPLs have been reduced to manageable levels, bank sovereign risk exposures reduced and bail in buffers are in place, we can conclude that the long shadow of the crisis has faded and state aid rules for exceptional circumstances can be accordingly re-moved. This will bring liquidation and resolution regimes closer to one another as they should be. ●

Jean Naslin

Executive Director,
Head of Public Affairs,
Caixabank

Calibration and subordination: open issues

There are still many unresolved issues among which the introduction of TLAC in European legislation, its implications on MREL, its unintended impact on market confidence and potentially financial stability, the ultimate objective. Concerns have been raised, diverging positions expressed in the current debates in Council and Parliament about what should be the right levels of calibration and subordinated debt. If the system is to work a balance must be struck.

The spirit of BRRD2 must be preserved. Resolution is the exception when facing a bank failure. Bail-in is not to be considered as the preferred resolution strategy.

Bail-in must be effective while preserving a balance of costs and benefits. MREL, necessarily costly, must not be intended to be higher than TLAC Pilar I unless fully justified. Whilst ensuring market discipline and preserve tax payers, bail-in must not induce further unintended financial instability risks and certainly not move away from resolution objectives risking to place deposits and clients' confidence at risk. Bailinable instruments should be appropriate to minimize resolution costs and not endanger sound and reliable banking business models particularly for deposit funded banks, large or small. MREL should be largely, if not fully, covered by subordinated debt held by informed investors. This is the only way to ensure that these objectives are properly achieved.

This of course has a cost. While some institutions, due to their global systemic importance need to face minimum requirements, MREL should be properly calibrated to the specific bank characteristics, risk profiles, business, funding model and resolution strategy.

Calibration and subordination must be framed to ensure it correctly addresses banks vulnerabilities and resolvability impediments under resolution scenarios whilst preserving market confidence.

"There must be a difference between debt and deposits, easily vulnerable which must be preserved."

- JEAN NASLIN

A much higher attention must be paid to liquidity under and after resolution. Most likely banks will face a liquidity crisis prior to failing or likely to fail. Depositor's confidence will be seriously affected if there are doubts over a bank deterioration and deposits were to ranks high in the hierarchy. Some argue all instruments should be bailinable to provide market discipline. This can true, but only up to a point.

There must be a difference between debt and deposits, easily vulnerable which must be preserved. This is precisely the objective of the new class of subordinated debt. If a bank is finally resolved due to a big loss eroding completely its capital position and its debt it will take a long time before market confidence is restored, whatever the level of new capital then held by participants with capacity to provide funding.

Ensuring emergency liquidity access under resolution and proper access to funds for an adequate period of time, after the bail-in is implemented, is paramount to ensure that the framework is really effective to achieve resolution objectives. ●

Mark Venus

Head of Recovery
and Resolution Planning,
BNP Paribas

The host with the most (MREL)

Europe has made immense progress since the financial crisis in creating a coherent and unified approach to banking supervision and to the resolution of failing banks. Building on the progress made at FSB level with the creation of the 'Key Attributes', BRRD has introduced the necessary resolution tools, and in the Banking Union, a unified resolution regime has been created under the auspices of the Single Resolution Board (SRB).

The concepts of 'resolution groups' and 'resolution entities' have been introduced, in order to ensure that losses are concentrated in resolution entities, to which the resolution tools would be applied.

The SRB is notifying MREL targets for resolution entities, and yet it is clear, even before internal MREL targets are fixed, that there is concern in host countries that the MREL provided within resolution groups may be insufficient. The Eurofi paper on enhancement of the Banking Union lays out cogently the fears of host authorities that they may be left 'holding the baby', with losses and/or liquidity needs concentrated in a local subsidiary in case of failure of >>>

>>> an international or intra-Union bank, and without the support of the parent resolution entity.

The instinctive, and indeed natural, reaction of host authorities may be to seek to protect their national economy and national depositors by imposing the highest possible level of internal MREL. But the race to be 'the host with the most' cannot be in the general interest. MREL in the form of internal bond issues is a blunt instrument, which can generate additional liabilities in subsidiaries that do not need additional funding, with an associated increase in interest costs for the bank, and ultimately for its domestic clients.

One can imagine other forms of MREL, such as guarantees, which avoid these pitfalls, but it is far from clear that such instruments are sufficiently certain in the application to bring the necessary comfort to assuage host country fears. But excessive internal distribution of MREL reduces the flexibility of banking groups to deal with crises when and where they occur. Conversely, the existence of higher MREL levels in local subsidiaries of international banks than in their local counterparties confirms their greater resilience and can lead to competitive distortions between local and international banks if they are faced with differing MREL requirements.

"But excessive internal distribution of MREL reduces the flexibility of banking groups to deal with crises when and where they occur."

- MARK VENUS

These fears may translate scepticism about the reality of the Banking Union resolution regime, and a possible lack of trust in the consistent application of resolution plans, despite the progress made in building resolution plans at a Union level, incorporating the input of host countries. These fears exist, can be understood, and need to be answered. The Eurofi paper puts forward several potential routes to enhance the confidence of host countries and open the way toward a truly pan-European resolution regime that is acceptable to host countries. Pending progress on these essential reforms, it is vital to take a measured approach to fixing internal MREL. ●

Post comments and questions
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Priorities for further integrating EU post-trading

Lieve Mostrey

Chief Executive Officer, Euroclear Group

Integration of EU post-trading – only a few pieces remaining for the puzzle to be completed

The securities settlement space in the EU has been the subject of significant and unique change over the last years. Significant, because CSDs are now awaiting their authorisation under CSD Regulation, which sets harmonised rules for CSDs and includes elements that should make CSDs more competitive. And, unique because T2S has now been implemented in full. The technical development of T2S has been accompanied by a comprehensive effort to harmonise market practices across those markets which are migrating to T2S.

With T2S only being recently launched and the implementation of CSDR ongoing, it may be too early to judge if, how and to which extent those two initiatives will effectively drive much-wanted competition and consolidation between CSDs. And, maybe there are still too many un-addressed barriers for such evolution to take place.

When looking at the excellent 2017 report of the European Post Trade Forum, clearly more still needs to be done. To meet the CMU objectives, it is imperative for the EU to work towards a complete dismantling of all identified barriers. This is a necessary condition for full integration of EU capital markets. With the removal of the identified barriers, the post-trade services reform will significantly contribute to the global competitiveness of EU capital markets.

From the barriers identified by the EPTF, we believe three barriers should be removed in priority:

- fragmented corporate actions and general meeting processes,
- lack of harmonisation of registration and investor identification rules and processes, and
- inefficient withholding tax collection procedures.

The industry is on the cusp of major disruptive technological change and innovation which will challenge both the industry and the regulatory authorities. Technology by itself will however, not be able to harmonise remaining barriers in the field of securities post-trading. This means that the benefits of technologies such as

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>>> DLT cannot fully materialise in the absence of such harmonisation. DLT (or other technology innovation) should therefore, rather be examined as a potential means to improve the future post-trading processes once harmonisation has been largely achieved.

The Commission may need to organise a joint public/private monitoring of progress in dismantling the EPTF Barriers (following the precedent of CESAME and the T2S Harmonisation Group) and on the effect of the introduction of new technologies. ●

Kay Swinburne

MEP & Vice-Chair, Committee on Economic and Monetary Affairs, European Parliament

'Giovannini barriers' in post trade revisited 15 years on

The attraction of the EU as a hub for global markets infrastructure is evident in the existence of global CCP's and ICSD's, and the level of integration in the post trade environment benefits from this global system. Interest rate swaps and credit default swaps in the three currencies - Euro, British Pound and US Dollar - are almost completely concentrated between two EU and US venues and EU firms provide settlement services for hundreds of jurisdictions on a daily basis.

In addition, the implementation of recent EU initiatives, such as T2 and T2S are showing modest but positive results - the first CSD to be authorised under the new CSDR was a merged entity, taking the place of three National CSDs in the Baltic States and there are numerous requests for access between CCPs and trading venues pending.

This trajectory however, is not felt universally across the post trade space - indeed it is highly concentrated in the cleared derivatives market. This is mainly thanks to the global nature of the derivative product, which lead to the development of global standardised contractual terms that were common practise long before the 2009 G20 Pittsburgh decision.

The cash equities market by comparison, is regional and in the case of the EU - local - at best - with interoperability still the exception not the norm. In the US, the concentration of cash equities clearing through DTCC has afforded their market a level of integration that the EU is right to covert. However, given the obvious challenges of creating a single public utility in the EU, we would need to adopt a different approach.

The cash equities market by comparison, is regional and in the case of the EU - local - at best. In the US, the concentration of cash equities clearing through DTCC has afforded their market a level of integration that the EU is right to covert. However, given the obvious challenges of creating a single public utility in the EU, we would need to adopt a difference approach.

When you look at the regulation that governs CPP's and CSD's, you can see the legacy of the financial crisis in their composition. Rather than taking steps to liberalise pan EU clearing and settlement, in the same way that trading was liberalised under the first financial services action plan - focus is attributed to safety and stability. Previous efforts to bring down costs for market participants and remove barriers to trading were almost completely lost and the result is that post-trade has not enjoyed the same 'big bang moment' that MiFID I gave to the trading world.

Whilst increased resilience in the post trade world is no bad thing - longstanding barriers to integration are. Although first identified and consolidated by Alberto Giovannini in 2003, the 15 'Giovannini barriers' as they came to be known, are just as damaging to true consolidation of Capital Markets today as they were 15 years ago.

EMIR, CSDR and SFTR were all created after the publication of the Giovannini report and although they are based on and all reference the "single market" clause in the EU treaties, you are hard pressed to find many articles that actually break down these known barriers between Member States.

Differing national Securities laws, taxation requirements and bankruptcy procedures, mean that the current level of integration enjoyed by cleared derivatives cannot be truly replicated in the rest of the post-trade space.

The priority of the Commission's EPTF group, especially in light of Brexit, should be to identify friction and step in to smooth a path. Technology will find a way to reduce costs and create a more efficient market – and for Europe to continue being host to global financial infrastructure it will need to work on encouraging that technology and look to break down barriers, instead of creating new ones. ●

Jochen Metzger

Director General Payments and Settlement Systems, Deutsche Bundesbank

Post-trade 4.0 – are Brexit and digitalisation perhaps a blessing in disguise?

Today's post-trade sector is coming up against two significant changes. On the one hand, we are seeing digitalisation making ever greater inroads into the financial sector – artificial intelligence, distributed ledger technology and FinTech are just three major developments I could mention here. Digitalisation will continue to gain importance for the financial industry, potentially transforming a whole range of post-trade processes as we know them today.

"Hence, a process of change driven by Brexit might also represent a major step forward for digitalisation."

- JOCHEN METZGER

On the other hand, the post-trade industry is faced with the UK's decision to leave the EU. This might impact substantially on the European clearing landscape, in particular. At present, OTC interest rate derivatives are cleared almost exclusively through UK CCPs, which are important for the functioning of the financial system in the EU but will soon be located outside the Union. It is crucial, then, to ensure that these CCPs continue to be subject to appropriate regulatory and supervisory requirements even after Brexit. However, the criteria for recognition of third-country CCPs as provided for in EMIR today cannot guarantee this to a sufficient degree. Therefore, a reform of the respective rules is under way which even contains the possibility – as a last resort – of not recognising systemically important third-country CCPs. In this case CCP participants would have to relocate their business, possibly to the EU. But even without any regulatory action with regard to a possible location policy, uncertainty about the future status of the UK could lead to the clearing market consolidating and relocating voluntarily. Whether Brexit turns out to be hard or soft, there will be significant changes which market participants will have to deal with.

At first glance, there would not appear to be any obvious link between the digitalisation of the post-trade industry and the future of the European clearing landscape. Yet it is worth taking a closer look. There is no doubt that the financial services industry will need to adapt to new circumstances, but it may well have a significant edge over other industries. For several years now, we have been seeing the emergence of FinTech solutions which often promise to boost banking sector efficiency. If structures are going to have to be changed anyway, Brexit might accelerate the pace at which these new ideas and technologies are taken on board. The structural break which Brexit is expected to cause therefore not only presents risks – potentially, it also opens up significant opportunities to enhance efficiency and forge a more interconnected European post-trade landscape. Hence, a process of change driven by Brexit might also represent a major step forward for digitalisation. ●

Andrew Douglas

Managing Director, Government Relations (EMEA and APAC), The Depository Trust & Clearing Corporation (DTCC)

Safety, stability and simplicity: the vision for the EU's post-trade landscape

Following the plethora of regulatory reform at EU and global levels, there is a continuing need for greater harmonisation and coherence in post-trade services in areas such as trade reporting, collateral management, clearing and settlement.

Regarding trade reporting, markets still need a globally consistent set of critical data elements, to enable a complete and harmonised view of the derivatives market and facilitate efforts to share and aggregate data in support of systemic risk monitoring. DTCC supports regulatory efforts to focus on a minimum number of common data fields to allow supervisors to perform their oversight functions. We also strongly encourage coordinated adoption of rules across jurisdictions under the guidance of international regulatory bodies, such as CPMI-IOSCO.

On collateral, in accordance with BCBS-IOSCO's recommendations, streamlining collateral processing across markets and enabling global access to collateral wherever it is held is essential. There are numerous operational challenges which undermine the industry's ability to optimise collateral. These can be overcome by using existing market infrastructure

processes and messaging utilities to achieve straight-through-processing (STP) from margin calls to settlement regardless of jurisdiction. >>>

>>> Other measures which should be put in place to enhance post-trade practices and increase the safety and efficiency of the EU's market infrastructure include higher levels of automation among buy-side firms, shorter settlement cycles, greater standardisation of asset servicing processes and a more consolidated community of CSDs. On technology, we believe that EU authorities should play a key role in driving harmonised technology standards and best practice among market structures in Europe for the purposes of integration and interoperability as well as increased efficiency, reduced costs and risk mitigation.

Looking forward, in ten years, the EU post-trade landscape should be defined according to the principles of safety, stability and simplicity. Within five years, EU policymakers should have put in place measures to achieve the ten-year vision, and should have established a Capital Markets Union (CMU) embodying these three principles:

"In ten years, the EU post-trade landscape should be defined according to the principles of safety, stability and simplicity."

- ANDREW DOUGLAS

- Safety is the ability to withstand crises and have the requisite tools to manage a market shock. It also entails the drafting of legislation and regulation that ensures consistency across the EU and its main international partners.
- Stability refers to a regime that provides legal and operational certainty and accountability for market participants and supervisory bodies. This regime puts in place tools to prevent crises and facilitates data sharing and aggregation for regulatory and data security purposes.
- Simplicity should be achieved by streamlining structures, processes and regulation through the adoption of global standards and open access frameworks.

DTCC believes the EU post-trade sector should move to a seamless integration of structures, processes and regulation in the coming five years. By 2030, the EU post-trade landscape should be aligned, where appropriate, with those of other jurisdictions to enhance efficiencies, improve transparency and better monitor and manage risk. In doing so, the EU should be able to provide full access to other market participants while remaining open and competitive internationally. ●

Ugo Bassi

Director, Financial Markets Directorate, DG Financial Stability, Financial Services and Capital Markets Union, European Commission

Post-trading: dismantling obstacles and building for the future

The Commission's top priority is to strengthen Europe's economy and stimulate long term investment to boost jobs and growth. Building the Capital Markets Union (CMU) is essential to achieve a strong and resilient European financial system. Efficient and safe post-trade financial services are key elements of well-functioning capital markets and a key objective for the Commission. It is therefore crucial to step up implementation of EU post-trade legislations and accelerate reforms to promote investor protection, financial stability and for avoidance of systemic risks. This is even more important considering the challenges ahead, such as the decision of the United Kingdom to withdraw from the European Union or the uptake of new technologies.

"Responding to technological advances is a priority, as it is driving rapid changes."

- UGO BASSI

Good progress has been made in recent years in dismantling obstacles to an efficient and integrated post-trade environment. This is the result of the combined efforts by European legislators and all market stakeholders. Yet, there are still some post-trade areas where further improvements are desirable and necessary. Taking into account stakeholder suggestions in the EPTF Report, the Commission launched a public consultation that ran until mid-November 2017 to learn all stakeholders' views about the state of post-trade markets and assess the existence and scale of remaining or new obstacles. Based on the feedback to that consultation, the Commission is currently crystalizing the needs and the priorities for the future, the best way to move forward, and will communicate on this later this year.

The Commission is committed to continue actions to further enhance EU post-trade processes, make services more efficient, and make market infrastructures more resilient and globally competitive. Among the various post-trade legislative initiatives at the heart of the CMU, including the CCP Supervision proposal improving supervision of EU and Third Country CCPs; a review of functioning of the European Supervisory Authorities to strengthen governance and enhance coordinated supervision; the adoption of the Code of Conduct for withholding tax procedures setting a pragmatic approach to improve efficiency and standardisations or tax processes; and the revising the Shareholder Directive enhancing efficiency and investor's capability for rights exercise.

Responding to technological advances is a priority, as it is driving rapid changes with the potential to positively impact a range of post-trade services, accelerate processes and boost investments. At the same time, there are risks such as cybersecurity that we need to address to support safe and innovative business models to scale up. Our challenge is to strike the right balance between embracing the opportunity of new technologies, while preserving financial stability and investor protection. In March 2018 the Commission has adopted the Fintech Action Plan setting out concrete measures to encourage the uptake of new technologies for a more innovative and competitive EU financial system. ●

James Cunningham

Managing Director and Senior Advisor, Public Policy and Regulatory Affairs, BNY Mellon

Why the European post-trade agenda is important

The post-trade agenda, and post-trade panel discussions at events such as Eurofi, are usually viewed with scepticism, and with some trepidation. Post-trade topics are seen as deeply technical, and as raising problems for which there are no good solutions. This scepticism is understandable, given the notable lack of progress over the past 17 years (since the first Giovannini report) in tackling the main post-trade problems.

Yet it is also unjustified. There are two main reasons for this. The first is that post-trade processes – specifically what happens during the life of a contract or of a security – are fundamental. We shall not achieve the objectives of the CMU project, or of the sustainable finance agenda, without reliable, fair and efficient post-trade processes. The second is that there is the real opportunity for major improvements in several post-trade areas.

This is because public and private sector actions over the past 17 years have created some important pre-conditions. Here I would highlight CSD Regulation and the Eurosystem's TARGET2-Securities settlement platform, as well as technological change, and the development of global standards.

The CMU project – no matter how limited in concrete achievements to date – together with the fintech agenda and the Digital Single Market project, do give us a valuable structure to tackle post-trade problems.

One notable example is the topic of inefficient procedures for the collection of withholding tax on income from securities. This barrier costs EU investors an estimated EUR 8.4 billion a year according to the European Commission, and it is usually considered the most important single obstacle to direct cross-border retail investment in securities. This barrier has traditionally been viewed as insurmountable, given that tax procedures are a member state prerogative.

And yet…Current tax procedures in some member states are demonstrably flawed…All parties have an interest in having simple, fair, efficient, and auditable procedures…A harmonisation of tax procedures will give benefits to investors from all member states…Tax procedures need to be compatible with market practices… (and market practices for the distribution of income on securities have largely been harmonised)…

At least for withholding tax on securities income, it is possible to make a clear distinction between tax procedures and tax policy… The Code of Conduct on Withholding Tax that the Commission issued last December is a valuable starting point for progress in this area. We need to seize the opportunities in this and in other areas. ●

Laurence Caron-Habib

Head of Strategy, Public Affairs and CSR, BNP Paribas Securities Services

Post-Trade harmonization should take into account an evolving environment

The integration of the post-trade systems in the EU is a long story which started more than 15 years ago with the publication of the Giovannini reports in 2001 and 2003. It is undeniable that dismantling of post-trade barriers is essential brick for the smooth functioning of a true Capital Market Union in Europe.

Considerable advancements have been made over the last years. Adoption of several legislations which directly apply to post trade is to be noticed, such as EMIR for clearing activities and the CSD Regulation in the issuance and settlement space. This is to be seen in conjunction with the go-live of the T2S platform which creates a single European settlement framework for European securities. Even if the full effects of these changes are still to be properly assessed, it is obvious that the post-trade landscape will substantially evolve in the coming years as a result of these major steps. We should see increased competition within and between the various categories of stakeholders, and new business models are expected to emerge in line with end-investors' expectations.

Publication of the EPTF report is also a key event. It was a great opportunity to assess what has been achieved concretely in terms of harmonisation and standardisation. But also, to define in a clear way what issues remain to be tackled and those which have emerged in the aftermath of the financial crisis. The report is a unique piece of reference for establishing what should be the priorities in the future for public authorities, but also for industry-led initiatives. A close and constructive cooperation between the public sector and the industry must be preserved as much as possible, and a pragmatic and targeted approach will be a crucial success factor.

Lastly, post-trade must not be seen in isolation. The role of the new technologies has been widely acknowledged as a game changer on a wide range of aspects. First, they should help improving efficiency of many operational processes which are still largely manual and/or not standardized. Use of artificial intelligence and of the Blockchain technology is widely tested by most stakeholders. Secondly, these technologies have the potential to disrupt the current post-trade models and could completely reshuffle the roles and articulation between the various traditional stakeholders. At the same time, there is still uncertainty as to the final outcome and on the timeline of such evolutions. Main objective should be to strike the right balance between enabling the full benefits of the innovation while preserving the current levels of safety and confidence ensured by post-trade providers all along the value chain. ●

Eurofi would like to thank very warmly
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Bulgarian Presidency of the Council
of the European Union

MiFID II implementation

Markus Ferber

MEP, 1st Vice-Chair,
Economic and Monetary Affairs Committee,
European Parliament

MiFID II goes live - First impressions

With the recast of the Markets in Financial Instruments Directive (MiFID II) one of the biggest legislative projects with regards to financial services has finally entered into force on 3 January 2018. The scale and complexity of the process is unprecedented and has even led to the entry into force being delayed by a full year.

Now that the first couple of weeks of trading have passed, it is time to do a first stocktake to see what works well and what areas might need further improvement. Overall, MiFID II has been off to a decent start. Unlike some pessimists have predicted, trading did not come to a standstill on 3 January 2018. On the contrary, things by and large went fairly smoothly.

Of course, with such a big file, there is the occasional hiccup, too. An example is ESMA's failure to perform the calculations for the double volume cap in time, which probably means that more preparatory work to coordinate data transmission with the respective venues could have been done. Other than that, the legal entity identifier regime is still a transitional one. While ESMA has found a pragmatic workaround for the first months, the objective should be to phase in the originally specified regime to as many instruments as possible.

While those issues will most likely smooth out over time, there are some trends that are more worrisome and probably need some adjustment in the long run. We have seen that some market players try to circumvent the provisions governing the publication of transparency data by publishing them either only for seconds or in unusable file formats.

While this might technically in compliance with MiFID II, it clearly defeats the purpose of the law. Possibly, a clarification specifying the acceptable file formats as well as the minimum storage time for such data could even be done via ESMA guidelines and would help solving the problem.

Another issue that is of major concern will need a legislative fix: On the first days of trading in 2018, we have seen systematic internalisers picking up an unusually large chunk of trading. One of the reasons for that is that they are not subject to the

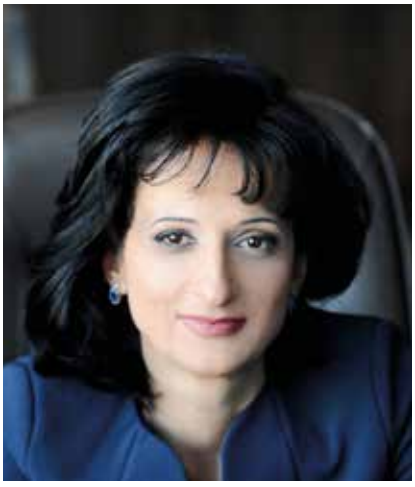
>>>

>>> tick-size regime and therefore can offer intra-tick quotes. This diverts liquidity away from lit venues. However, if we want MiFID II to become a success, we need a level playing field across venues. So this issue needs to be fixed. ESMA has already suggested an adaption of the relevant RTS, but the Commission insists on a change of the level 1 text. Either way, we need to find a fix for that problem and we need to find it fast. The European Parliament has already signalled that it stands ready to pass such a fix quickly once the Commission has decided on the best and most legally sound way forward.

The elephant in the room regarding all issues relating to EU financial services legislation is Brexit and many people ask if Brexit will trigger a major overhaul of MiFID II. Arguably, when MiFID II was negotiated, Brexit was on no one's radar. When the deepest financial market in Europe will suddenly become a third country, this will have some impact on a file like MiFID II that deals with a multitude of issues relating to how trading is done across the European Union.

Brexit will therefore certainly require a recalibration of certain elements of MiFID II, but Brexit it is not going to be the starting point for MiFID III. There will be a lot of little screws that will have to be adjusted - in particular everything that involves calibrations based on actual market data (e.g. tick sizes, transparency thresholds, definition of liquid markets).

However, almost all of this can be done with minor fixes of regulatory technical standards and maybe a few targeted adjustments to the level 1 text. However, the scale and depths of the changes will most likely only emerge when there is a better picture of the future relationship between the EU and the UK. Once that is clear, we can turn the necessary screws to make MiFID II a post-Brexit success. ●



Karina Karaivanova

Chair, Financial Supervision Commission, Bulgaria

MiFID II - capital changes for capital markets

The European legislation in the capital markets area has gone a long way in the past 25 years since the Investment Services Directive came into force. From a fragmented, 20-page Directive to a comprehensive legal framework, consisting of a variety of legal acts, amounting to thousands of pages, the capital market legislation in Europe has rapidly evolved, mirroring the development of the markets themselves. The markets 'integration and complexity, combined with increased market penetration, demand a very high level of legal harmonization and convergence of the EU authorities' supervisory practices.

Despite the successful implementation of the ambitious Lamfalussy action plan and the implementation of the MiFID I, the financial crisis showed that the EU framework was still too fragmented and the opacity and the complexity of the capital markets have contributed to the deepening of the effects of the crisis. The need to strengthen the framework for the regulation of markets in financial instruments was evident. Thus, the main purpose of the new MiFID II framework is to increase transparency, better protect investors, reinforce confidence, address unregulated areas, and ensure supervisors are granted adequate powers to fulfil their tasks.

"New MiFID II framework is to increase transparency, better protect investors."

- KARINA KARAIVANOVA

In attaining these high level goals, the new framework sets clear and comprehensive rules on pre- and post-trade transparency for all types of financial instruments. In order to increase the level of legal certainty, these rules are provided for in the directly applicable regulations. The high level of detail of the said provisions would indeed decrease the compliance cost for the market participants when providing >>>

>>> cross-border services, once the respective IT systems are in place. In order to better protect the investors, the MiFID II framework requires that the investment firms understand the financial instruments' features offered or recommended and act in their clients' best interest.

Moreover, the significant evolution of the trading technology usage in the past decade raised the need for extending the MiFID II provisions to new areas, such as algorithmic and high frequency trading. The increased reporting requirements in turn led to introducing an entirely new type of supervised entities - the data reporting service providers.

The financial crisis also showed that the financial sector supervision needed to be further strengthened. MiFID II specifies a minimum set of powers the competent authorities should have, such as the power to require existing recordings of telephone conversations, electronic communications and data traffic records, along with the ability to access natural and legal persons' premises. Despite the undeniable benefits of the successful MiFID II implementation, some challenges still need to be taken into consideration.

Significant investments should be made by the business in IT infrastructure upgrades, a vast number of new internal rules and policies must be introduced, the companies' compliance teams should be expanded. The burden, however, falls not only on the business, but on the regulators as well.

They need to also upgrade their IT systems, take their administrative capacity to a higher level and streamline the supervisory processes in order to meet the extended expectations. ●

Dr. Alexandra Hachmeister

Chief Regulatory Officer,
Deutsche Börse Group

MiFID II is finally a reality

MiFID II has kept us busy. After more than eight years of intensive discussions and planning for both the regulators and the financial industry, and more than 30,000 pages written, read, analysed, and implemented, MiFID II finally went live on 3 January 2018.

We at Deutsche Börse Group have always thought – and still do! – that all these efforts will have been worth it to achieve the legislators' objectives of transparency, stability and investor protection. I do see some merit in stressing this big picture of MiFID II/ MiFIR given the general mood on both sides to grumble about the burden of implementing the new rules.

Admittedly, many aspects will require time. Not all Member States have fully implemented MiFID II and many areas still require additional data to rightly calibrate thresholds and make rules applicable. However, we remain confident that these problems will be fixed over time.

Early market observations since the go-live date show us that:

- Markets successfully opened on 3 January: the vast majority of participants were well prepared and markets functioned without major hurdles.
- New trading venues, Systematic Internalisers (SIs) and data service providers have successfully been authorised. The most notable development can be observed in the area of SIs – under MiFID I we had less than 20, now we already have 109 authorised firms, although the phase-in period for authorising has not yet elapsed.
- We can already observe a significant decrease of OTC trading for equities. At the same time, the share of trading on SIs has increased from around 2% to almost 25%.

Europe needs a true level playing field. The principle of 'same business, same rules' is the prerequisite of fair markets. Competition should be based on how good you are at serving your clients' needs, and not on discriminatory rules. Policy-makers and regulators clearly understood the importance of that topic when designing the new transparency-based market structure in MiFID II. We strongly welcome their current efforts to monitor how markets adapt to the new set of rules and their willingness to close any remaining loophole to ensure that a maximum of trading volumes contributes to enhancing price discovery and competition.

"The principle of 'same business, same rules' is the prerequisite of fair markets."

- DR. ALEXANDRA HACHMEISTER

However, fixing Brexit will be the true challenge for policy-makers, regulators and the whole financial industry. MiFID II was originally designed for 28 EU countries, including the UK. Once the UK will have left the EU, it will lose its EU passporting rights for financial services and becomes a third country. The existing regime will reach its limits given the volumes of EU trading taking place in UK and vice versa.

Many thresholds that are essential parts of MiFID II for determining transparency and trading obligations will need to be recalibrated as the biggest financial centre will not be part of the sample anymore. In addition, we will need to develop third country regimes that are able to cope with the relevance of the UK for the EU financial markets. Only in achieving the MiFID II objectives of transparency, stability and investor protection will the EU be able to make the much needed CMU a true reality. ●

Klaus Kumpfmüller

Executive Director, Austrian Financial Market Authority (FMA)

Challenges of MiFID II implementation in smaller markets

The MiFID II package is one of the most comprehensive regulatory reforms in a decade, yet at this early stage of application, we can only gauge some longer term structural implications. They will most likely not be uniform, and depend on the size and structure of the respective markets.

The Austrian financial services market had its latest shake-up in the wake of the global financial crisis – a process of swift consolidation and professionalisation, driven by supervisory efforts to restore investor confidence by sorting out unsound providers. So if MiFID II is a child of the crisis, it is in some respects a continuation of a process that had started earlier.

A challenge for smaller European markets is to scale MiFID II to their own situation. There were concerns that it might overburden or disrupt markets. As a regulator we are glad we were able to alleviate most of them. We used the long implementation phase to engage, stabilise expectations and ensure a smooth transition.

This does not mean that there will be no longer term effects. Taking the Austrian example, let me highlight two areas of particular interest:

1. **Transparency:** Retail financial services in Austria are dominated by more than 500 banks, most of them organised in de-centralised banking sectors which benefit from a close proximity to their customer base and wide regional coverage. In turn, their business model is largely commission-based. MiFID II will not change this structure completely, but may impose a trade-off between transparency and costs and, ultimately, inclusiveness of services. Commission income can no longer be taken for granted. Sectors and banks have to proof to customers the added value created from it. Also, as business models become more transparent, providers need to be smarter about them, especially with digitalization of standard retail services. In the short run, costs for services could rise. Eventually, it will turn out to be an opportunity, as transparency makes customers realise the value of better investment services.

> *"MiFID II enhances our toolbox for integrated supervision, at a time of economic and regulatory spillovers."*
>
> - KLAUS KUMPFMÜLLER

2. **Integrated supervision:** Adaptations also concern supervisors. Crucially, MiFID II enhances our toolbox for integrated supervision, at a time when economic and regulatory changes create spillovers between markets. Low and negative interest rates incentivise banks to push fee and commission income – potentially on the back of retail customers. Also, within the recovery and resolution framework, banks may wish to tap retail customers to fulfill MREL requirements and not advise them properly on the specific risks of such instruments. The new rules on product development und governance enable supervisors to put a lid on mis-selling incentives before they boil over, ensure that sustainable services are provided, and that economic pressure is kept where it is best dealt with – in prudentially supervised institutions.

MiFID II brings more transparency to financial services and more integrated supervision. Incumbent structures need to adapt to this. This may in some areas come at a short-term cost, which we should be willing to pay in exchange for longer term benefits. ●

Ugo Bassi

Director, Financial Markets Directorate, DG Financial Stability, Financial Services and Capital Markets Union, European Commission

MifID II – Smooth sailing so far

The application of MiFID II changes the way financial markets function in the EU. That is why the co-legislators agreed to an unusually long implementation phase of 30 months, later extended to 42 months. MiFID II seeks to introduce greater transparency in securities trading; it strengthens investor protection and introduces more discipline on investment firms when executing clients' trades. With respect to derivatives trading MiFID II delivers on the G20 commitments.

Several Member States still have not notified the full transposition of MiFID II. Not fully transposing MiFID II may have an important impact on the cross-border provision of investment services. The Commission calls on Member States to fully transpose MiFID as soon as possible.

Notwithstanding transposition challenges, the operational implementation of MiFID II has been successful and no serious issues have emerged so far. >>>

>>> However, certain issues do require closer attention. For example, ESMA will need to have good cooperation with trading venues to calculate the double volume cap (DVC). A stable approach will need to be found on trade reporting and notably the Legal Entity Identifiers (LEI). Despite these teething issues, the industry is adapting without major disruptions or drops in liquidity.

"The operational implementation of MiFID II has been successful and no serious issues have emerged so far."

- UGO BASSI

In order to achieve greater transparency, MiFID II introduces an 'on-venue' trading obligation for shares and certain derivatives. In order to ensure continued international access of EU investment firms to key overseas markets, the Commission, in 2017, adopted equivalence decisions for five jurisdictions whose shares are traded systematically and frequently in the EU and for those who have adopted trading mandates for certain highly liquid derivatives. With respect to those derivatives, the EU venues also benefit from equivalence granted by third countries.

The Commission is assessing the impact of the MIFID II inducement rules on SME-focused research. The next phase will be the development of a consolidated tape – an essential feature of a competitive capital markets union (CMU). ●

Verena Ross

Executive Director, European Securities and Markets Authority (ESMA)

MiFID II implementation – First experiences

Market participants, national competent authorities (NCAs) and ESMA put in the last years and months significant efforts into ensuring the timely and successful implementation of MiFID II and MiFIR. This in turn helped ensuring a smooth start of the new regime, without

any major incidents or negative market impact, when it entered into force on 3 January 2018.

A number of complex IT-systems developed by ESMA went successfully live by the beginning of the year. It was only in the area of so called "double volume cap" where we faced some initial difficulties with data quality and coverage, forcing us to postpone the relevant actions to March. The latter, once solved, resulted in the suspension of dark trading under the reference price waiver and the negotiated transaction waiver in more than 700 instruments across the Union.

"ESMA, together with NCAs, will monitor the application of the new requirements by market participants in order to exchange practical supervisory experiences and identify and prioritise the areas where additional work might be appropriate."

- VERENA ROSS

However, despite this promising start, it is premature to assess long-term impact for investors and financial markets in general. One of the main aims of MiFID is ensuring that more trading takes place in a more transparent way on trading venues, such as on regulated markets, multilateral trading facilities (MTFs), and organised trading facilities (OTFs). 34 OTFs are currently operating in the EU and, in addition, more than 90 systematic internalisers (SIs) have opted-in under the new regime. ESMA therefore expects that more transactions will be concluded on these venues, thereby resulting in a more transparent trading environment. In this context, I should also underline that the transition into the trading obligation for shares and for derivatives, which both became effective on 3 January 2018, was successful and should also help deliver on the goal to move more trading into lit markets.

A further key objective of the new MiFID framework was to strengthen the protection of investors, in particular through stricter product governance requirements and tightened rules for distribution of financial instruments, mainly in the area of third party payments (inducements), mandatory disclosures on costs and charges and self-placement. In addition, the quality of investment advice has been enhanced under the revised framework and the provision of execution-only services has been restricted in order to avoid that retail investors purchase complex investment products in an inappropriate manner. Finally, product intervention powers have been added to the supervisory toolbox of both NCAs and ESMA.

Looking ahead, ESMA, together with NCAs, will monitor the application of the new requirements by market participants in order to exchange practical supervisory experiences and identify and prioritise the areas where additional work might be appropriate. This is in line with ESMA's supervisory convergence programme where MiFID II/MiFIR implementation remains a strategic objective, to ensure that the spirit of the new requirements is correctly understood and properly applied, and that they ultimately benefit investors in Europe. ●

FOLLOWING EUROFI EVENT

3, 4 & 5 April 2019

Bucharest - **Romania**

V. FINTECH AND DIGITALISATION

Issues at stake

Technology offers new opportunities that could lead to radical change in the financial sector. All financial activities are concerned and can potentially reap the benefits of digitalisation and fintech. Although most present applications are improvements of existing services and processes, fintech and digitalisation also facilitate the introduction of new business models and the entry of new players into the market.

These new technologies however pose challenges in terms of regulation, supervision and standardisation, which are currently being addressed by EU initiatives. They may also give rise to new risks such as cyber-risk, which require a coordination of efforts at the global level and also between the industry and the public authorities.

Content

Impact on business models and value chains

Brian D. Quintenz

Commissioner, U.S. Commodity Futures Trading Commission (U.S. CFTC)

Technological innovation and fintech developments in capital market business models and value chains

The CFTC seeks wherever possible to support innovation that promotes competition, vibrancy, and growth in our financial markets. Last spring, Chairman Christopher Giancarlo launched an initiative called LabCFTC to support this effort and begin an active, ongoing dialogue with the FinTech community and other regulators.

For example, LabCFTC meets with innovators to provide timely and meaningful feedback on new ideas. Through early engagement during the development process, LabCFTC hopes to offer clarity and guidance about our regulatory framework that will save innovators time and money.

LabCFTC also helps the agency identify where potential changes to the existing regulatory framework may be beneficial. In some instances, an innovation may achieve the desired outcome of a regulation, but not fit within the letter of the rule. In such cases, instead of a complete rethink of the technology in question, LabCFTC can advise the CFTC on whether regulatory relief should be provided or if it may be appropriate it consider rule revisions. More broadly, the CFTC strives to adopt technology-neutral regulations, so that existing requirements do not unintentionally inhibit the development of alternative, and perhaps better, innovations.

The CFTC also explores the potential application of new technologies to the derivatives markets through the Technology Advisory Committee (TAC), which I sponsor. The TAC is comprised of industry leaders and subject matter experts who make recommendations to the CFTC regarding technological innovations and advances. One technology in particular that has garnered attention from TAC, as well as the press, is distributed ledger technology (DLT). DLT holds great potential to transform how firms handle trade execution, processing, reporting, and recordkeeping of derivatives. However, DLT is also a good example of how innovative technologies face practical obstacles toward implementation.

Specifically, with respect to swap data reporting and recording, market participants will have to decide if there is a business case for the widespread adoption of DLT. Firms will have to evaluate the merits of investing in DLT infrastructure versus utilizing existing back office processes. Depending upon how this question is answered, interoperability questions may arise. The CFTC could find itself in a position where some market participants prefer the reporting >>>

>>> status quo, while others choose to migrate to a particular ledger. The regulatory efficiencies of DLT could be greatly diminished if the markets developed multiple ledgers, with each requiring the CFTC to develop the infrastructure necessary to access and analyze the data.

Through thoughtful and transparent engagement with the FinTech community via LabCFTC and TAC, I think the CFTC can play a critical role toward fostering technologies that will be truly beneficial to the markets and regulators.

Are additional initiatives required at the global level in this respect?

The CFTC seeks to coordinate with other U.S. and international regulatory authorities to support market-enhancing innovation. Through formal and informal relationships, the CFTC seeks to collaborate with, and learn from, the experience of fellow regulators to develop best practices and recognize emerging trends. In particular, the CFTC strives to engage with other regulators across the globe to ensure that national borders do not form artificial barriers to ingenuity and competition.

For example, in February 2018, the CFTC entered into an arrangement to collaborate on FinTech innovation with the United Kingdom's Financial Conduct Authority (FCA). The agencies' respective FinTech initiatives, LabCFTC and Project Innovate, will share information regarding market trends and developments, as well as insights derived from innovation competitions sandboxes, or other similar endeavors. My hope is that together the CFTC and FCA can support market-enhancing innovation and help truly innovative companies navigate the regulatory landscapes of our respective countries. ●

Vilius Šapoka

Minister of Finance, Republic of Lithuania

Developing financial markets: enabling the future rather than foreseeing it

Adapting to new technologies is not new to the financial sector. Still, the recent buzz about fintech is a clear signal that the pace of innovation has also increased the expectations for the future of finance. Fintech breakthroughs are perceived as one of the cornerstones of the further development of the EU financial markets.

The belief in the promise of fintech is also well reflected by mainstreaming of tech jargons, e.g. such terms as blockchain, API and ICO (to name just a few) became common in European capitals and innovative start-ups alike. However, practical application of technologies and their usage in society is not as widespread as the pioneers would like it to be.

One could say that the market forces will sort out technologies which are the most beneficial – there is no need to rush. Indeed, winners of the innovation struggle will be selected by customers. Politicians are no prophets and should not embrace particular solutions which are not tried and tested.

Nevertheless, it is precisely the job of politicians to enable the future to happen (especially in the face of an increasingly global financial market and competition). Thus, how could policy makers direct the financial technologies to a meaningful role in shaping the future instead of championing one or the other technology?

Firstly, by highlighting that technologies are here to serve the interest of customers. The financial sphere is not the end in itself, and neither are financial technologies. As >>>

>>> Marshall McLuhan once wrote that the most human thing about us is our technology. Politicians and business leaders have a duty to mind the real economy and people's needs. Therefore, the key objectives of consumer protection and financial stability should always be taken into deep consideration.

Secondly, ongoing digitalization of finance depends on the state-of-the-art cybersecurity. The possibility of large scale cyber-attacks needs to be minimized; otherwise the suspicion might seriously hinder the smoothness of global financial activity. Without a reliable cybersecurity, we cannot have a proper consumer protection and data protection as well. Therefore, the governments should be active in this regard. For example, in Lithuania the National Cyber Security Centre integrates and ensures security of public and private IT networks by implementing the Code of Conduct in order to achieve resilience of critical digital infrastructure.

Thirdly, any obstacles to the cross-border operation of technologies across the EU should be reassessed and removed if possible. The FinTech Action Plan of the European Commission shows our willingness to enable innovative business models to reach the EU scale. Leveraging the size of the single market and ensuring standardisation where appropriate is a must in order to be globally competitive in terms of fintech.

Last but not least, the birth of new technologies should be encouraged by specialised facilitators. Both private and public facilitators are needed. A good example could be seen in the emerging blockchain sphere: there are various private blockchain centres as well as implementation blockchain solutions in the public sector.

I believe that high expectations regarding the role of technology in the future of finance will be met. It is up to business leaders to develop new technologies and respective business models. Historically, Europe always had much to offer to the world in terms of technological advancement. Now, it is the best time to contribute to the growth of fintech worldwide. Moreover, I am certain that public authorities will enable this process on their part. ●

Jesper Berg

Director General, Danish Financial Supervisory Authority (Finanstilsynet)

Fintech brings a tremendous potential – and a need for regulators to understand the risks

It has never been easier for consumers to get access to new digital services. Apps can be downloaded with a single swipe and provide the consumer with access to everything from online shopping, to gaming, to social media. Tech giants, such as Facebook, Google, and Amazon have lead the way in providing the consumers with intuitive easy-to-use products. This has in turn lead to a demand from consumers for equally easy-to-use financial products. Consumers increasingly expect their mobile banking, investment management and payment solutions to be as easy and intuitive as using a mobile phone.

Banks, in order to stay relevant, must continually improve their offerings, as consumers increasingly demand efficient and intuitive banking experiences. If ignored by banks, fintech companies that focus solely on niche products will develop specialised it-platforms to provide a "facebook-like" experience that the consumers demand.

This trend proposes a number of different challenges to both the banks and to us, the financial regulators. For banks, the rise of fintech can lead to an unbundling of banking services with a subsequent fight for ownership of customers, as more and more consumers switch to specialised providers. This will make it difficult to sustain the level of customer loyalty, which many banks currently enjoy. >>>

>>> Data is the air that digital firms breathe, and banks will need to invest in the development of banking systems, if they want to keep up with the new players. In addition, new regulation such as GDPR and PSD2 transfer ownership of data from banks to customers, by requiring banking systems to allow for this third-party access. The need for state of the art banking systems is therefore increasingly important. Banks, and especially those that are not digitally prepared will face a difficult future; a future with increased competition from new fintech players and changing customer demands.

For financial regulators the challenges are different. The new data driven world tests the way we understand the financial market. How do we ensure that we understand the risks that open banking brings along? How do we understand the inner workings of new business models that are built on artificial intelligence and machine learning? How do we ensure that consumers are properly protected?

In Denmark, we see a tremendous potential in fintech and the use of new technology in the financial sector. However, it is important as a regulator to understand the risks associated with fintech. At the Danish FSA, we have launched a number of initiatives to achieve this. Last summer we established a dedicated digitalisation division within the FSA to better understand and supervise the new risks that arise with the increasing digitalisation of the financial sector. At the same time, we established a dedicated fintech division that works together with the fintech community. The fintech division also studies new business models deriving from the possibilities within digitalisation in order to achieve a better understanding of both possibilities and risks in this new area.

Navigating through the financial regulation can be difficult for fintech start-ups. As a regulator, our main hope is twofold. By reaching out to this community, we hope to ease the entrance into the regulated financial world. In addition, we hope that fintech companies, at an earlier stage than today, be-come aware of the financial regulation, in order for them to include regulatory aspects into the business model.

To achieve this we have launched a number of initiatives, including improved guidance to fintech start-ups and a sector forum for discussions of fintech. Most prominently, it includes FT Lab, our regulatory sandbox. FT Lab is a safe environment in which we will test new technologies and business models together with fintechs – both established financial institutions and start-ups. This will allow us to under-stand better these new technologies and models, and hopefully it will promote the use of new technology and fintech in the financial sector, to the benefit of consumer who will get easy-to-use and innovative financial solutions that have the same level of protection as traditional financial products. ●

Andreas Dombret

Member of the Executive Board, Deutsche Bundesbank

How should regulators respond to digitalization?

Financial technology stands for change. We are seeing change in every segment of banking, from instant payments to mobile banking and robo-advice. Last but not least, customers are part of this change as well. So there is indeed a strong case for preparing to meet further change.

But although the impact of digital transformation is felt almost everywhere in the financial industry, we still do not know where it is leading us. Technological, economic and societal questions still need to be answered. This is a de-manding environment for regulators and supervisors. If we look at concrete policy issues, these often concern very distinct issues, ranging from digital signature to crypto currencies. Moreover, a variety of policy objectives are in-volved, such as maintaining a risk-adequate financial regulation, ensuring consumer protection and fostering innova-tion. In such an environment, maintaining both a general view and keeping abreast of the problems at hand is of key importance.

From the viewpoint of a German supervisor, we have so far had good experiences with a technologically neutral ap-proach to regulation in our country. The idea is to regulate activities, not technologies per se, and to regulate those activities in a risk-adequate way. This prevents regulation from becoming outdated as soon as new technologies and new businesses emerge. >>>

>>> Still, the digital age is likely to necessitate policy adjustments as the financial sector continues to evolve. In that re-spect, an overall objective from a European point of view should be to avoid fragmentation of regulation from the start. Especially in a digital environment, where borders and long distances become less and less important, harmoni-sation of rules is an ongoing topic. We have witnessed European directives without full harmonisation requirements (such as rules for AML/KYC) that have led to diverging national implementations. This is an impediment to a prosper-ing single market and the scaling of fintech. The EU needs to take a stand in favour of comparable business and innova-tion environments across member states. The EU Commission's Action Plan of 8 March addresses these concerns. Alt-hough we do not fully agree with all its proposals, such as establishing "regulatory sandboxes", the general thrust of the Action Plan points in the right direction. ●

Eva Maydell

MEP, Committee on Intern Market and Consumer Protection, European Parliament

Bridging the gap between EU financial markets by technology

Even before the digital era technology has always had an impact on financial markets. For instance, many explain the rise of the New York Stock Exchange at the expense of the Philadelphia Stock Exchange on the liquidity the former attracted from orders collected over the telegraph. When the telegraph network spread all over the US, the local financial markets got much better integrated, receiving information from each other instantly, without hours or days of delay.

Fast-forward to present day, one does not have to be an expert to know that, unlike almost every other field, the financial services industry has been remarkably impervious to technological innovations. Even though recent tech developments in areas such as cloud computing, AI, mobile applications and big data analytics are being embraced by banks to improve their business models, the change is not disruptive enough to act as a catalyst for integration of EU financial markets.

This is mainly due to the fact that the Internet that we have been using for the past 30 years is an environment for spread of information but not assets. The recently becoming popular distributed ledger technology, which prime example is blockchain, allows digital information to be distributed but not copied, which is essential difference when it comes to financial services.

This technology can boost development and integration of EU financial market in several ways.

First, Blockchain could lower dramatically the cost of many financial activities by making them automated. This would have a dramatic effect on incumbent big financial institutions, which face high operating costs. For instance, blockchain can provide more efficient pricing calculations and better risk management methods.

Second, the way financial markets work could be fundamentally changed by cutting out the intermediaries such as banks or payment systems, which can be done using blockchain. However, despite this sounds like a shortcut to achieving better market integration within the EU, it's important that regulators first make sure that the new technology is reliable and can guarantee safe and secure transactions.

Third, blockchain technology provides consumers with their own digital identity. Besides the obvious advantages for consumers, digital identities bring enormous benefits for financial institutions such as reduced risk and cost of data breach, efficient compliance management and monitoring, easier clarification of the tax status and many others.

Last but not least, distributed ledgers could improve compliance with the ever expanding EU legislation in the financial sector and thus harmonise operations between institutions from different markets. The use of blockchain would allow regulators to easily resolve compliance issues, monitor new regulatory obligations and enforce internal audit requirements for insurers.

Clearly, technology has the potential to play a decisive role in the development and the further integration of EU financial markets. However, the Capital Markets Union and the Banking Union cannot be completed without the necessary regulatory efforts by Member states, no matter what technological innovations are applied. ●

Lauri Rosendahl

President, Nasdaq Nordic

Want Fintech to succeed in Europe? Embrace it fully

Europe is at a major turning point in its history. With a variety of regime changes and new policies impacting the private and public sectors, like MiFID II to Brexit and its outcomes post-March 2019, there is certainly a lot happening. Not all of it positive, but whatever shape it comes in, change always also brings some opportunities with it.

One area that has had near universal interest—and excitement—has been the substantial growth of new fintech in past few years. Europe, and not least the Nordic region, I am proud to say, has been a world leading region in this space.

Technologies such as blockchain, machine intelligence and cloud have real-world applications that are directly improving how Europe's financial systems operate. Some of these technologies, particularly blockchain, are not necessarily even in the emerging phase anymore. Instead, we are starting to see how they are quickly evolving from buzzwords into more mature technologies that are starting to show what and how they can be applied in real life. That said, there are still also countless opportunities ahead to explore. >>>

>>> The way I see it, many of these technologies are not fly-by-night in nature, but here to stay and in some cases already being applied by Europe's capital market ecosystem.

Also, we are starting to see more and more industry groups and companies who are coming together to explore how they can make the best use of technology, and ensure their implementations comply with regulations. Examples include the CSD Working Group of Distributed Ledger Technology, and our Nasdaq cooperation with SEB, one of the leading Nordic banks, to develop a blockchain based solution for the fund market.

Local European regulators and Brussels have important roles to play in supporting and further developing the European financial ecosystem, in order to embrace new and emerging technologies to improve competitiveness and maintain the momentum they currently enjoy. Therefore I warmly welcome the Fintech Action Plan that the European Commission put forward in March. Especially, I encourage the initiatives to harmonise regulatory considerations around cloud technology. Also, I appreciate the Commission's intent to stay technology neutral in policy making and I believe the international approach on Initial Coin Offerings is very relevant. I hope that a more unified European Fintech approach will also enable more cooperation with similar institutions in other parts of the world.

As for Nasdaq's fintech ambitions in 2018, we will continue to roll out Nasdaq Financial Framework, which is our modular market technology architecture that provides next generation capital market capabilities. We are evolving our core services that already run at over 100 marketplaces globally into a new suite of business applications.

We look forward to continued partnerships with Europe's market participants, issuers, regulators and other technology companies and encourage collaboration between all parties to create a stronger, more efficient and transparent capital market ecosystem ready for the future. ●

Adriana Pierelli

Managing Director, Regional Executive Southern Europe, BNY Mellon

Fintech – areas of focus for legislators and for the financial services industry

Fintech is an important and fascinating topic.

In its Fintech action plan published on 8 March, the European Commission explained that the financial sector is the largest user of digital technologies, and is a major driver in the digital transformation of the economy and society.

With respect to fintech, the main objectives of the public authorities are to ensure that the potential benefits of fintech are realised, and that new fintech developments do not create undue risks for end users and for the financial system itself.

The main objectives of banks with relation to fintech are very similar. We want to seize the opportunities offered by fintech, and we want to ensure that the transformational changes brought about by fintech lead to a financial system that is safe and secure and that delivers real benefits to end users.

Both public authorities and banks have a major interest in understanding the ways in which fintech will change current financial processes and market structures.

Two areas of technological change that will be particularly important for the financial industry are robotics and distributed ledger technology.

Robotic Process Automation (RPA) is a way of integrating robotics into financial processes. RPA is based largely on software tools called "bots" which are capable of performing repetitive or routine business tasks; they interact with different software applications through APIs replacing time-consuming repetitive tasks and freeing up staff for other more creative activities.

If RPA is the current reality, other types of robotics, such as artificial intelligence (AI) and cognitive technology (like natural language processing, speech recognition and others), are the future. These are still less easy to implement on large scale, and in many cases are still in a development stage, but they have the potential to aid staff both for back office, and for selected front office, activities.

Distributed ledger technologies (DLT), including block chain, are very interesting, as they offer the potential for improved management and distribution of data, especially when the data have to be transferred, and used by different parties. In the financial services industry, there are important business processes – relating, for example, to issuer and end investor information, and to withholding tax processing – for which currently there are difficulties in managing and processing data.

Transformational change is dependent on new technologies, but it

is also dependent on other factors, such as whether there is a sufficient culture of innovation, the absence of market and regulatory fragmentation, and the existence of platforms that can serve as the connecting point allowing end users to access multiple products and services to be delivered using new technologies.

Compared to the rest of the world, Europe may not be weak in new technology, but it is certainly weak with respect to innovative culture, fragmentation, and the development of platforms.

We shall need an increased focus both on the development of competitive, European platforms, and on the strategic implications for the European financial system of major financial flows being facilitated and processed on largely unregulated, global platforms. ●

Per Callesen

Governor, Danmarks Nationalbank

The role of central banks in a transformative financial system

The financial sector is transforming as innovation and technological developments together with new regulation, including PSD2, pave the way for new business models and new market players. These new market players comprise of fintechs as well as bigtechs, who are expanding their services to new business areas. For incumbent market play-ers this transformation entails that they must be ready to face increased competition and be open to new partnerships.

Increased innovation and competition should be embraced by financial authorities just as we welcome innovation and competition in other sectors of the economy. In Denmark, the Danish FSA have taken steps to promote such virtues by, among others, creating a single point of entry for fintechs and launching a sandbox initiative. Such initiatives and closer dialog are to mutual benefits for the supervisory authority and the fintechs.

While welcoming new market players, the overarching purpose of financial authorities is to safeguard against sys-temic stability problems. Thus, it is vital that new players who provide bank-like services, e.g. players who start tak-ing deposits and provide lending, are regulated as banks and face the same requirements as banks.

The foundation of an efficient financial system is the underlying payment infrastructure that enables businesses and consumers to transfer money efficiently and safe. Central banks continuously play a pivotal role in the financial sys-tem by providing financial institutions with safe, efficient and scalable payment systems and by ensuring the pur-chasing power in terms of low and stable inflation. Being the bank of the banks, which is the core business model of a central bank, is thus as relevant today as ever before.

The prevalence of new technologies does not call for a change in the core business model of the central bank. How-ever, sticking to the business model does not imply that central banks should merely look passively at a financial system that is evolving ever faster. Central banks must take a catalyst role when needed to benefit society in the long term. One example is the area of payments where central banks have played an important role in the development of instant payment systems that enable players in the market for payments to provide new and better services. This demonstrates that central bank involvement can be a driving force in enhancing the underlying basis from which market players compete against each other to the benefit of consumers, businesses and society as a whole. ●

Alan Marquard

Chief Strategy &
Development Officer, CLS

Moving from concept to production: FinTech comes of age

Innovation has always changed how financial services are structured, provisioned and consumed, but the pace and extent of innovation today is enabled by technology that has the ability to dramatically transform financial services as we know them. Regulators, policymakers and financial market participants are seeking to answer the many questions presented by FinTech: what is it, who is it, how should it be incentivized, developed and used and how should it be regulated?

Although there is much talk of FinTechs versus incumbent organizations and who will succeed first in delivering major technological change to the market, FinTech is not an organization type. In reality, new, disruptive ideas in financial services are being incubated by large technology companies and the well-funded innovation centers and labs of banks and their consortiums - organizations that do not fit the stereotypical image of the garagiste FinTech start-up. The primary question is not where the technology comes from, nor even always what the technology is, but rather how disruptively you can apply it to businesses.

The rise of FinTech has been accelerated by business model and value chain challenges and inefficiencies – many existing ways of doing business are simply not working. However, new technologies are unlikely to transform the market until they are translated into solutions to business process problems. That translation involves a deep knowledge of the business processes, the ability to integrate with existing processes and platforms, and for really important activities such as those currently undertaken by FMIs, oversight, governance, credibility and trust. The full potential of FinTech in critical applications will only be realized when those firms developing new and innovative technologies join with organizations that have experience of running and maintaining resilient technology and operations at scale. For that reason, numerous organizations and consortiums that had approached financial innovation from a technology-first perspective have reached out to experienced market players like CLS to collaborate. As more small firms are moving out of the sandbox into the bigger playground, we expect to see more partnerships across technology firms and traditional financial services providers that can make a proof of concept a reality. Regulators and policymakers should consider taking steps to encourage and facilitate this type of collaboration in the marketplace. ●

Kaj-Martin Georgsen

Head of Corporate Responsibility
& Public Affairs, DNB

In a fintech world, embrace partnerships to stay relevant

Like many incumbents, at DNB we started hearing the first whispers about fintech about five years ago. The first mentions of the word fintech in Norwegian media appeared in 2014, when it was used in exactly 43 articles. In 2017 the figure was 571. By the time the PSD2 directive was adopted in 2015, the realisation had sunk in that something big was afoot.

At the time, we would read reports and draw up strategy slides describing the coming onslaught of the fintechs. Having endured a "tsunami of regulations" following the financial crisis, we braced ourselves for a second tsunami of lean, hungry, tech-savvy startups that would eat away our margins and leave us as an overregulated supplier of expensive legacy infrastructure. Fortunately, things did not quite turn out that way.

Because we soon learned that fintech is not something you are, it is something you do. And it turned out to be something we could do ourselves – and had in fact been doing for years. Today, two of the top ten apps in the Norwegian App Store have been developed by DNB. Our P2P payment app Vipps has 2.7m users in a country of 5m people. We hire more technologists than business graduates. Instead of being outcompeted by startups, we are spinning off startups of our own.

Along the way, we have learned a few lessons about the value of partnerships.

First, partnerships with fintechs help us adapt more quickly and bring new services to market faster. Tech startups are just as interested in working with us as competing with us. For a startup, a bank has a lot to offer: an established customer base, compliance teams versed in KYC and AML rules, and financial muscle.

Second, partnerships with public authorities have helped us set up a web of APIs that allow us to establish fully digital processes, such as the processing of mortgage applications, for which you typically need data from banks, tax authorities and property registers. Today, a house buyer in Norway can apply for a mortgage from our app and have it approved in less than two minutes. That would not be possible without a strong digitalisation drive from the public authorities.

Third, partnerships with other banks enable us to build scale and increase customer uptake quickly by establishing open standards that allow for competition on top of our shared infrastructure. This approach has resulted in the most cost-effective payment transactions in the Nordics and an industry-driven national eID scheme used by 75% of all Norwegians. Increasingly, we see banks not just as competitors, but as potential customers. When we partnered with a British and a Dutch tech startup to develop a customer onboarding solution based on biometric passports, instead of keeping it to ourselves, we realised we could sell it as a service to other banks.

Fourth, partnerships with businesses allow us to cross-fertilise good ideas across sectors. By working with our corporate clients to help them adapt and grow, we hope to be able to contribute to the long-term viability of companies whose business we will depend on in the future.

At DNB, we have gained a lot by actively seeking co-innovation opportunities with both existing vendors and new players alike. We believe building strong partnerships is the key to competing in the digital marketplace. ●

Fintech in the CMU

Felicia Stanescu

Head of Financial Services Policy and International Affairs Unit,
DG Financial Stability, Financial Services and Capital Markets Union,
European Commission

#FinTech EU – Financial innovation as key driver of the EU single market

On 8 March 2018, the Commission unveiled its FinTech Action Plan for a more competitive and innovative European financial sector. This document is the first EU-wide strategy to promote innovative and digital solutions in the financial sector.

The Action Plan draws on the comments received from a public consultation on FinTech. The large number of responses to the public consultation reinforced the Commission's belief that a non-prescriptive approach, based on technology neutrality and same activity, same risk, same rule principles towards FinTech is the best response to facilitate the scaling up of new technologies and services at the EU level.

Europe's financial markets will be more integrated, safer and easier to access and firms and entrepreneurs will have more opportunities to pitch their ideas to a wider base of funders as a result of the recent legislative proposal on crowdfunding, which grants EU passporting rights. The plan will also help the financial industry to benefit from the technological development (e.g. blockchain) and strengthen cyber resilience. An in-depth assessment of the regulatory obstacles to financial innovation is also part of the proposed actions.

At the same time, the Commission will continue to support regulators in acquiring relevant skills through an EU FinTech Lab where European and national authorities will engage with tech providers in a neutral, non-commercial space. This will contribute to supporting the uptake of innovative solutions in all EU Member States. Furthermore, the Commission has already launched an EU Blockchain Observatory that will map the most promising initiatives in the EU, build a community on these topics, and report on the challenges of distributed ledger technology's application in and beyond the financial sector. Experimentation is a keyword in the EU FinTech action plan: at national level, several member states already took steps to promote financial innovation and to provide market players with regulatory compliance guidance through national hubs and sandboxes: the Commission will present best practices on regulatory sandboxes.

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>>> Overall, the FinTech action plan will be beneficial to regulators and supervisors, to established and new market players and to citizens. In particular, the initiatives aim to enhance supervisory convergence towards technological innovation, to prepare the EU financial sector to embrace the opportunities brought on by new technologies, and allow new business models and technologies to scale up at the EU level. Everyone will benefit from more choice, more competition and more safety when using technology-based solutions for their own daily activities.

FinTech is also about social inclusion, jobs and growth, which have always been priorities for President Juncker's Commission. FinTech will help fostering social and financial inclusion bringing more easy-to-use services to citizens, and it will stimulate other forms of financing benefitting from single market's economies of scale. New jobs will be created, new skills will be developed and this will have important effects not only on labour markets but also on young generations' education. FinTech will also help boost economic growth: new services, new business models and new opportunities offered by progressive digitalisation will be key drivers of future economic growth.

The dynamism of the FinTech sector could not find a better place than the European Single Market, which offers the best opportunities to exploit economies of scale, with a market of more than 400 million citizens.

Finally, this action plan has important synergies with other Commission initiatives, such as the Consumer Financial Services and Sustainable Finance Action Plans, the wider Digital Single Market and Cyber Security strategies. It will contribute to the development of the Capital Markets Union as FinTech has the potential to transform capital markets by bringing efficient solutions, increasing competition and lowering costs for business and investors. ●

Contributors: Francesco Oriano Passera, Delphine Leroy and Jon Isaksen

Tracey McDermott

Global Head - Corporate Affairs, Brand & Marketing, Standard Chartered Bank

FinTech, disruption and regulation: what we can learn from Asia

Customer expectations are changing the banking landscape. The traditional banking model, with products and processes for savings, lending, and business services, provides a fertile ground for disruption. Technology-enabled innovation is creating new players and forcing established ones, like banks, to re-think themselves. With the emergence of new players, technology is also changing the rules and the wider environment in which all market participants, both old and new, operate.

It is widely acknowledged that there are emerging risks that need to be managed. In this context, it seems inevitable that regulators will have to re-think their traditional role and how they adjust to the current world. With fairness, transparency and ethics in artificial intelligence (AI) and personal data ownership at the very top of the public policy agenda, regulators will need to work hand in hand with non-banking regulators and other governmental agencies, such as information commissioners and privacy teams. In Singapore, the MAS is already aligning to the privacy regulator on some of its initiatives. Further, regulators around the world are facing the challenge of needing to strike a delicate balance between creating an ecosystem to promotes innovation, whilst also guaranteeing the right level of consumer protection. In the AI space for example, a balance needs to found between the question of auditability and the need for regulators to reflect on how much of an "explanation" as well as audit trail they require. This will require careful consideration of what is necessary for consumer protection bearing in mind the demands for speed and convenience and the potential ability of data >>>

>>> analysis, beyond the capability of individual human beings, to provide more specific and targeted advice.

Beyond their traditional role, another way in which banking regulators are influencing the fintech space is by championing specific projects using emerging technologies that require industry level coordination and can help improve efficiency. Drawing from our experience, in Singapore, Standard Chartered partnered with DBS Bank and Singapore's Infocomm Development Authority to successfully complete a proof of concept to deliver the first ever application of distributed ledger technology (DLT) to enhance the security of trade finance invoicing. Leveraging DLT, the initiative reduces risk around duplicate invoice financing for banks while preserving client confidentiality.

"Banks can work together with regulatory authorities to develop innovative solutions."

- TRACEY MCDERMOTT

In Hong Kong, last year we announced the successful completion of another proof of concept leveraging DLT and the use of smart contracts for Trade Finance to bring an ever better customer experience, enhanced operational efficiencies, and reduced potential frauds for financiers, importers and exporters. We did this under the auspices of the Hong Kong Monetary Authority's Fintech Facilitation Office, collaborating with Deloitte Touche Tohmatsu Limited and four other banks.

Our experience both in Singapore and Hong Kong demonstrates how traditional banks can work together with regulatory authorities to develop innovative solutions. The EU FinTech Action Plan is a welcome development, which we hope will create a framework to boost financial innovation across Europe, whilst ensuring new emerging risks are duly considered. ●

Kalin Anev Janse

Secretary General, European Stability Mechanism (ESM)

The ESM: how a public sector issuer deals with Fintech

Digitisation has been around for many years, but society has only just begun to explore the possibilities it has opened up. The next industrial revolution is now on the brink of making its impact fully felt. The operating models of businesses and public institutions stand to modernize fundamentally. In banking, the changes brought by what is now known as "Fintech" will be especially deep. Fintech has the potential to alter the nature of capital markets, the financial industry and the behaviour of issuers and investors for good.

As the new kid on the bloc of public sector institutions, the European Stability Mechanism is right in the middle of this shift. The ESM was set up only in 2012, preceded by the European Financial Stability Facility by just two years. It does not have the systems others inherited from a long past. The ESM is a lean outfit and uses new digital technologies. ESM systems are cloud-based and we use support tools based on algorithmic data analytics. An "ESM 4.0" staff group is evaluating new digital opportunities, such as robotics.

But that is not the only reason that the ESM is looking so closely at the changes that will transform the financial world. Digitisation will make capital markets far more efficient, which could foster financial stability. Standardization of debt instruments and the way they are traded and settled, artificial intelligence, and a well-informed regulatory framework that can react fast, will all allow for more efficient markets. Such a modernisation of fixed income markets – where innovation has been largely absent since the early 1990s, especially with respect to operational and syndication processes - would fit seamlessly into the European Union's efforts to set up a Capital Markets Union. It would promote cross-border capital flows, improve the allocation of capital and liquidity, reduce Europe's heavy reliance on bank funding and increase euro area economic risk sharing. These are all important policy goals that will help the work of the ESM, which has the mandate to protect the euro area.

Moreover, the ESM is a prominent bond issuer, which needs to be close to its investors. And so, we want to be prepared for the changes technology will bring. The innovations mentioned above will bring about differences in execution in the primary and secondary markets: not just for banks, but also for issuers. Competition from non-bank providers - with high digital capacities - will become stronger. We can already see banks experimenting with electronic platforms and distributed ledger technologies to distribute debt. The way public issuers sell debt to investors is bound to look very different in a number of years' time. The ESM wants to be prepared for that new situation, whatever it may be. This is in the interest of our investors and shareholders. The ESM doesn't want to be forced into accepting a new status quo that is suboptimal. It wants to have a say in how its bonds are issued in the future. As a public sector institution, that is a duty towards taxpayers. And it is in line with its mandate of achieving the lowest cost for its shareholders – the 19 countries of the euro area – and for the programme countries that are receiving or have received its support.

It is to that end that the ESM has proposed setting up a European issuance platform, which would be fully in sync with the Fintech revolution. Syndicate banks would still play an important role on the platform, but that role would be non-exclusive and possibly at a lower price. First tentative discussions about the idea are now taking place. A common European platform for sovereign debt issuance would suit the many policy goals I mentioned above. It would contribute to the stability of the euro area. It would fit right in with the ESM's mandate. And it would be true to our nature as an organisation born in the digital age. ●

Mirèl ter Braak

Senior Policy Advisor Innovation & Fintech, Dutch Authority for the Financial Markets (AFM)

Tech is driving change not only within commercial businesses, but also within regulators and supervisors

Innovation is a vital ingredient for any healthy economy. Only by constantly innovating and reinventing themselves, companies will be able to keep meeting consumer needs. The AFM together with the Dutch Central Bank and supervisors in other jurisdictions make a range of services available to innovative firms, from answering regulatory queries to other bespoke and tailor-made approaches, designed to encourage and enhance innovation. Moreover, these interactions are also a great learning experience for both supervisors and commercial businesses. As digitalisation is taking place at a speed we haven't been confronted with in terms of earlier innovations, supervisors need to stay on top of things.

"Moreover, these interactions are also a great learning experience for both supervisors and commercial businesses.

- MIRÈL TER BRAAK

Offering a bespoke service to fintech firms and incumbents helps to detect unnecessary barriers to innovation. Most barriers are caused by misunderstandings or different interpretations of legislation by regulators/supervisors and firms. Therefore, we do not see many European regulatory barriers that prevent Fintech firms to scale up and provide services across Europe. However, differences between countries in the application of legislation can hamper fintech firms that operate without an international footprint to provide cross-border services, or due to the national nature of the legislation of certain activities. For example, national supervisors can in practice apply the same European obligations differently with regard to the client onboarding process or the suitability of board members. When these differences are not justified by cultural/national differences, we very much support supervisory convergence in these areas and the coordination of regulatory interpretations. We also support a proactive role for the Commission in collaboration with the ESAs and perhaps global organisations to stimulate convergent national sandbox initiatives taken and to support cross-border sharing of best practices and sandbox outcomes. Sandboxes shouldn't lead to regulatory competition between jurisdictions.

In considering the appropriate regulatory and supervisory response to technological innovations in the financial sector, we believe a number of principles should be consistently taken into account. Regulation and supervision should be: 1. activity-based as opposed to entity-based, 2. technology-neutral, 3. proportionate, 4. applied with an 'accommodating mindset', 5. complemented by the development of adequate non-regulatory instruments and remedies, and 6. developed based on a horizontal approach.

These principles will help legislators and supervisors to strike the right balance between facilitating technological innovation and enhancing the integrity (safety and reliability) of these technologies for investors, consumers and the financial system as a whole.[1] ●

1. These principles are also reflected in our response to the European Commission Consultation on Fintech.

Märten Ross

Deputy Secretary General for Financial Policy and External Relations, Ministry of Finance, Republic of Estonia

Can fintech provide an extra boost to the CMU?

How may fintech contribute to achieving the CMU?

Continued technological innovation in financial sector (fintech), if well supported by regulation, is there to play an important role, i.a. in lowering transaction and screening costs. Thereby it supports both domestic and -- probably even more so -- cross-border aims of the CMU. Certainly, many basic aspects of >>>

"Fintech is certainly adding to the promise of more efficient regional or even global financial intermediation".

- MÄRTEN ROSS

>>> the capital markets, like well-functioning bankruptcy procedures or how to strike a right balance in the information requirements for issuers change little with fintech per se. But suggestion that capital markets thrive without taking advantage of fintech is not well founded and would push our own and foreign investors away from Europe.

What policy measures and supervision are needed at EU level to support the development of fintechs?

Financial regulation must be sufficiently flexible for leaving room for supervisors' on-site knowledge and strive for technological neutrality. Or at least thinking in these terms.

The whole process must be supportive of innovation and take advantage of opportunities. In the side of supervision the must is open mind and expertise, both in technological risk assessment and in understanding fintech links with financial intermediation. This should not be mixed with the calls to relieve prudence on risk controls, but supervisors' role is important to support the functionality of regulation. Therefore, the March roadmap by European Commission is touching right questions. However, it is in many aspects the question of global competitiveness, so there is no time to be wasted.

Should a cross-border development of fintechs be encouraged?

Yes. Fintech is certainly adding to the promise of more efficient regional or even global financial intermediation. It would be strange to hinder that. However, that should be put into the context – fintech is mostly about improving the processes we already know. It would not as such change the basic questions of finance. Therefore, this encouragement should not be done via creating strange new institutions.

What role may ESMA play in this context?

There is hardly a single answer. Fintech refers to many different areas and there is no need for genuinely separable fintech-supervision. And it is not just business linked to ESMA.

Therefore, as long as there is logic to preserve shared supervisory system of capital markets the fintech as such is hardly changing the concept. In general there is an assumption that ESMA could play important role as a single market facilitator.

And there is also a case to keep fintech in mind when reviewing the ESA concept. However, where local touch is relevant today it is rather certain to survive also fintech. ●

NEXT EUROFI EVENTS

5, 6 & 7 September 2018
Vienna - **Austria**

3, 4 & 5 April 2019
Bucharest - **Romania**

September 2019
Helsinki - **Finland**

Digital payments

Madis Müller

Deputy Governor,
National Bank of Estonia

Embracing "open banking" and instant payments will advance digital banking

Digitalisation is improving transparency and access to information, and moreover it helps prepare the ground for further innovation. In recent years Europe has witnessed a number of new market entrants that aim to make payments and financial services more efficient and digitally tailored so as to simplify the lives of end-users. Europe is now in the process of implementing open banking by granting third party access to bank accounts, while SEPA instant payments are gaining traction as well. These ongoing developments create opportunities that allow digital retail banking and payment solutions to advance at the pan-European level.

The new payment services of PSD2 and its regulatory technical standards for common and secure communication are just the beginning of open banking. Open banking was given a kick-start when incumbent banks were obliged to allow third party PSPs to use their online banking infrastructure to provide payment initiation and account information services. This should promote the development of seamless and user-friendly solutions for initiating payments. More importantly, account information services could unleash opportunities beyond merely aggregating account statements to display the balance and recent transactions. For instance, with the payer's clear consent, the PSPs could couple the aggregated information with big data analytics to anticipate customer needs better and improve credit scoring with a view to offering digitally tailored retail banking services and financial planning solutions.

The implementation of the two new services through API-based (Application Programming Interface) communication between third party PSPs and account servicing PSPs has to be completed before September 2019. The PSD2 regulatory technical standards have been finalised, the API standards are being evaluated and work is ongoing at the Euro Retail Payments Board level, but the implementation might still result in fragmentation because of the voluntary parts within the API standards. This implies that truly implementing open banking will require continuous effort, and moreover, providers should also consider cooperation beyond payments. In practice, open banking increases competition and cooperation at the same time, as both incumbent banks and new PSPs want to provide added value for their customers. So the future could be even more integrated, as end-users would prefer

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>>> one-stop-apps or platforms that let them choose the most suitable financial services from anywhere in the Digital Single Market.

SEPA instant payments should become the new normal in retail payments. The implementation of instant payments will make retail payments more efficient and will encourage innovation. With inter-PSP e-commerce payments for instance, there would be no need to provide payment guarantees for merchants as the funds would be credited within seconds. Instant payments could also be used for person-to-person payments to replace cash, when people are splitting a lunch bill for example, and could facilitate payments between a payer's accounts at different banks.

There are also discussions to be had on how to leverage instant payments at physical points-of-sale, particularly for smaller businesses and in competition with card payment schemes. If the banks do not see a positive business case for developing such innovative solutions on top of instant payments, then non-bank third party payment initiation service providers might. However, for this to work, instant payments ought to be taken as the new normal in online banking. Otherwise the third-party service providers would not be able to use the advantages offered by instant payments to develop innovative payment solutions in the person-to-person and person-to-merchant domains.

Private customers need a single secure solution for eIDs and eSignatures that is accepted throughout Europe. Digital identities and video know-your-customer solutions could improve borderless access to financial services and help providers to reach new customers through open banking. Where national solutions have not taken off, the banking sector could consider cooperation to improve the national solution or, if this is not feasible, could propose the development of a better solution that could ultimately form the basis of a well-functioning national solution. ●

Ashley Fox

MEP, Committee on Industry, Research and Energy, European Parliament

Does PSD2 lead towards a safer and more innovative European Payments Market?

When the Commission proposed the revised Directive on Payment Services (PSD2) in July 2013, the ethos behind this dossier was 'to create safer and more innovative European payments'. However, with the final text entering the Official Journal almost 5 years later, this directive is for a European ecommerce market that has grown by more than €250 billion since. Is it fit for purpose?

PSD2 is a victim of a technological revolution in the payments industry. When PSD2 was first being discussed in the Economic and Monetary Affairs Committee, Strong Customer Authentication (SCA) was deemed to be the gold standard of verifying identity. Subsequently, this was enshrined into the Level 1 text. Since, industry has developed technology that surpasses the resilience of two-factor authentication. Through the use of Artificial Intelligence and Machine Learning, businesses are able to optimise payment routes, detect fraud and lower costs. The turning point is that industry has moved from being able to collect data, to being able to process and utilise it so that it can detect fraudulent transactions. Whether that is through identifying the items being purchased as characteristic of the purchaser or if the mouse is being moved in the usual way. This somewhat renders SCA at an arbitrary €30 pointless and ultimately less safe.

Data is the key component in this development. At the time of discussing PSD2, many of the discussions were focussed on lowering charges for consumers and banning surcharging for card payments. However, industry has had a complete U-Turn from the days of charging 20 cents per transaction. Market players have altered their value chains and are now trying to incentivise payments through their systems in order to collate as much information as possible so that they can obtain a clearer picture of the payments market. This would enable them to deliver more tailored products.

As the importance of data grows, it would be remiss not mention >>>

>>> the impact of the General Data Protection Regulations (GDPR). Though PSD2 and the GDPR were drafted independently of each other, both pieces of legislation look to put ownership of data back in the customer's hands.

Whilst the GDPR takes a strong view over what is consent and what is considered personal information, PSD2 lacks such clarity. Voluntary standards are being suggested on establishing consent for what Third Party Providers (TPPs) are being given access to. Banks will receive a request from the TPP and then will have to check with the customer exactly what they have agreed to before granting access to the information. Lack of clarity on matters such as this could stymie innovation. In addition, banks are not allowed to share 'sensitive payment data', but it is banks who decide what sensitive payment data is. As primacy of legislation has not been decided, banks will take a more conservative interpretation so as to avoid the fines of up to 4% of global turnover as per the GDPR.

"PSD2 is a victim of a technological revolution in the payments industry."

- ASHLEY FOX

The future of the payments sector relies on the safe and free flow of data. Whilst there is a lack of clarity over the interpretation of PSD2 and the jurisdiction that GDPR has over the payments industry it will be difficult 'to create safer and more innovative European Payments'. ●

Narinda You

Secretary General & Member of EPC Board, Crédit Agricole S.A.

Payments: the new frontier

Banks have definitely lost their monopoly on payment services.

They received the mandate ten years ago to provide the European market with standardized core payment services: the SEPA credit transfer and the SEPA direct debit. SEPA is a reality: harmonisation is not totally there yet but reachability is a fact.

While the banking industry was spending billions of euros to provide the backbone of payments interoperability, the noncash payment market kept on growing by 5 to 8% per year fostering the interest of new players allowed by the Payment Service Directive.

The end customer expectations were on the other hand moving fast due to matured "new technologies" and new entrants offering smart services.

Banks could at that time only witness these new players investing the field of the acceptance side of the business, proposing solutions that were designed to address the merchant's and the buyer's needs (omni-channel acceptance solution, one click payment, simplified enrolment, frictionless payment…).

They knew they had to react.

Different strategies were on the table. i) To leave the market: some banks decided to sell their acquiring activities – I suppose it is not the will of the regulators as banks provide at least a certain level of security. ii) To work with Fintechs to get more agility – it is what the industry has been doing in every country, ending up with a number of solutions that are similar yet different, thus difficult to interoperate. iii) To partner with global players to ensure the sustainability of the service – with the risk of losing a European governance.

"Fintegration" might become the new key with one tangible example, which can be summarized in 3 letters – A P I: a technological protocol enabling communication between several IT systems, which in our case means enabling banks to provide their end-customers with services developed by Fintechs.

Banks can also decide to offer as an industry an interbank payment solution that create the adhesion of their customers, be they consumers or merchants.

The instant payment could be a mean to reposition the payment account at the very center of the debate and giving back to the Account Servicing Payment Services Provider (PSP) the power to authenticate and execute the payment instruction of its customer.

The customer experience will be key: why is an Über trip so convenient? It is not only because you get a bottle of water and a candy, but also because you get the service without having to give your card, key your pin code, or hand over some cash and receive the change!

Could this experience fit all usages? This may be what banks should think about.

A new paradigm must be found that can respond to our customers' new needs and ensure a fair value sharing and sustainable model among all players. ●

Adam Farkas

Executive Director, European Banking Authority (EBA)

PSD2 and the EBA's regulatory and supervisory priorities in 2018

On 13 January 2018, the revised Payment Services Directive (PSD2) started to apply in the European Union. PSD2 is a game changer retail payments across the European Union, as the Directive has a large and ambitious set of objectives, in particular to enhance competition through the creation of two new types of payment services, so called account information and payment initiation services. It also aims at facilitating innovation, increasing the security of payments, contributing to a single EU market in retail payments, enhancing customer convenience, and it intends to achieve all this in a way that is also technology and business model neutral.

These objectives create formidable opportunities for businesses and consumers but also pose a number of challenges to supervisory authorities such as the European Banking Authority (EBA). The EBA was mandated by PSD2 to develop >>>

>>> six technical standards and six sets of guidelines, has had to deal with the conflicting nature of the aforementioned objectives throughout the development of these mandates, and was therefore required to make difficult trade-offs between the resultant competing demands. In order to achieve a suitable and desired balance, the EBA consulted widely on its draft requirements, carefully assessed the strengths of the arguments presented in the thousands of pages of consultation responses received, and then frequently re-calibrated its requirements before final publication.

Now that these challenges have been met and nearly all of the mandates have been delivered, the EBA is shifting its focus in 2018 to its statutory objective of supervisory convergence, that is: the consistent implementation and supervision across the 28 EU Member States of the Directive and the EBA's supporting mandates. In so doing, the EBA will be focusing on a number of key requirements, including those related to the security of payments, which consist of the EBA's Guidelines on the Reporting of Major Security Incidents, the Guidelines on Operational and Security Risks, and the Technical Standards on Strong Customer Authentication and Common and Secure Communication (RTS on SCA&CSC).

Amongst those, the RTS on SCA&CSC will be at the center of attention throughout the second and third quarter of 2018, as the RTS that was published in the Official Journal in March 2018 assigns to national competent authorities the responsibility to assess in consultation with the EBA whether or not a bank can be exempted from having to make available a so-called 'contingency measure'. In essence, these are fallback interfaces through which a bank's payment accounts can be accessed should its dedicated interface not be performing as expected.

The EBA will work with the national authorities to agree on a common and consistent understanding of these responsibilities and aims at ensuring transparency with market participants by publishing the agreements found. The EBA will also participate as an observer in the industry expert group on Application Programming Interfaces in order to provide technical assistance where feasible. ●

Marc Bayle de Jessé

Director General Market Infrastructure and Payments, European Central Bank (ECB)

TIPS: Eurosystem's project for pan-European instant payments

Europe's retail payments ecosystem is currently undergoing a massive transformation to accommodate user needs that stem from widespread digitalisation. On the regulatory side the Revised Payment Services Directive (PSD2) will support innovation and competition in retail payments, as well as enhancing the security of payment transactions and the protection of consumer data. On the payment services side, the European Payments Council launched the SEPA Instant Credit Transfer (SCTinst) scheme in November 2017 to enable instant payments in euro across the Single Euro Payments Area (SEPA).

Over the past few years, various instant payment solutions have been introduced in a number of countries. Some are steered by central banks (Mexico), others are industry-driven (Denmark, Poland, Sweden, the United Kingdom, etc.), and there have even been joint approaches (Australia). European Automated Clearing Houses mostly offer instant payments at national level, so a risk of fragmentation is beginning to emerge. With a view to fostering financial market integration and drawing on the demand for instant payment services, the European Central Bank (ECB) has decided to go ahead with the TARGET Instant Payment Settlement (TIPS) project.

As from November 2018, TIPS will lay the groundwork for the smooth functioning of pan-European instant payments. The platform's flexible structure and broad participation criteria – similar to those of TARGET2 – will ensure a high level of reachability. Operating under a full cost recovery principle, TIPS will make payments possible around the clock every day of the year. The TIPS service will also guarantee safety and efficiency by offering settlement in central bank money and account holdings that count towards the required minimum reserve. In addition, TIPS will possess the technical capacity to support multi-currency transactions.

When all is said and done, the future of instant payments is going to be determined not only by schemes and the supporting infrastructure, but also by the willingness of service providers and end users to buy into them. In January and February 2017 the ECB consulted with market participants on user requirements for the TIPS service. Later on, in October, the #TIPSapp Challenge was kicked off to raise general public awareness. This initiative proved very successful, with a number of providers responding to the call to develop original mobile applications for the initiation and processing of instant payments. Prototypes were presented in a marketplace during the #TIPSapp event in February 2018, which also featured panels with high-level representatives from the banking and retail sectors.

As instant payments become increasingly familiar to consumers, more and more providers will step up to offer innovative solutions. The TIPS platform offers a harmonised service that will ensure a full reach of instant payments across the euro area. This is a crucial next step in ECB's European integration agenda, as I anticipate that in the long run instant payments will come to be considered as a standard service for all types of transactions. ●

Tim Keane

Vice President & Chief Operating Officer, Western Union Payment Services Ireland Limited (WUPSIL)

FinTech - Keeping pace with customer expectations

The publication of the FinTech Action Plan by the European Commission is to be welcomed. This initiative with the objective of supporting innovative financial companies to access capital, scale-up in Europe and compete globally while also addressing threats will shape the industry in the future.

There are many definitions of FinTech but in the widest sense it can be described as the place where financial services and new technologies overlap. Financial services have always relied on technology. In fact, the foundations of Western Union were the new technologies of the mid-19th Century- the rise of the telegraph lines that introduced the possibility of wire transfer of money.

What makes the FinTech debate so relevant today is the speed of technological change and the way customers are adopting new technologies in their daily lives. Established financial institutions are rethinking how they do business, reducing costs and offering both improved and new services to their customers. Equally it enables new players to enter the market creating greater competition and choice.

From the Western Union standpoint new technologies offer at least two significant opportunities. WU continuously invests in effective risk management and AML compliance. In fact, around one third of our staff work in compliance making it the company's most important activity. We are investing heavily in monitoring and detection tools and are testing AI and other applications. WU similarly invests into the delivery of its services with mobile and online solutions. These investments are driven by growing customer demand.

What does this mean for public policy and regulation? The existing regulatory and supervisory framework is broadly fit for purpose. The rules determine parameters for conduct irrespective of the technology by which the service is delivered. At times the rules are updated, and the result is that industry adapts to meet new compliance obligations. The PSD has been an excellent example of regulation tailored to the nature and risks of the non-bank payment sector.

Where there may be room for improvement and where the FinTech Action Plan may offer a real opportunity is around the wider use of electronic identification in KYC. The investment in new technologies would also be assisted by more consistency in the application of EU rules and the removal of national discretions, for example regarding the involvement of host state supervisory authorities and the EU's anti-money laundering rules. WU would like to see the EU adopting a more harmonised and streamlined approach that would foster further integration of the Single Market. ●

Jérôme Reboul

Deputy Assistant Secretary for Banking Affairs, DG Tresor, Ministry of Economy and Finance, France

Disruption in payments: leveraging promises to foster a deeper EU market

The payment sector is experiencing considerable innovation-driven transformation. Business models are deeply transformed, the payment industry revamps itself, payments break increasingly free from traditional core banking and Fintechs rethink how individuals make transactions. That is a considerable opportunity for the EU market, ultimately to the benefit of the end-user. It also raises a number of challenges as to how regulators should leverage such opportunities, while keeping threats at bay - such as cyber-attacks.

For merchants and banks, payments have become a key differentiating activity. It has shifted from a cost center to a revenue provider and offers renewed go-to-market opportunities. The illustration of Klarna, which offers consumer credit through payments, speaks volumes in this regard. Disruption also come from Fintechs in a wide variety of products. They change end-user transactions, as consumers are changing habits based on a better user-experience and unprecedented trust for start-ups, usually unlikely in the financial field. Lydia offer real-time money transfer through mobile payments. Aggregators, like Bankin', Linxo or Budget Insight, provide a renewed access to financial data. Not to mention more general innovations, like Regtech, chatbox or algorithms, which can drastically facilitate users-enrolling.

How to turn these innovations into opportunities for a deepened EU market is quite a challenge for regulators. Decentralization and disintermediation offered by new payment methods contribute to expanding cross-border access to financial services. The Single Euro Payments Area (SEPA), and more recently Payment services directive 2 (PSD2) as well as the General data protection regulation (GDPR) constitute remarkable milestones to structure EU payments. Instant payment is the new landmark, although >>>

"Payments have shifted from a cost center to a revenue provider and offers renewed go-to-market opportunities."

- JÉROME REBOUL

>>> great challenges lay ahead to find business models for proxy-payments in physical stores.

However, when implementing these provisions, we must beware of fragmentation as well as cyber-risks. A plethora of APIs under PSD2 would be an obstacle for new entrants. A very limited number of APIs would be much preferable – work done by STET in France or the Berlin group are very helpful in this regard. Increased digitalization also means a broader surface for cyber-attacks. That is why France has decided to strongly encourage market players to adopt APIs before the end of the transitional period, to limit "web-scraping" related risks.

Finally, when dealing with innovation, caution is to be recommended as to the concept of sandbox. Choosing which start-ups are in or out, and articulation with EU legislation raise important questions in terms of both level-paying field and consumer protection. The adoption of agile frameworks proportionate to risks appears to be a sounder approach. ●

Brett Loper

Senior Vice President,
Global Government Affairs,
American Express

Europe's chance to set the tone in FinTech

Payments as a global sector is undergoing a rapid evolution, particularly in Europe. Security and technology are just two of the elements where we have seen major advances in recent years. In 2018 we are heading towards mobile payments, which are instant, secured through digital identity and powered by Blockchain technology. The accelerating pace of the payments sector is tangible. Companies are embracing these changes, e.g., American Express' collaboration with Blockchain technology providers such as Ripple.

Looking at current EU regulation, the European Commission demands that services become interoperable to give the best-possible experience to consumers. Equally, banks, payment providers and FinTech companies are asked to provide solutions that facilitate payments no matter their business model or internal structures in place.

In January 2018, the revised Payment Services Directive (PSD 2) entered into force, aiming to create a seamless open banking environment. The Regulatory Technical Standards on Strong Customer Authentication and Secure Communication will further consolidate Europe's position as the place to be for payments and FinTech companies. Furthermore, in May 2018, the General Data Protection Regulation (GDPR) will enter into force and set an EU-wide standard for the treatment of personal data and its ownership. These laws will accelerate the ongoing convergence process of best practices in the sector. This is crucial as innovation does not wait and often simply does not fit existing structures. However, it is important that regulators monitor developments while ensuring technological neutrality.

"The best regulatory environment might decide where the next "FinTech-giant" will be located".

- BRETT LOPER

The future of digital payments is tied to the future of FinTech in Europe. As FinTech companies already identified, digital payments will only thrive if the consumers adopt the new opportunities PSD 2 and GDPR will create, and it is the industry's duty to deliver.

The EU is aiming for the global driver's seat to enable innovation in the FinTech sector.

The recently published FinTech Action Plan is another step in the right direction, but it is also important to speed up the regulatory process. Staying up to speed - by being nimble in the approach - is not only important for the industry but increasingly more so for regulators as well.

To meet consumer expectations, well-established players and FinTechs must both shape the future of the payments sector and speed up the innovation process putting the consumer at the center. Ultimately, as we all are operating in a global environment, competition is growing, also across ecosystems and so, potentially, the best regulatory environment might decide where the next "FinTech-giant" will be located. ●

Cybersecurity challenges

Marc Bayle de Jessé

Director General Market Infrastructure and Payments,
European Central Bank (ECB)

Strengthening the cyber resilience of Europe's Financial Market Infrastructure

The rapid pace of digitalisation and technological developments has made the world we live in increasingly accessible and interconnected. It has also given birth to a number of innovative solutions and opened the door to new market entrants which are redefining the financial landscape as we know it.

Nevertheless, new opportunities often carry new risks. The European financial ecosystem rests on a highly interconnected and interdependent operational network that facilitates the interactions between a range of actors, including financial market infrastructures (FMIs), banks and critical service providers. In such an environment, a successful cyberattack can lead to a chain reaction with a large-scale impact. Therefore, the cyber resilience of each entity and of the financial ecosystem as a whole is of the upmost importance for the European Central Bank (ECB).

We recognise that the interconnectedness goes beyond the European dimension. The resilience of the global financial system requires a strategically aligned approach to cybersecurity at international level. The ECB takes an active part in international fora that discuss this topic and has contributed to developing the CPMI-IOSCO guidance on cyber resilience for FMIs and the G7 Fundamental Elements of Cybersecurity for the Financial Sector. In line with these globally-applied guidances, the ECB has launched the Eurosystem Cyber Resilience Strategy for FMIs, based on three core pillars.

The first pillar covers individual market infrastructures. A number of tools have been developed to assess whether FMIs are sufficiently prepared to cope with cyberattacks. One of these tools is a cyber survey which was sent out to all payment systems in the euro area. The results revealed that many of the respondents must improve their cyber governance and awareness, focusing on their people and processes, and not just on technology.

To further help the FMIs and their respective overseers, the ECB is developing the Cyber Resilience Oversight Expectations, which set out more detailed best practices for FMIs to embed in their cyber resilience frameworks. These will be subject to a public consultation in due course.

Another assessment tool is the EU Threat Intelligence Based Ethical Redteaming (TIBER-EU) Framework, which facilitates intelligence-led red team tests on >>>

>>> FMIs and financial institutions, looking to mimic the tactics, techniques and procedures of real-life attackers. The red team tests allow FMIs and financial institutions to test their protection, detection and response capabilities and enhance their level of cyber maturity. The TIBER-EU Framework is currently in preparation and will become operational in due course.

The second pillar of the strategy aims at enhancing sector resilience. To get a better understanding of the operational interdependencies between the actors in the financial ecosystem, Eurosystem overseers are developing an analytical framework and methodology for sector mapping. Having a deeper understanding of the operational network will allow the Eurosystem to identify the critical nodes, take policy decisions and improve crisis management. Additionally, the Eurosystem is closely collaborating with other authorities to ensure a consistent approach and information sharing.

The third pillar of the strategy focuses on building a public-private forum for all relevant stakeholders. In this respect, the ECB recently launched its Euro Cyber Resilience Board (ECRB) for pan-European Financial Infrastructures, which held its inaugural meeting in March 2017. The Board is chaired by Benoît Cœuré, Member of the Executive Board of the ECB, and brings together high-level representatives of pan-European financial market infrastructures, critical service providers and competent authorities. It will focus on strategic discussions about how to raise awareness of common cyber challenges, foster a spirit of trust and collaboration, and catalyse joint initiatives and solutions where necessary.

The guiding principles and actions detailed above will not bear any fruit unless we have trust and collaboration across the industry. Cyber resilience is a collective and multilateral endeavour, and it is predicated on the simple idea that at any moment, any one of us could be a victim. I believe that the joint efforts at both European and global level will have a positive impact on the stability of the financial industry, and strengthen us all. ●

Morten Linnemann Bech

Head of Secretariat,
Committee on Payments and Market Infrastructures,
Bank for International Settlements (BIS)

Strengthening wholesale payments security throughout the industry: a strategy

A chain is only as strong as its weakest link, and the chains that bind the financial system are the wholesale payment systems that handle large-value and time-critical payments. A staggering amount of money changes hands via these systems every day ($13 trillion, 22% of annual GDP, 2016 daily average for all CPMI jurisdictions). These systems and their participants are connected via messaging networks, through which payment instructions flow.

The networks have strong cyber and physical security. Yet, experience in the recent years (eg the Bank of Bangladesh incident) has shown that the network "endpoints", where payment instructions are transmitted and received, may be vulnerable to fraud perpetrated by nefarious insiders or outside attackers. Fraudulent payment instructions from compromised endpoints may result in sizeable financial losses and reputational risks for those directly involved. In extreme cases, fear of fraud may undermine confidence in the integrity of the entire payments chain and system participants may individually take overly precautionary actions, which in aggregate could create gridlock and cause a build-up of unsettled positions and exposures.

Addressing wholesale payments fraud presents many challenges. First, fraudsters are becoming ever more sophisticated. Second, wholesale payments are large-value, immediate and final, and thus more tempting targets for fraud and with limited response options available. Third, operators of the systems >>>

>>> and networks cannot control every link in the chain – they rely on the resilience of user endpoints.

Fourth, each party has an inherent incentive to guard against fraud, but the broader economic costs may not be anticipated and sufficiently internalised by individual parties, resulting in underinvestment. Fifth, even if individual parties have the right incentives, a fraud needs only one weak link. Last, wholesale payment systems are typically operated by central banks, and sharing fraud-related information (which would otherwise help others) may be a sensitive issue. All these factors suggest that in our fight against fraud we need strong commitment and collaboration, encompassing all relevant private and public sector stakeholders.

"In our fight against fraud we need continuous holistic committed collaboration."

- MORTEN LINNEMANN BECH

To that end, the CPMI has been developing a strategy to prevent, detect, respond to and communicate about fraud. In operationalising this strategy, each system and jurisdiction needs flexibility to reflect their unique features and achieve most effective solutions as well as to adapt to an evolving risk environment and risk reduction technologies. Such flexibility, however, should not lead to slow implementation or inconsistency of security requirements across systems and jurisdictions.

Our strategy needs to be supported by robust global and local monitoring and coordination with clear commitment shared among stakeholders. Through this strategy we can strengthen all the links in the payment chains that hold the financial system together. The CPMI will champion this process. ●

Gil Delille

Group Chief Information Security Officer, Crédit Agricole S.A.

Cybersecurity challenge in a fast changing environment

Digitization is one of today's major challenges facing banks. The issue is to meet the growing demand for new functionalities while addressing the risks arising from these technologies. Whilst banks are not the exclusive victims of cyberattacks, they remain very attractive targets.

Although innovative strategies have always been developed by banks to defend themselves against crime, cyber threats pose an unprecedented challenge to banks' ability to adapt. These threats are characterized by a possible intrusion into the information systems, which, if not detected in time, would make it possible to place trades on behalf of the bank itself or to extract large amounts of data.

Given the novelty of this threat, the security of banking transactions, of data and of the integrity of information systems must evolve to prevent the risks of significant losses, of reputation, as well as risks for financial stability and for corporate performance.

In response to this need, institutions have developed a three-point strategy to complement their traditional approaches. First, the development of analysis capacities for events and the continuous enrichment of the errors database constantly improve the detection of frauds (and their avoidance). Second, the urbanization of systems steadfastly aims at avoiding any interaction between software received from the Internet and essential devices. Lastly, the fight against data proliferation out of the most secure systems proves to be essential for banking institutions.

Banks have largely demonstrated their ability to develop security infrastructures that reconcile the expectations of their customers (functional wealth, ergonomics) with the control of cyber risks. Banks were therefore well engaged in the development of their activities on the internet.

However, the emergence of a new variable has disrupted the ecosystem and responsibilities: the introduction of the EU directive on payment services (PSD2). This text introduces new players, which will be able to act on banks' information systems to initiate payments and collect data.

While banks need to host in their security ecosystem actors with whom they risk sharing fraud and image impacts, transaction and data security must be maintained. Banks' security must thus involve third parties which cannot or will not necessarily want to engage in prevention and detection means proportionally to the potential impact of the threat posed by cybercrime, and whose consequences will, in the first place, be left to banks to deal with.

"Banks have largely demonstrated their ability to develop security infrastructures that reconcile the expectations of their customers with the control of cyber risks."

- GIL DELILLE

As we are entering a "test & learn" era, a constructive and quality dialogue is needed at the European level. Stakeholders (including regulators) must collectively move from a reaction stance to a co-construction rationale. Regulators' acceptance of the banks' provision of channels dedicated to new players, the Application Programming Interfaces (APIs), would be the first step. This choice responds to both the demand for expanding the financial services market and the preservation of banks' capacity to analyze relevant security events and rapidly correct errors.

Whilst we welcome this first step towards a balanced and evolving ecosystem, it is essential to remain vigilant so that its development respects the interests of customers and the economy. ●

Petra Hielkema

Division Director Payments and Market Infrastructures, De Nederlandsche Bank

Raise the bar on cyber resilience at the individual and collective level

Financial institutions and authorities in Europe have worked on a stronger baseline of security fundamentals and at the same time have recognized the need to raise the bar beyond traditional approaches in order to become more cyber resilient. When central banks and financial market authorities worldwide published the CPMI-IOSCO guidance on cyber resilience for financial market infrastructures in 2016 the aim was to encourage more harmonization of cyber resilience approaches in the financial system.

One of the key elements that the guidance emphasizes is that the board is ultimately responsible and accountable for cyber resilience. In order to address cyber resilience issues also more collectively at board level, the Eurosystem has established the Euro Cyber Resilience Board, consisting of major financial market infrastructures and card schemes and a number of Eurosystem central banks. The aim is to establish trust and collaboration among participants at board level, and to catalyze joint initiatives to enhance sector capabilities.

Another key element of the guidance is that the approach to strengthen cyber resilience extends beyond compliance to regulations and includes more advanced testing of how cyber resilience measures work in practice. At the Eurosystem level, the framework for Threat Intelligence-based Ethical Red-Teaming (TIBER-EU) will be established as a common framework to harmonize the ways to perform intelligence-led red team tests across the Eurosystem, whilst also allowing each authority a degree of flexibility to adapt the framework to their jurisdictions. In the Netherlands, for example DNB has been driving the TIBER-NL framework together with the financial critical infrastructure. From this advanced test setting the institutions involved in the framework learn ways to improve the cyber resilience and share lessons learned and good practices together. In Europe, we expect further benefits when authorities and industries cooperate closer and speed up the wider adoption of the TIBER-EU framework in the financial ecosystem.

To conclude, when we observe the dynamics in the threat landscape there is a strong recognition that there is still significant work ahead for all stakeholders in the financial ecosystem to truly improve cyber resilience. In Europe, public authorities and industry will need to actively work on establishing trust in the relationships in order to facilitate cooperation on cyber resilience initiatives that benefit the wider financial ecosystem. We have started making steps in the right direction and should use the evolving good practices to speed up and build a more cyber resilient financial ecosystem in Europe. ●

Natasha de Terán

Head of Corporate Affairs, SWIFT

The cyber threat: a global challenge requiring a consistent, coordinated response

The financial sector is arguably among the most advanced economic sectors when it comes to the use of IT and, logically has invested hugely in IT security. But it is also one of the most interconnected worlds – and a clear target for cyber criminals. The cyber threat is not transient or static, and the attackers' focus on the financial industry is neither accidental nor fleeting.

Aware of this, authorities around the world have developed strategic initiatives and rolled out new supervisory approaches; they have published guidance papers and promulgated regulations; all aimed at strengthening the cyber resilience of both individual institutions and the global financial system.

SWIFT welcomes these initiatives and supports all ongoing efforts to strengthen cyber resilience around the world. Pivotal to this is the development of a consistent and coordinated global regulatory landscape. That landscape should ideally be built around a principles-based and risk-based global framework that will provide a common approach and avoid fragmentation. This will both effectively enhance the cyber-resilience of the global financial sector and contribute to reducing overall risks to financial stability. Threats are global and so too should solutions be global.

At SWIFT we take cybersecurity very seriously: it is core to the service we offer – a secure and reliable communications channel to facilitate message exchange between our 11,000+ customers across more than 200 geographies in every corner of the world. Day-in, day-out, since our inception 40-odd years ago, we have maintained an unrelenting focus on our security.

While there no evidence that SWIFT's own network or core messaging services have ever been compromised, recent breaches of customer firms have evidenced that attackers are clearly focussed on the correspondent banking industry, and that they are >>>

>>> prepared to invest time in their attacks. In a matter of weeks after the first such a customer event came to light, SWIFT determined that, while each customer has to be responsible for its own security, a community-based approach would be the best way to solve the security issues facing the industry. We thus established a dedicated global initiative designed to reinforce and safeguard the security of the wider ecosystem – a system that stretches right around the world. Addressing customers of all shapes and sizes in geographies near and remote, sophisticated and developing, the SWIFT Customer Security Programme debuted formally in May the same year. Now well underway, actions on the programme include the introduction of mandatory security controls, new services to help prevent and detect fraudulent activity, and a global community-wide information sharing initiative to prepare for, exchange information about, and defend against, future attacks. All of this will continue in the months and years ahead as we continue in our efforts in supporting the industry face this unprecedented threat. ●

Paolo Marullo Reedtz

Head of the Directorate General for Markets and Payment Systems, Banca d'Italia

An effective cyber security strategy from a central bank perspective

The increasing digitalisation of financial services brings new challenges for financial authorities. They have to ensure complete trust in financial services, managing the balance between innovation, complexity and safety in a contest of increasing interdependencies and global and rapidly evolving cyber threats.

This requires a comprehensive financial cyber resilience strategy built upon three pillars: regulation, cooperation and risk awareness.

Regulation is a core element in ensuring sustainable innovation and preserving cyber security. The revised EU Payment Service Directive (PSD2) and

the EU NIS Directive have intervened extensively on security issues, setting security requirements for both operators and institutions.

"Strategy built upon three pillars: regulation, cooperation and risk awareness.

- PAOLO MARULLO REEDTZ

However, over-regulation can have unintended side effects, such as increased complexity owing to the articulation of regulatory levels and the need for coordination with other sectorial legislation.

Moreover, regulation has to be combined with other forms of intervention, such as cooperation. Because the financial ecosystem is a network economy, its cyber resilience relies on the willingness of financial operators to invest in and collaborate on cyber security; the key challenge is to overcome the lack of incentives for financial firms, which may not be interested in arranging common defence with their direct competitors. Central banks, as neutral third parties, can play the crucial role of trust builder, catalysing the participation of financial firms in cooperative and centralised threat intelligence and information sharing initiatives.

The third pillar relates to the human factor; cyber security is not only a technology issue, it includes processes and people, which may represent the weakest link. Employees and consumers need to be made aware of the risks arising from new technologies, which includes technical aspects, identification of potential risks, as well as full understanding of social rules and expectations.

In accordance with national and international policies, the Banca d'Italia is taking a new approach to cyber security issues, focusing its oversight framework on cyber risk assessment methodologies and promoting cooperation within the financial sector. On 1st January 2017 Italy set up the Financial Cyber Security (CERTFin), a body open to all categories of financial institutions and fully committed to delivering information sharing, threat intelligence services and awareness campaigns to its constituency. ●

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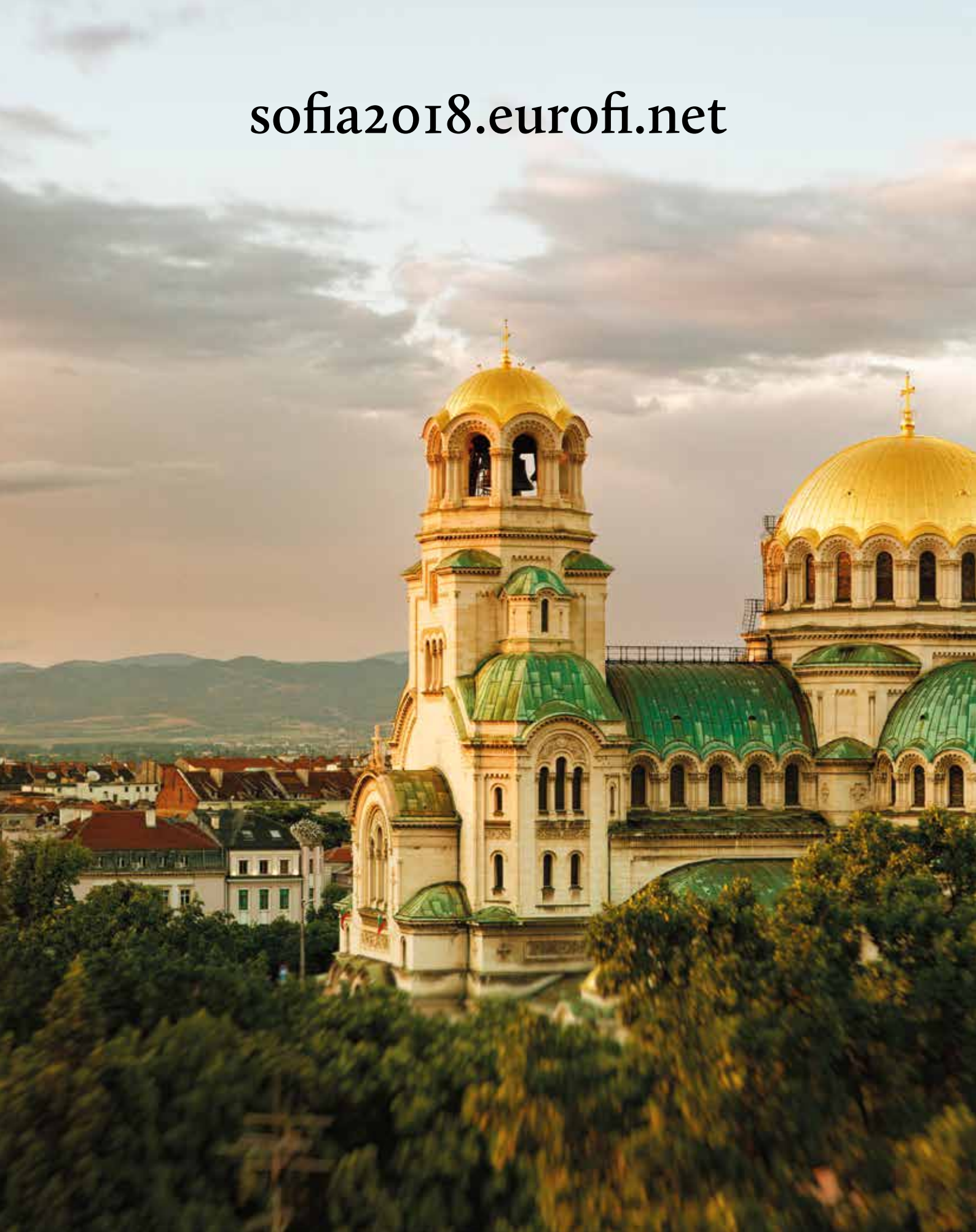

GDPR impacts

Pēteris Zilgalvis

J.D., Head of Unit, Startups and Innovation, Digital Single Market Directorate, Directorate General Communications Networks, Content and Technology & Co-Chair of the FinTech Task Force, European Commission

FinTech, digitalisation and decentralised technologies: implications for data protection

Digitalisation and the advent of new technologies such as Blockchain, Artificial Intelligence (AI), machine learning, and Big Data are posing challenges for data protection and privacy but are also offering new opportunities for European Union citizens to exercise more control over their data. As of 25 May 2018, with the entry into application of the General Data Protection Regulation (GDPR), there will be one set of data protection rules for all companies operating in the EU, wherever they may be based.

Stronger rules on data protection will mean that:

- People will have more control over their personal data
- Businesses will benefit from a level playing field and new opportunities to innovate and to make beneficial use of new technologies.

In relation to new decentralised, digital technologies such as artificial intelligence, Big Data and blockchain, implementation should aim to maximise the benefits and user control of data that the technologies could be designed to offer while minimising risks. Recital (4) of the GDPR states that, "The processing of personal data should be designed to serve mankind. The right to the protection of personal data is not an absolute right; it must be considered in relation to its function in society and be balanced against other fundamental rights, in accordance with the principle of proportionality." In the 2017 report of the European Data Protection Supervisor, it was written that, "it is essential that data protection experts begin to examine the concepts behind blockchain technology and how it is implemented in order to better understand how data protection principles can be applied to it.

An integral part of this process should be the development of a privacy-friendly blockchain technology, based on the principles of privacy by design." Such an approach will be followed by the European Blockchain Observatory and Forum, >>>

>>> which was launched on 1 February by Commissioner Mariya Gabriel and which will assess the legal issues, including compliance with the GDPR, that need to be addressed in order for blockchain to flourish in an innovative EU ecosystem and for it to be used for public services.

Switching specifically to the financial sector and the link of the aforementioned issues with the FinTech Task Force and the recently adopted FinTech Action Plan, the use of new technologies in the financial world should make the life of customers easier: providing consolidated views on their different accounts, use of new payment solutions on different platforms and across the borders, less personal data to enter in order to access services and to change suppliers, and giving them more control over their personal data. This means that data platforms and services should be interoperable and able to exchange data seamlessly.

The new Payment Services Directive puts in place the regulatory framework for banks to give secure access to customer data to alternative payment service providers. However, interoperability of services and platforms should be made possible beyond dedicated legislation such as PSD2: by design.

The FinTech Action Plan proposes measures to foster the development of standardised APIs for payment services, but also standards for the architecture, governance, security, identity, privacy and interoperability models for blockchain and distributed ledger technologies, in order to enable them as technologies benefiting consumers and enterprises in the financial sector but also more broadly in the economy and society. International discussions in fora such as the International Organization for Standardisation (ISO) Technical Committee 307 on Blockchain and on legal and policy issues between regulators and stakeholders are already taking place and this event is one such example. ●

Laurent Lascols

Global Head of Public Affairs,
Société Générale

Complying with GDPR: a multifaceted challenge for financial institutions

In 2016, the EU legislator adopted the General Data Protection Regulation (GDPR) that aims to create a standardized framework that will govern the way organizations handle data. It comes into effect and will be enforced from 25 May 2018. A matter of days now.

GDPR is a new demonstration, if need be, of the primacy given by the European Union to private data protection, recognized as a fundamental freedom in the Charter of Fundamental Rights, which became legally binding on the EU institutions with the entry into force of the Treaty of Lisbon, in 2009.

Against this background, financial institutions are concerned in the first instance given the tremendous amount of data they deal with and consequently their role of trusted third party. Let's indeed mention that in a 2017 survey, 85% of French people said they were concerned about the protection of their private data. We would probably have similar results at the European level.

In that respect, complying with GDPR naturally compelled financial institutions to tackle important managerial and operational challenges. Still, far from being a constraint, this new regulation is first and foremost a lever of digital transformation and can ultimately become a competitive advantage.

"This new regulation is first and foremost a lever of digital transformation."

- LAURENT LASCOLS

Complying with GDPR first led financial institutions to implement a genuine "data governance", supposed to number, inter alia, a Chief Data Officer (CDO) in charge of overseeing all the "data relays" in the various departments of a given organization. CDO's have to instill a "data culture" among employees, >>>

>>> making them "data fluent". To round off this "data governance", a Data Protection Officer (DPO) was appointed, whose detailed tasks, profile and rights are set forth in article 37 of the GDPR.

Moreover, many banking groups have increased their client advisory training programs in their retail networks to empower employees providing data and digital expertise for clients, reinforcing their key position of trusted third party.

GDPR will also push financial institutions to implement innovative technical measures to respond in an appropriate and timely fashion to requests by data subjects resulting from the extension of customer rights under GDPR, for instance the "right to be forgotten" or the "right to data portability". Current information system architectures will have thus to be streamlined in terms of data storage, transformation and processing of personal data.

Organizational challenges will also have to be taken up in the event of a data breach, one of the main focuses of the new GDPR. Financial institutions will have to be reactive and follow a specific procedure, reporting to the competent supervisory authority within 72 hours with a detailed notification of what the breach consists in. By imposing this end-to-end accountability, GDPR ensures clients their data is well protected by compelling not only the bank but also its support functions to fully embrace compliance. ●

Jad Ariss

Group Head of Public Affairs
& Corporate Responsibility,
AXA Group

GDPR: an opportunity to nurture a trustful relationship with customers

In May 2018, European citizens will have additional rights when it comes to their personal data. It represents a paradigm shift for all data handlers, particularly for insurers. But beyond a set of requirements, GDPR is also an opportunity to strengthen a trustful relationship with customers.

Compliance with GDPR, and this is its distinctiveness, may be understood on two levels – which could be broadly described as "process compliance" and "principle compliance".

i. Process Compliance means conformity with an explicit set of rules regarding data processing, data storage, anonymization, etc.
ii. Principle Compliance means – and this is new compared to existing regulations – implementing an overall approach to the handling of personal data.

For data driven companies such as insurers, reaching first level compliance is challenging but also opens new business prospects

Insurers have been making since 2015 massive investments to adapt to this new paradigm. First challenge has been to translate GDPR generic requirements into insurance-specific requirements (e.g. what does data portability mean for an insurer?).

Internationally active players additionally had to deal with local specific requirements (e.g. data detention guidelines may differ from a country to another). From an operational standpoint, insurers had to set up a complex governance, encompassing most professional families across all businesses: IT operations, IT security, Digital, Data, Marketing, Risk management, etc. They also had to cope with the constraints of their IT legacy, with sometimes more than twenty-year old IT systems, given the long-term nature of insurance products.

Beyond these challenges, at AXA we are also determined to lever the business opportunities GDPR has opened. As an illustration, it states that data analytics may be used not only for commercial and contractual activities, but also for statistical purposes, when data is aggregated and anonymized.

It also opens significant business and technical opportunities to work on cyber risk, cyber protection and cyber insurance.

Principle compliance to GDPR, a step stone for a principle based relationship with customers

Compliance with GDPR will go beyond "point-by-point" compliance and will mean building a principle based trust relationship with customers, which may go beyond GDPR requirements. At AXA, we have set up a Data Privacy Advisory Panel to support us in this approach, helping us establish guidelines and commitments regarding client and employee personal data. Composed of eight external independent experts, it is a governance body where issues raised by GDPR implementation and approaches to deal with data in a responsible manner are discussed. Following its recommendations, we are developing an initiative to secure that algorithms we build are designed to be ethical.

"Insurers had to set up a complex governance, encompassing most professional families across all businesses: IT operations, IT security, Digital, Data, Marketing, Risk management,..."

- JAD ARISS

We also believe that, when relevant, our internal data could be shared to the benefit of the most. With the "Give Data Back" website, we openly share – on an anonymized basis - data on water damage and theft claims in six European countries, a way to help customers and prospects better assess their risks at home and prevent them. And an illustration of our commitment to build a trustful relationship with customers and society at large. ●

Murat Abur

Chief Technology Officer,
Suade Labs

GDPR and the opportunity for technology to put a value on personal data

The General Data Protection Regulation (GDPR) is coming in to full swing this year and the impact it will have on technology in the financial industry is unknown at best. From a policy point of view, it brings the topic of personal data and the importance of its ownership into the decision-making process of the customer. This is the first step for financial services customers to consciously put a value on their privacy.

Personal data, in many ways, is an extension of private property for the digital age. Hence, it seems natural that individuals should have similar rights. The problem with personal data, however, is that it is very hard to value for the user, but very easy to value for the company acquiring the data.

Large technology companies like Google have made that core to their business. Consider the moment you launch a mapping application on your phone. "Would you like to share your location?" You can answer "No, thank you" and still use the rest of the features and functionality. Logging in with an email account might open further features like personalised search results. The service provider is effectively trading information for features. In fact, the service provider probably knows the exact monetary value of a user with location turned on versus one without. Contrastingly, there are ride-sharing apps that do not allow any functionalities without location sharing turned on. This is effectively asking a user to go "all-in" before seeing the flop (to use a poker reference).

The first approach appeals to a spectrum of users but requires a huge amount of analysis and segregation of services that can be delivered independently. The second, monolithic approach is more efficient, but has a binary impact on users. Both models are "successful" in that they have willing and accepting users.

Drawing parallels to the financial system, most firms, due to Know Your Customer (KYC) regulations, take the latter approach of requiring a large amount of information, after which, you are granted access to a wide range of services. This presents an opportunity for Financial Technology (FinTech) players and banks to compete on privacy. Some information required for a current account, a bit more information for an overdraft and a bit more for a mortgage.

"This is the first step for financial services customers to consciously put a value on their privacy."

- MURAT ABUR

It is not hard to imagine a world where a FinTech firm or bank might come to a user and say, "If you link three social media accounts to your card number, we will give you an extra 1% on a 6-month time deposit, after which we will delete all references to your social media accounts." This agreement seems to wrap in the GDPR principles of consent (at start) and the right to be forgotten (after 6 months). But what if the firm, through a combination of AI, machine learning and other technologies deduced 1,000 other data points about the user or the user's friends in that six month period? Does the user then also have the right to request data erasure for their friends? Will "highly connected" individuals then be targeted for their personal data? GDPR is just the beginning of that understanding.

These are difficult questions with difficult answers, but ultimately GDPR and the regulations that follow will force businesses to put a value on personal data and at least allow consumers to know when they are "all-in." ●

VI. IMPROVING FINANCIAL STABILITY

Issues at stake

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

In addition, macro-economic risks stemming from protectionism, global indebtedness, monetary policy and climate-related developments could threaten the sustainability of the current global and EU economic expansion in the medium term.

Content

Vulnerabilities in global and EU financial markets

Luiz Awazu Pereira da Silva

Deputy General Manager,
Bank for International Settlements (BIS)

The end of complacency and its new risks

Last year at the Eurofi meeting in Malta, many expressed surprise at investors' complacency vis-à-vis a growing perception at the time of policy uncertainty and mounting geopolitical risks. However, this February, after a long spell of eerie calm in markets, we received a jolt. One can argue about the precise weights to be assigned to rising wage pressures on inflation, a procyclical US fiscal expansion and related bond issuance, dollar depreciation and positioning in equity volatility. Whatever the reason, yield curves shifted up, and stock markets fell by 10%, the first sharp decline since January 2016 when market participants had struggled to interpret events in China. The VIX, a measure of expected stock market volatility, jumped more in one day than ever before to reach levels unseen since August 2015. One could read these signs as pointing to the end of investors' complacency.

And indeed, after long bull markets, sharp declines in equity prices are nothing unusual and volatility can serve as a useful reminder to investors of the risks they are taking. However, if such declines steepen, the risk emerges that they could trigger amplification mechanisms that lead to financial stress. This could put policymakers, especially central banks, in a challenging position. Policymaking becomes especially delicate when a significant market correction occurs with potential amplification by a highly leveraged financial sector. In addition, amplification can be greater when monetary, fiscal and macroprudential policy have little space to counteract any lasting real effects of financial stress. So where are we in early 2018? Are we well positioned to deal with repeated episodes of market turbulence?

Fiscal policy space has declined in most advanced economies over the past decade. Public debt/GDP ratios have increased since the Global Financial Crisis (GFC) of 2007–09 crisis (median: +30 percentage points). This indicator has also increased in many emerging market economies (median: +10 percentage points), in particular for commodity exporters since the decline in commodity prices in 2015.

Regarding monetary policy, the current trajectory of normalisation is creating some policy space in some jurisdictions, but from a historically low base. In the face of

>>>

>>> rising inflation, further US policy tightening can be expected. Indeed, this is what markets have begun repricing over the past weeks. The puzzle thus far is how the increase in US policy rates has not led to an overall tightening of financial conditions.

In contrast to limited fiscal and monetary policy space, macroprudential policy options have somewhat increased over recent years. Policymakers have more macroprudential instruments in their toolkit, including, under Basel III, a broad-based countercyclical capital buffer. Many countries have also gained more experience with using other prudential measures for countercyclical purposes.

Where does this leave policymakers? As they start to normalise policy, central banks face a challenging task: they are building the conditions for exiting this "Goldilocks economy" but need to do so without running the risk of triggering a new "Minsky moment". That means meeting both their price and financial stability mandates while walking a thin line when signalling their future actions. Obviously, that needs to be communicated and done skillfully. A successful example has been the Federal Reserve's announcement of its plans for unwinding asset purchases.

In addition, the GFC showed that disturbances in a relatively small market can create havoc in the whole financial system via some unappreciated links. The financial system is marked by local vulnerabilities, and the timing and severity of their manifestation are hard to predict, like the subprime exposure prior to the GFC. Where do risk surveillance and regulators need to look now, post-GFC, in early 2018? Cryptocurrencies? Exchange-traded funds? Shadow banking? Which phenomena might amplify initial shocks? We know that leverage plays a key role in amplification. However, other structures are less well understood. For example, do algorithmic trading and passive investment strategies lead to more herding in financial markets? Might asset managers respond to investor redemptions not by drawing on cash holdings but by increasing them? Could funds offering instant liquidity on the basis of illiquid assets prove fragile?

To conclude, one must hope for the best, but one should prepare for the worst. Policymakers cannot discard the new risks posed by an abrupt tightening of financial conditions. Therefore, we should use the as yet favorable environment to strengthen policy buffers as much as possible. While central banks arguably can do (and have done) a lot, monetary policy cannot be the only game in town. In the short term, we need to rebuild buffers and open up policy space on the fiscal and prudential fronts; in the medium to long term, we need to engage in structural reforms that can reduce the cost of adjusting to shocks. ●

I would like to acknowledge comments from Robert McCauley. However, the views expressed here are my own and do not necessarily reflect those of the Bank for International Settlements.

Andrei Magasiner

Treasurer, Bank of America

Technology, democratisation, demographics – How will the industry respond?

Last year I wrote about short term vulnerabilities arising from uncertainty across political, economic and regulatory landscapes. A year on, these themes continue to dominate:

- Politics: from guessing election outcomes to a sweep of new governments leading game-changing reforms from Brexit to trade and foreign policy. With protectionist leanings in the negotiations, accident risk is arguably high. >>>

- Economics: with growth picking up, central banks are expected to normalise policy to curb inflation, which itself faces spike risk from unexpected rises in wages or commodity prices. The speed and path of normalisation is critical given asset prices and leverage have trended higher. Markets will also be wary of sovereign risk if support for growth moves from monetary to fiscal policy.
- Regulation: Basel 4 finally arrived so uncertainty shifts to national implementation. There is a risk of divergence and an uneven playing field as countries are at different stages of the economic cycle.

The good news is that markets generally absorbed political-driven uncertainty, helped by a cyclical upturn in growth and a healthier banking sector. However, the recent hike in market volatility raises a question mark on continued confidence, given the range of possible negative outcomes.

From my perspective, navigating through heightened uncertainty is business-as-usual in the post-crisis world. BAC continues to manage uncertainty through stress testing and scenario analysis, wrapped up in our strategy of 'responsible growth' through 'operational excellence'.

In fact the balance between growth and efficiency is what the wider banking sector continues to grapple with in its pursuit of sustainable returns. Regulators have raised low profitability as a key risk to stability since it is through profits that banks generate capital to keep balance sheets healthy and continue lending to support the economy. While the outlook is rosier with growth and rates picking up, revenue growth is still impeded by higher capital and liquidity requirements. So the focus will be on costs, where management need to drive significant efficiencies.

Looking ahead, banks will face new profitability challenges from emerging trends changing the structure of the financial sector:

- Technology: advances allow automation which reduce banks' costs, but the same advances can increase cybersecurity risk and activate new competitors challenging established financing models by offering higher returns (e.g. P2P lending) and lower cost for services (e.g. e-payments).
- Democratisation: developments in the use of customer data by banks enable customised product and service offerings. In Europe PSD2 and 'open banking' initiatives lower entry barriers for new players, loosening banks' control of their client interface and ability to provide a 'one-stop-shop' for banking products.
- Demographics: ageing populations mean a fundamental demand shift from conventional banking products to new financial products adapted for longevity.

While these trends generate increased activity and innovation, they will increasingly be offered by new players that are not necessarily banks, prompting changes to the playing field. How should the industry respond to this disruption?

Regulators should be vigilant of financial stability risks shifting away from the banking system, and increasing complexity of the financial system as products are compartmentalised and serviced by a range of new providers. Some banks may need strategic overhauls of business models to ensure capital generation keeps apace with structural change. This is important because, come what may, bank lending will continue to be vital to the global economy.

So it is important for governments, central banks and regulators to work together to establish a global environment that facilitates responsible lending to productive investments. In particular I would recommend:

- public initiatives to incentivise productive private sector investment given the era of cheap credit is ending;
- tweaks, not fundamental change, to regulation that encourages risk-sensitivity (in the US, the Collins Floor is an easy target) and lending to key sectors such as SMEs and infrastructure ;
- better cross-border cooperation and globally consistent application of regulatory and supervisory standards to ensure efficient allocation of capital and comparability between banks.

Francesco Mazzaferro

Head of the Secretariat, European Systemic Risk Board (ESRB)

High levels of indebtedness

Excessive credit growth and leverage of the non-financial private sector have been at the origin of many past financial crisis. In particular, evidence from the global financial crisis shows that non-performing loan (NPL) ratios tended to be higher in those EU countries which experienced large increases in the debt-to-GDP ratios of households (HHs) and non-financial corporations (NFCs). Furthermore, it is also widely considered that private sector debt in developed economies remains at the centre of the global debt overhang with increasing indebtedness also observed in emerging economies. Considering public indebtedness, while the improving economic outlook and favourable sovereign financing conditions mitigate sovereign risks, fiscal fragilities remain at the country level, as identified both by the European Central Bank and the European Commission.

There are two decisive factors that could act as a trigger for the materialisation of vulnerabilities in this area: (i) unfavourable global geopolitical shocks as well as political events inside the EU; and (ii) the expected gradual rise of global yields over the next years, which is directly increasing the funding costs of the public and private sectors, making the refinancing of large outstanding amounts of debt more challenging.

In comparison with the recent global financial crisis, risks of short-term fiscal stress have receded very significantly, although medium-term risks to debt sustainability remain. Indebtedness of HHs and NFCs stands high in many EU countries and, in most cases, is still above the pre-crisis level. Moreover, the evolution of debt payment obligations in relation to income signal that their debt servicing capacity has not significantly improved despite prevailing low interest rates (it is important to note that in the aftermath of the crisis, HH and NFCs have accumulated important buffers of cash and liquid assets that may cushion them from potentially rising indebtedness concerns). Regarding sovereign debt, diversification has also improved over the recent past, but a considerable degree of home bias still exists, in particular for banks and insurance corporations in countries with higher debt levels.

"Indebtedness of HHs and NFCs stands high in many EU countries and, in most cases, is still above the pre-crisis level."

- FRANCESCO MAZZAFERRO

The range of macroprudential tools to address vulnerabilities stemming from excessive indebtedness is limited, since typically macroprudential policy targets financial institutions. Macroprudential concerns about the level of indebtedness in an economy could be channelled through institutions providing credit to indebted agents (i.e., banks). Borrower-based measures (like Loan-To-Value or Debt-Service-To-Income) would be effective tools, in case macroprudential authorities are concerned about excessive indebtedness in particular segments of the private sector. Other relevant actions in this field would comprise the continuous monitoring of lending standards and asset quality, and the enhancement of insolvency frameworks and resolution tools for HHs and NFCs. ●

Jesús Saurina Salas

Director General, Financial Stability, Regulation and Resolution, Banco de España

European banks at a crossroad

Price to book ratios of Banking Union banks' are far below those of Scandinavian, North American or Australian banks. This is the result of current lower profit prospects, given the margins expectations, the legacy assets still overwhelming their balance sheets (e.g. non-performing loans, level 3 and some level 2 assets,...), and the low efficiency ratios, as they cope with still large brick and mortar networks in the midst of a technological revolution. Overcapacity is still an issue for many continental European banks. Moreover, new agile competitors entering into the market, with lighter structures, are starting to dent income sources and targeted customers.

Despite the grim prospects embedded in price to book ratios below one, the undergoing economic recovery in the euro area offers a unique opportunity to shed legacy assets, increase margins, as lending and activity will grow >>>

>>> further or at least stop their decline, improve efficiency by adjusting the capacity (e.g. branches and employees) to the new environment, and reinforce capital, reducing leverage further.

Regulatory policy, at both micro- and macro-prudential levels, including resolution tools and MREL requirements, should move along with the recovery of the real economy and the banking sector.

More precisely, it should not forget the lessons of the last financial crisis nor to stifle banks' business models, which have been the engines of progress in Europe for many decades by providing funding to SMEs, individual entrepreneurs and families. A reasonable balance needs to be struck between enhancing the solvency of European banks and, at the same time, allowing for a recovery in the economy supported by bank lending. Still different lending cycles among European countries call for diversity in macroprudential measures, in particular the CCyB (countercyclical capital buffer) and the systemic capital buffers.

"Completing simultaneously the risk-reduction and the risk-sharing in the Banking Union should be a key policy priority."

- JESÚS SAURINA SALAS

Similarly, different access to capital markets, depending on the business model of European banks diverse in organization and size, calls for a thoughtful implementation of resolution requirements, so that banks can reinforce their financial position without putting at risk the otherwise viable provision of banking services.

Moreover, a close alignment of capital requirements to risks should be enforced, among all types of banks, preventing undue usage of measuring tools and models, which may distort incentives to manage risks properly and blur risk perception by investors.

Last but not least, from a regulatory perspective, completing simultaneously the risk-reduction and the risk-sharing in the Banking Union should be a key policy priority, so that regulation can contribute significantly to reduce the vulnerabilities of European banks and, importantly, to cement further the Banking Union, completing the roof of the institutional building before the next rainy season arrives. ●

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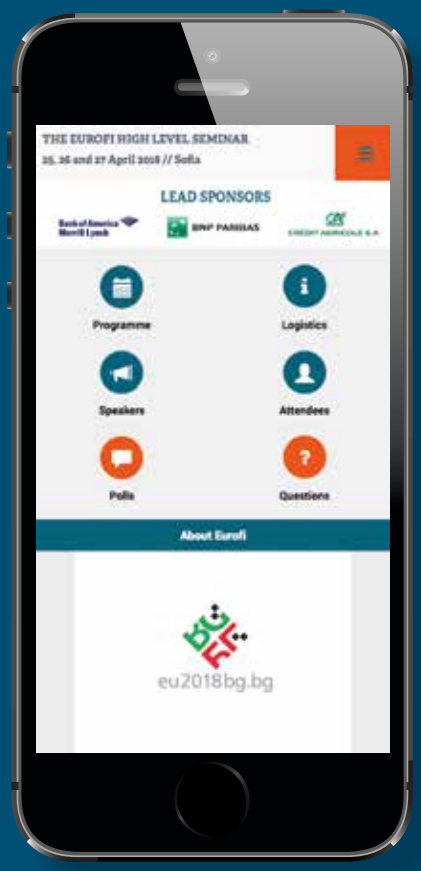

Supervision of EU and third-country CCPs

Ugo Bassi

Director, Financial Markets Directorate,
DG Financial Stability, Financial Services and Capital Markets Union,
European Commission

Ensuring safer markets through enhanced CCP supervision

The proposal[1] adopted by the Commission in June 2017 is the latest piece of the puzzle aimed at making OTC derivatives markets and central counterparties (CCPs) more transparent and safer. It follows the adoption of a Regulation on a framework for the recovery and resolution of CCPs in November 2016 and the adoption a Regulation introducing technical changes to EMIR targeted at alleviating the burden on small and medium enterprises in May 2017. This latest proposal aims at a more consistent and robust supervision of CCPs, given their growing systemic importance and the expected impact that the withdrawal of the UK will have on the regulation and supervision of central clearing in the EU.

The overarching goal of the proposal is to mitigate risks in derivatives clearing as its scale and importance continue to grow, while taking into account the role and impact of third-country CCPs in the clearing of financial instruments that are relevant for the stability of the EU financial system. To achieve this, the proposal introduces changes in the supervision of both EU and third-country CCPs.

In order to enhance the supervision of CCPs established in the EU, the current supervisory arrangements should be streamlined and further centralised through the establishment of a European supervisory mechanism, ensuring the proper involvement of national authorities, central banks of issue (CBIs) and ESMA within the scope of their responsibilities. This will help improve the coherence of supervisory arrangements for CCPs established in the EU, by promoting a level playing field amongst European CCPs and homogeneity in the application of EMIR across the EU. It will also ensure that specific areas of supervisory responsibility and related national fiscal responsibility remain adequately aligned. This will contribute to lower costs both at an institutional level, by avoiding supervisory overlaps between authorities, and for CCPs, by simplifying their supervisory framework simplified and by limiting the risk of supervisory duplication.

"This balanced approach will allow for a proportionate supervision of third-country CCPs."

>>>

>>> The Commission also proposes that third-country CCPs will be subject to a 'sliding scale' of additional supervisory requirements by ESMA and relevant central banks of issue (CBIs) based on objective criteria. The systemic nature – for the Union and its Member States – of CCPs located outside the EU and wishing to offer clearing services to EU clearing members and trading venues will need to be assessed by ESMA and the relevant CBIs through a clear and transparent process. While less systemic 'Tier 1' CCPs will remain under the primary responsibility of the home supervisor, 'Tier 2' CCPs of a more systemic nature will be subject to direct supervision by ESMA, in close cooperation with the relevant CBIs, making sure that potential contagion risk stemming from these CCPs is appropriately mitigated from an European perspective. These systemic CCPs will benefit from a mechanism of comparable compliance which will allow for closer cooperation between EU and cross-border authorities. Additionally, the proposal envisages that should a CCP be of such a systemic nature that it would only be allowed to offer services in the EU if it applied for authorisation in a Member State of the Union.

This balanced approach will allow for a proportionate supervision of third-country CCPs and adequate mitigation of any associated systemic risk, without undue fragmentation of the global system and excessive costs for market participants. This will improve the ability of EU supervisors and CBIs to address third-country CCP risks while ensuring a level-playing field between CCPs established in the EU and third-country CCPs, and providing for better ongoing enforcement and compliance of third-country CCPs.

Discussions on the Commission proposal are well under way in the Council, while the European Parliament has already tabled its draft report with the objective of voting on amendments in May. Together, once adopted, the three EMIR related Commission proposals will contribute to a safer clearing landscape in the European Union. ●

1. Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) and amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs

Danuta Hübner

MEP, Committee on Economic and Monetary Affairs & Chair, Committee on Constitutional Affairs, European Parliament

CCP supervision: a major reform to lead

It is time for a change in the supervision of CCPs. This is so for two types of reasons: a structural long-term trend and a specific new context that we are facing.

The long-term trend is the steady rise in the importance of CCPs. This rise has already prompted international bodies and EU institutions to pay more attention to those institutions, for instance through international and European work on the recovery and resolution of CCPs. It has implication for the way CCPs have to be supervised: as the role of CCPs grows, so does the need not only for good regulation but also for good and competent bodies checking compliance with this regulation. At the same time, the case for closer supervisory cooperation on cross border issues and, in the Union, for a more European approach allowing economies of scale and a sound management of cross border externalities, becomes stronger as well.

The new context of course results from Brexit and the future situation of infrastructures crucial for the economy of the Union but no longer subject to Union regulation and supervision. >>>

>>> So, the current situation calls for a well-designed overhaul of our framework. As regards third country CCPs, our system for supervision should be enhanced. We should make sure that whatever risk is brought to the Union financial system from the outside is controlled in a proper, but also proportionate, way and that we create the conditions for cooperation between EU and third country supervisors. European authorities shall be able to be heard or even act where and when a third country CCP is significant for the Union and takes actions that affect EU members and clients. Good cooperation, good memoranda of understanding and the creation of a common working culture between supervisors from major jurisdictions will be key so that supervisors can take into account each other's concerns and work effectively together.

The possibility to deny recognition to a third country CCP should exist, but as a last resort insurance mechanism, triggered after a reflection on the consequences of the decision taken on the EU markets and the EU financial system and designed in a way that protects EU clients and members of the potential negative consequences of a decision that is not meant to be taken lightly. Denying recognition to a CCP is a mechanism to safeguard financial stability. We should ensure it will in practice be so.

In the Union, the proposed amendment to EMIR is a very welcome opportunity to introduce a more European approach and build up ESMA as a trusted supervisor. A proper balance between the EU level and the national one will be crucial. ESMA should be able to step in and present the general interest of the Union, under the form of amendments to the decisions of national authorities, when needed. The priority should be to have, even with those constraints that will inevitably result in some degree of complexity, a legible system, made as simple as could be. We should also pay proper attention to designing a system that allows decisions to be taken swiftly by an entity bearing a clear responsibility in times of crises or market stress.

Within ESMA, due care shall be taken of the specificity of CCP supervision and a specific structure dealing with CCPs is necessary. This structure, however, should be properly integrated within the broader setup of ESMA. A way of doing this is to have the decisions of this structure looked at and endorsed by the Board of Supervisors, in charge of the general work of ESMA.

ESMA shall also cooperate with relevant central banks where and when monetary policy concerns arise. We should be clear about how this cooperation should take place and clearly distinguish monetary policy concerns from financial stability ones. ●

Steven Maijoor

Chair, European Securities and Markets Authority (ESMA)

CCP supervision: a right balance required for efficient cross-border oversight

The global post-crisis regulatory reform has changed fundamentally the importance of CCPs in the financial system and they now play a central role in reducing systemic risk in financial markets. For this reason, robust supervision of these financial infrastructures will continue to remain an important objective for policy-makers and regulators in all major jurisdictions.

In the European Union, EMIR established a mixed model for oversight of EU CCPs, where the ongoing direct supervision by national authorities and the cooperative oversight by CCP colleges have been supported by ESMA's validation of the CCPs' risk models, EU-wide CCPs stress-tests, peer reviews, opinions, guidelines and Q&As. While this system works relatively well, experience has also revealed certain deficiencies, which are addressed in the Commission's EMIR 2.2 proposal.

The aim of EMIR 2.2 is primarily to enhance the convergence of supervisory practices to the benefit of the EU financial market as a whole. This greater convergence of national supervisory practices is needed to address the cross-border risks that are inherent to the model of central clearing with interconnected CCPs and clearing members. ESMA as an EU Authority is very well placed to >>>

>>> take on the enhanced coordination role as proposed by the European Commission, while leaving the day-to-day supervision to national competent authorities. Furthermore, while the proposal rightly recognises the legitimate interests of central banks of issue in CCPs' activities, a better balance between tasks and responsibilities of ESMA and those of central banks issue under the new framework should be achieved. In particular, once the appropriate level of involvement of central banks is identified, alternatives to the separate consent of central banks, as envisaged in the original proposal, should be explored in order to avoid potential deadlocks.

I welcome the progress made by the co-legislators on the other important part of the EMIR 2.2 proposal, related to the oversight of systemically important non-EU CCPs (Tier 2) recognised by ESMA, following a positive equivalence decision issued by the Commission. From a European perspective it will remain key to ensure appropriate supervision vis-à-vis the most systemic and critical non-EU infrastructures active in EU markets – similar to solutions introduced and used by other jurisdictions. I am convinced that this approach is prudent but also proportionate, as the current recognition regime will continue to apply for non-systemically important CCPs (Tier 1 CCPs).

In the months ahead ESMA will be ready to build up relevant supervisory capacities and cooperate further with authorities from both EU and non-EU jurisdictions in order ensure a robust and at the same time efficient cross-border CCP oversight framework, in line with the principles of the post-crisis regulatory reform. ●

"This greater convergence of national supervisory practices is needed to address the cross-border risks that are inherent to the model of central clearing with interconnected CCPs and clearing members."

- STEVEN MAIJOOR

Erik Tim Müller

Chief Executive Officer,
Eurex Clearing AG

Building on the achievements of the G20 reforms

With the outbreak of the financial crisis in 2007, supervisory arrangements proved insufficient and deficiencies in the risk management of the financial industry became apparent. More than a decade later, there is merit in reminding ourselves how much society suffered from the consequences.

It was against this background that the G20 committed to bringing OTC markets towards more stability, mainly by introducing the obligation to collateralize most risk exposures and centrally clear certain products. For CCPs in particular, this meant they were entrusted to become the independent risk managers of financial markets – a critically important decision for our society.

The EU introduced highest standards for CCPs with the implementation of the European Market Infrastructure Regulation (EMIR). EMIR has significantly improved the systemic stability of financial markets – as for example witnessed on 24 June 2016 following the Brexit referendum. While market swings were similar to the ones in relation to the default of Lehman Brothers, markets remained sound and stable.

As neutral risk managers, we highly welcome the regulatory efforts in establishing a recovery and resolution framework for CCPs – as it will make financial markets even more robust if designed with a focus on stability and the need for appropriate incentive structures for all market participants across risk management in financial markets.

Nevertheless, it is important to remember that a CCP will only enter into recovery or resolution if the supervision of clearing members has failed. In Europe, Brexit adds another layer of complexity to the discussion with the EU rethinking the supervisory set up for CCPs.

ECB President Mario Draghi recently recalled the importance of swiftly enhancing the supervision of third country CCPs as "failing to do so could leave central banks and supervisors without the appropriate tools to handle the risks linked to systemic euro CCPs operating outside the umbrella of EU regulation."

The degree of CCPs' interconnection with payment systems, clearing members and their clients, as well as CCPs' critical risk management, means that any disruption of clearing activities may distort the proper conduct of monetary policy and financial stability. It is therefore understandable, that Europe needs to find answers to these challenges.

However, it is critical that supervision is enforceable and compatible with our global partners. A multi-layered supervisory system, where all authorities have rights on all others, will not function in times of crisis. Deference, coupled with direct supervision of systemic regional markets within the home jurisdiction provides the best way forward. The US has pursued this avenue post the financial crisis. Effectiveness, clear decision-making structures and time are of the essence to avoid negative spillover effects from a financial crisis to the real economy and broader society.

While politicians and regulators will have to decide on how this can best be achieved to cater for the legitimate public interest, we at Eurex Clearing take our responsibility as the EU27's leading CCP very seriously. Our Partnership program is designed to establish an alternative liquidity pool for "Euroclearing" on the continent – which does not only cater for political and regulatory concerns but also offers an efficient solution for market participants, thereby providing greater price transparency, more choice and competition and a safe harbour for business continuity. ●

Daniel Maguire

Chief Executive Officer,
LCH Group (LCH SA, LCH Ltd and LCH Llc)

A tailored supervision of third country CCPs to preserve EU clients' access to markets

The supervision of third-country (TC) CCPs should be tailored to the membership they serve (local v. global) and the products they clear (equities, debt, interest rates etc.). EMIR acknowledges that EU CCPs offer a range of products with diverse characteristics. It imposes different risk managements for each clearing service and allows for the authorization of specific clearing services.

With the EU seeking to directly supervise them, the same approach should be taken for TC CCPs: ESMA supervision should be adapted to the systemic importance of each clearing service provided by a TC CCPs (Tier 1, Tier 2 or assessment of a potential denial of recognition). This would create proportionality and reflect the need to supervise certain market segments that are of specific systemic relevance for the EU.

Different products potentially raise different types of risks, some of them specific to the EU, and call for different supervisory approaches. Clearing services for these products should be treated separately, specifically when contagion risks between services is fully limited, for e.g. by the use of segmented default funds. Applying identical solutions to different clearing services could have counterproductive consequences.

Indeed, some cleared products are of specific interest and potentially of systemic importance for the EU because they play a direct role in the central banks' of issue monetary policy operations or because the closure of a specific service could limit the capacity of central banks of issue to react to money market conditions. This is perhaps the case of EU sovereign debt repos which have inspired the first debate on a 'location policy'.

In fact, bonds and repos (cleared or not cleared) could imply material liquidity and physical settlement requirements in default that need to be managed and could lead, in case of severe liquidity stress, to the need to access to central bank of issue liquidity. The clearing of EU government debt repos could be considered of systemic importance for the EU and the location of this offering deserves a specific discussion.

However, whilst OTC interest rates swaps and futures markets could be considered of systemic importance because of their size, they are not systemic products in and of themselves. They are real economy hedging tools and have much smaller liquidity needs than repos, as they are not physically settled. In line with G20 Leaders Declarations, the global nature of these markets should be protected and fragmentation avoided in light of the consequences in terms of choice, costs and risks that an isolation of the EU customers from global markets would imply.

"The supervision of (TC) CCPs should be tailored to the products they clear."

- DANIEL MAGUIRE

We should define regulatory solutions tailored to the internationally integrated OTC interest rate swaps and futures market that address the concerns of the EU and avoid their fragmentation. The EU should implement a proportionate supervision of these markets in light of EU participants' role in the markets and in line with the approach of other G20 jurisdictions.

The systemic importance of each clearing service offered by a CCP should thus be assessed separately and allow for specific solutions for clearing services and products of systemic importance to the EU, whilst not preventing EU real economy firms efficient access to the most liquid global markets. ●

Denis Beau

First Deputy Governor, Banque de France

Clearing the air in Europe: the case for relocating substantially systemic clearing activities

The European Commission proposes an appropriate risk-based approach to third-country CCP supervision, inasmuch as it includes both an enhanced supervision for systemically important third-country clearing activities and a location requirement for the most important of them. To ensure proportionality which is at the heart of this approach, the location requirement should concern only clearing activities which are deemed substantially systemic and possibly not the whole set of activities of a given CCP, which might offer an array of heterogeneous –but not all critical for the EU- clearing services.

Even if specific criteria remain to be defined, clearing activities representing essential services for the EU financial system –because of systemically large volumes of EU currencies denominated transactions- are first and foremost concerned by the location requirement, because a situation where offshore CCPs serving significant volumes of >>>

>>> euro-denominated activities would be subject to conflicting instructions from their domestic regulators and supervisors and from the relevant EU authorities would penalize the stability of Eurozone markets. It has already happened; we should prevent it from happening again.

More precisely, introducing a location requirement in the EU for the services that clear large volumes of euro-denominated transactions is essential. Not as a last-resort tool to address crisis times, but as a preventive way to ensure that EU authorities have the final say on the supervision of such activities and avoid substantial implications for the financial system stability in the EU.

The activities in question concern mainly euro-denominated repos and interest rate derivatives, which are critical to the effective implementation of the monetary policy and the smooth financing of the Eurozone, for multiple reasons. Repos are a key instrument supporting of the Eurosystem credit operations. Interest rate derivatives likewise are fundamental for assessing the expectations of market participants, particularly concerning central bank actions, and also play an important role in the monetary policy transmission mechanism. In addition, the clearing of euro-denominated repos and interest rate derivatives generate high amounts of liquidity needs, and therefore entails a significant risk of moral hazard as a default of a clearing member may require the central bank to intervene as a last resort lender. Against this background, the stakes of the liquidity risk management of CCPs clearing substantial amounts of euro-denominated repos and interest rate derivatives for both monetary policy implementation and financial stability in the Eurozone cannot be ignored.

"A location requirement in the EU for the services that clear large volumes of euro-denominated transactions is essential."

- DENIS BEAU

Conversely, an enhanced supervision would suffice for third country CCPs on which EU clearing members and end-users have large non-EU currencies-denominated exposures. ●

Eric J. Pan

Director, Office of International Affairs, U.S. Commodity Futures Trading Commission (CFTC)

Building bridges and not barriers

Efficient and vibrant cross-border financial markets are critical to long-term economic growth. To this end, the CFTC and EU share a mutual interest in applying our regulatory and supervisory programs in such a manner as to avoid overlaps, gaps and conflicts.

Currently, the European Parliament and Council are considering new amendments to the European Market Infrastructure Regulation (EMIR). The EMIR amendments, which were put forward by the European Commission, would substantially alter how EU authorities supervise central clearinghouses (CCPs). The EMIR amendments would expand the powers of the European Securities Market Authority (ESMA) and European Central Bank (ECB) over third-country CCPs. Under the proposal, ESMA would have legal competence to require third country CCPs to comply with all provisions of EMIR and also have increased supervisory oversight over such CCPs.

The EMIR amendments would appear to subject US CCPs to regulatory and supervisory oversight by the EU that, in the absence of clear direction otherwise in the amendments, would conflict with how the CFTC regulates and supervises such CCPs. Not only do the amendments explicitly expand ESMA and the ECB's powers over US CCPs, but the amendments express no commitment to preserving the recognition and equivalence conditions that govern how US CCPs provide clearing services to European market participants today.

In 2016, the European Commission and CFTC concluded three years of negotiations to reach an agreement on the terms and conditions of (i) what EMIR requirements US CCPs would have to follow in order to provide clearing services to European market participants and (ii) what EMIR requirements would be included in the CFTC's substituted compliance regime for EU CCPs. Those terms and conditions set forth a deference-based regulatory and supervisory framework that governs how we regulate and oversee each other's CCPs. Moreover, this framework has helped our trans-Atlantic market operate smoothly by providing regulatory certainty to market participants.

As the European Parliament and Council consider the new EMIR amendments, the CFTC is seeking assurances that the new supervisory framework will fully respect and abide by the terms and conditions of the 2016 agreement.

The CFTC is fully supportive of the EU's efforts to strengthen its institutions and its financial markets. CFTC Chairman J. Christopher Giancarlo has expressed his great respect for, and desire to work constructively with, all EU authorities, especially ESMA. Chairman Giancarlo has spoken at Eurofi about the importance of regulatory and supervisory deference where we can rely on each other because we have strong regulators on both side of the Atlantic Ocean who are dedicated to cooperation and comity.

The issue of CCP regulation and supervision should not be an issue to divide Europe and the United States. Instead, I hope the European Parliament and Council will take their current opportunity to shape the new EMIR amendments to re-affirm cross-border regulatory and supervisory cooperation with the CFTC and the United States. ●

The views expressed in this article are the personal views of the author and do not necessarily reflect the views of the CFTC staff, the CFTC Commissioners, or the US government

Finbarr Hutcheson

President, ICE Clear Europe

Supervision of systemic cross-border CCPs in light of jurisdictional boundaries

CCPs are important nodes of the financial infrastructure and the largest ones are undeniably systemically important. They have been subject to increasing scrutiny from regulators ranging from CPMI-IOSCO to the FSB, predominantly in the wake of the G20 initiative to push for more CCP-cleared business.

As a result of this attention there is a detailed and comprehensive set of internationally agreed standards governing the operation of CCPs in the major jurisdictions: CPMI-IOSCo's Principles for Financial Market Infrastructures. Given that some large CCPs have global significance, such standards allow comfort that CCPs in jurisdictions that have implemented them are being held to the same disciplines irrespective of location.

Clearly there needs to be close supervision of such systemically important institutions, but this is an administrative job that must be affected locally, especially if the fiscal implications of failure are local, no matter if the CCP is systemic. The only alternative is to have all stakeholders involved in supervising cross-border CCPs, which would be wasteful and duplicative, as well as potentially disastrous in a crisis when decisive action is paramount.

Rather than multiple supervisors, a CCP's local supervisor should be the lead, and others should defer to it. Regulators that have a legitimate interest may have visibility - which means information sharing between regulators and the supervisor. We do not see any reason why information cannot be distributed by a CCP's supervisor to interested regulators under appropriate confidentiality, rather than CCPs having to field multiple, similar data requests.

So our formula for rigorous and proportionate cross border supervision of CCPs is:

1. Strong, clear international standards (CPMI-IOSCO).
2. Local supervision.
3. Comprehensive visibility to regulators and central banks with an interest. ●

Jonathan Taylor

Managing Director,
Agency Derivative Services,
Barclays

Don't risk the risk management

It is critical to the safety and soundness of any CCP and the market it serves that the CCP has the agility to manage the risks generated by a clearing member default (or potential default). This includes actions the CCP might take in a stressed market prior to a default. In this context, the agility of a CCP's risk management function is paramount.

The European Commission has proposed amendments to EMIR that seek to give EU regulatory authorities a more significant role in the supervision and oversight of EU and non-EU CCPs. These proposals run the risk of impeding the responsiveness of CCPs to such scenarios.

Attention has been focussed primarily on the most controversial aspect of the proposals; the idea that EU regulatory authorities may prevent a non-EU CCPs from offering clearing services to EU clearing members or EU clients where such CCP is of "substantial systemic significance".

The industry is quite rightly concerned that a forced relocation of clearing services to the EU risks; increasing costs for EU end users, fragmenting liquidity and increasing operational and legal risk.

Whilst these are all concerns that we share, the proposals also raise issues for CCP risk management that merit closer attention. The Commission is seeking to grant relevant EU central banks (including the ECB) a greater say in the assessment of a CCPs' risk management activities. This would include determinations on the acceptability of collateral and the level of haircuts, for instance.

"The agility of a CCP's risk management function is paramount."

- JONATHAN TAYLOR

It is critical that such powers (and the way they are exercised) do not undermine a CCP's agility to independently and effectively risk manage the positions and exposures that it houses, in accordance with its agreed procedures. Any unnecessary fettering of the ability of a CCP to respond to changing market conditions may undermine the ability of the CCP to minimise costs and risks for clearing members as well as the market impact of a clearing member default or potential default. The systemic risk implications of this outcome are not something that should be underestimated.

As a clearing member which provides clients with access to the CCPs of their choice globally, the main concern we would have from any regulatory change designed to enhance EU authorities' oversight and supervision of CCPs is that it be done in a way that does not unnecessarily restrict access, reduce choice or increase risk for ourselves or other market participants. We would also encourage constructive dialogue between regulators and rule makers across jurisdictions to avoid conflicts and inconsistencies between regimes and to safeguard against a retrenchment in the openness and cooperation we see today. ●

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Vulnerabilities from asset management activities

Francesco Mazzaferro

Head of the Secretariat,
European Systemic Risk Board (ESRB)

Addressing potential liquidity and leverage risks in investment funds

The EU's investment fund sector has grown considerably in recent years. Since 2008 total net assets have more than doubled, growing from around €6 trillion to more than €15 trillion in the third quarter of 2017. In the same period European alternative investment funds (AIFs) more than tripled in size to almost €6 trillion.

The fund management sector has become an increasingly important part of financial markets and there are potentially significant structural vulnerabilities. For example, unexpectedly high redemption demand could result in funds rapidly selling into a falling market during a market shock. This can be particularly relevant for highly leveraged funds and those offering short term redemption periods while investing in highly illiquid assets. Investment funds show a particularly complex range of potential behaviours in reaction to market stress. They are just one of a number of major types of investor in financial markets – others include banks, insurance companies, pension funds, retail investors, family offices, sovereign wealth funds and a range of intermediaries. In addition, investment funds can have a wide range of retail and institutional investors with distinct behavioural profiles.

Fund managers already have liquidity management tools available to help them manage some of these risks. However, the availability of these tools is not standardised across jurisdictions. As part of their risk management processes, individual funds also tend to stress test their portfolios against sudden redemption shocks. An ESRB review found that the frequency and severity of these stress tests can vary significantly. Data limitations also mean that it can be difficult to assess the degree of interconnectedness across markets which can make it difficult to identify system-wide risks and vulnerabilities.

The European Systemic Risk Board (ESRB) has published a Recommendation on liquidity and leverage risks in investment funds in February 2018. The ESRB's Recommendation is addressed to ESMA and the European Commission and

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>>> focusses on UCITS and AIFs. UCITS are highly regulated investment funds. They face regulatory leverage limits and, theoretically, are less prone to liquidity mismatches as their assets and liabilities should be tradeable in a short time frame. AIFs are investment funds which are permitted to invest in assets similar to those in UCITS but are not subject to such detailed restrictions on diversification, liquidity or leverage.

The ESRB's Recommendations focus on five areas where the ESRB sees a need for further guidance to supervisory authorities on applying macroprudential elements of the current regulatory framework and/or for legislative changes to be made. First, a wide range of liquidity management tools should be available to fund managers across EU jurisdictions. Tools such as redemption fees, gates or fund suspensions can help to mitigate liquidity risks at fund level. Further guidance is also needed to specify national authorities' role when using their existing powers to suspend redemptions where there are cross-border financial stability implications. Second, excessive liquidity mismatches should be addressed at fund-level, in particular for open-ended AIFs. Third, high level guidance is needed on the practice of liquidity stress testing of asset managers to ensure tests are of sufficient frequency and complexity. Fourth, a reporting regime for UCITS would allow for harmonised risk monitoring indicators to be developed. Finally, guidance is required on a framework to assess leverage risks and on the design, calibration and implementation of leverage limits.

The implementation of the Recommendations should ultimately help to reduce systemic risks. Fund managers should have the tools available to suitably manage unexpectedly high redemption requests. The purpose of the ESRB's Recommendations is, obviously, not to stop fundamental market movements. However, if implemented appropriately, the changes can support orderly market transitions in times of severe market stress by helping to reduce fire-sale dynamics and excessive market volatility. ●

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Felix Hufeld

President, Federal Financial Supervisory Authority, Germany (BaFin)

Systemic risks in the investment fund framework: investigation, analysis and action

As the saying goes, it is easy to be wise after the event. After the recent financial crisis, we all learnt that shocks that are considered isolated can rapidly have a systemic impact due to the interconnectedness of financial markets. While the literature on such systemic risks in the banking sector could fill entire bookshelves, systemic risk was far less discussed in the securities sector for a long time. The focus here was mainly on investor protection. This changed, at the latest, when the Directive on Alternative Investment Fund Managers (AIFMD) entered into force in July 2013, not least because of the significant increase in fund assets managed worldwide, interconnectedness within the sector and the large number of transactions carried out since then. In addition, some investment funds have become bigger and more complex.

At the micro-prudential level, investment funds are already adequately regulated, for instance, under the AIFMD and the Directive on Undertakings for the Collective Investment in Transferable Securities (UCITS). International bodies, such as the International Monetary Fund (IMF) and the Financial Stability Board (FSB), are now focusing on macro-prudential aspects. Systemic risks may arise if investment funds seek to sell certain assets on a large scale in certain market situations. This could lead to sharp price fluctuations or liquidity squeezes, which in turn could spread to the banking sector or the insurance sector. The question as to whether the trend towards index-based fund management entails systemic risks is also being discussed at the moment.

Last year, the FSB identified liquidity mismatch and leverage as key systemic risks in its study entitled "Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities".

In its recommendations, the European Systemic Risk Board (ESRB) encourages legislators and regulators to create a legal framework for >>>

>>> using a wider range of liquidity management and pricing tools. The recommendations are essentially aimed at developing a common European understanding of the purpose and potential uses of these tools and reaching a consensus on the nature and scope of cross-border coordination. For instance, a standardised reporting format for all funds could contribute towards gaining a better overview across Europe.

In order to better manage the risks that investment funds could entail for the financial system, the micro stress tests that already exist at institutional level should be designed to produce even more informative results. These will be accompanied by macro stress tests in the future. The necessary preliminary work at the level of the European Securities and Markets Authority (ESMA) and the ESRB is already underway.

"Although all these measures are suitable for mitigating systemic risks in the fund segment as well, there is still work to be done."

- FELIX HUFELD

Although all these measures are suitable for mitigating systemic risks in the fund segment as well, there is still work to be done. The fast-growing amount of data needs to be processed in a more targeted way so that it can be used efficiently. Otherwise, identifying risks at an earlier stage will be difficult to achieve. However, this is crucial if we want to minimise the risk of another financial crisis on capital markets as well. The community of regulators and supervisors would rather be wise before the next crisis occurs. ●

Frédéric Bompaire

Head of Public Affairs, Finance and Strategy, Amundi Asset Management

Can highly regulated funds create systemic risk?

Regulators have now taken stock of the agency business model of asset managers (AM) and agree that their clients carry market risks consistent with their own risk appetite.

FSB identified liquidity risk as a factor specific to funds, since they offer liquidity terms that may be difficult to meet under stressed market conditions. As a consequence FSB and IOSCO recommend to develop appropriate Liquidity Management Tools (LMT). IOSCO has also been asked to propose measurements of leverage in order to monitor potential risks of a systemic nature that could be exemplified by funds.

In February 2018, the ESRB echoed these concerns and issued 5 recommendations directed to the European Commission and ESMA. The ESRB recognizes the high degree of regulation of UCITS. If AIFs are subject to less constraints, many AIFs are UCITS-like and a large majority of AIFs do not use significant leverage nor invest in inherently illiquid assets. The bias that ESRB shows against the relative VaR risk management approach relies in our view on the misconception that less simplicity means higher risk: innovative investment strategies may be quite straight forward but may require expert and sophisticated risk management; such is the case with relative VaR.

"How much systemic risk can stem from funds?"

- FRÉDÉRIC BOMPAIRE

ESRB's recommendations converge with IOSCO's and FSB's. It supports the development of LMTs that should be available for AMs to activate under their own responsibility; it wishes to identify inherently illiquid assets (and should refrain from introducing liquidity buckets); it promotes effective liquidity risk stress testing at the level of each fund; it asks for an extended reporting by funds that should in our view be made consistent with the existing reporting requirements under other regulations; it calls for monitoring systemic risk and for guidance by ESMA on leverage limits imposed to AIFMDs on macro prudential grounds.

But the key question has not been addressed: how much systemic risk can stem from funds? ●

Dennis Gepp

Senior Vice President, Managing Director & Chief Investment Officer, Cash, Federated Investors (UK) LLP

Unbalanced & unchecked: A Brexit risk to the EU Parliament & small Member States

The European Union's political structure was designed to provide key checks and balances between the European Commission (EComm), European Council and European Parliament (EP). This delicate balance is now at risk in a post-Brexit world.

Member States (MS) discretion on governing matters is effectively being eliminated. Directives which were intended to provide MS with a limited amount of discretion are being replaced with Regulations. Proposals have been >>>

>>> tabled shifting power from the EComm and EP to European Supervisory Authorities (ESAs), whose mandate was once limited to providing technical advice without binding authority. Large MS' influence over smaller MS has never been greater, and the EComm appears willing to permit agencies to rewrite level 1 text in direct contravention of legislative intent. It is important, now more than ever, that all MS consider each issue tabled, not just through a telescopic lens, but instead from an EU wide perspective- ask not if the issue impacts one's local market and if it does not, remain indifferent, but instead ask "What is best for EU citizens? What is best for EU investors? What is best for the markets in the EU? What is really good fair and governance?" And finally, "What is good transparent regulatory practice?" After all, the goal is to operate in an efficient, stable and successful single EU market.

"Member States (MS) discretion on governing matters is effectively being eliminated."

- DENNIS GEPP

A recent example that highlights this, concerns action taken by ESMA and the EComm; in particular ESMA's overreach on a Level 1 issue and the EComm's acquiescence, despite strong opposition from the EP and Key MS. ESMA, clearly beyond its Level II mandate in respect of the EU MMF Regulation, unsolicitedly questioned the permissibility of the existing use of the Reverse Distribution Mechanism (RDM). The EComm, notwithstanding this overreach, issued unsupported guidance prohibiting the use of RDM. No legal analysis was provided to Parliament nor MS to support such a decision. In fact, each of the key Rapporteurs on the file have specifically written to the EComm voicing their opposition to this clear usurping of power from the judicial process. If changes to Level 1 are required, a public process and debate should ensue.

One can only wonder if such injustice is somehow enabled by the imbalance in power now seen between MS and in the clear intention to remove sovereign power from them and place it in the hands of the ESAs. Whilst this particular issue may not be one of concern for all, future issues may be, as is the risk of failure to maintain proper checks and balances in a post-Brexit world. ●

Michael Rüdiger

Chief Executive Officer,
DekaBank Deutsche Girozentrale

Diversity fosters risk reduction

In view of the increasing importance of the asset management industry, early identification of potential risks and structural risk vulnerabilities is important both for financial stability and investors. Previously, the focus was on the use of stress tests for ex ante identification of market price risks, as these have a direct effect on fund performance. Periodic routine stress tests required by regulators for the assets under management were used for this, together with customized ad hoc stress tests performed in advance of political and economic events that were expected to have a significant effect on the market.

Recently, regulators have increasingly identified liquidity risk as an important systemic risk in a stressed market environment due to potential herd behaviour on the part of market participants. This particularly applies to mutual funds due to the obligation to redeem units, generally on a daily basis. European regulators have also introduced detailed requirements for asset managers in this area, primarily through updates to the UCITS and AIFMD directives. Given the diversity of financial products in use, the current rules sensibly create a general framework of requirements for liquidity management and give asset managers the freedom to determine the details of the methods used.

In addressing the question of whether further regulations are needed, German market standards were analysed by examining the models used by selected investment companies for liquidity risk stress tests. The analysis found that a sound market standard exists that properly addresses the individual features of different investment products in accordance with the principles-based approach. At the general level, liquidity risk is managed using similar approaches that compare fund assets to potential outflows of funds, accompanied by a diversity of methods at the detailed level and in the design of stress tests, such as the classification of liquid and illiquid assets.

With respect to concentration risks for supposedly liquid assets, this diversity of methods can lead to a reduction in risk – particularly during periods of stress.

With this in mind, additional regulations that go beyond the principles-based approach with the well-intentioned aim of achieving standardisation and harmonisation at the EU level could even be counterproductive and increase the likelihood of herd behaviour. ●

Insurance systemic risk framework

Burkhard Balz

MEP, EPP Coordinator,
Committee of Economic and Monetary Affairs,
European Parliament

Systemic risks in insurance - more time, more ambition for international solutions

While knowing that the adoption of the revised set of standards for the international regulation will not be before end of 2019, the European Parliament is already attentive towards the work that the IAIS is currently undertaking. The recent involvement of the ECON Committee in the process of finalising the Basel III accords has demonstrated that the ex-ante accountability of international fora is an immanent issue for elected politicians who are required to transpose the international standards into law at the very end.

The Committee will most certainly not hesitate to engage in a similar way as in the Basel III process, in case the IAIS negotiations risk leading to unbalanced conclusions. The regularity of exchange with the Commission in its capacity as IAIS observer as well as with EIOPA in its capacity as IAIS member is an important request by the Committee. The same accounts for the Parliament's access to relevant documents while naturally respecting relevant confidentiality arrangements.

It is evident that the regulation of systemic risk has to be driven by the international level, as this is the only approach that ensures an appropriate level playing field between globally active companies and that enables regulators to mutually follow up on the process of implementation. In order to gain support, the international work, however, has to be better explained and well specified, in terms of commitment and credibility and in terms of its purpose and its consistency with the existing domestic regulation. The IAIS has made some positive efforts, which are to be acknowledged. It is important that the process of designating GSIIs is better understood by pointing to a newly scheduled revision of the methodology including a comprehensive assessment of potentially risky activities. However, there are still substantial issues pending with regard to the convergence in valuation methods as well as with regard to the use of internal models. The field testing exercise that >>>

>>> covers internal models on a voluntary basis has been a positive signal, but not yet an achievement. Therefore, further strong and consolidated engagement from the EU participants in IAIS should be warranted. Amongst others, it should be ensured that all elements encompassing the ICS are tackled in parallel in order to work on the basis of a more predictable holistic rather than on the basis of a staggered approach.

Solvency 2 provides for an extensive regulation and supervision of systemic risks. Solvency 2 also covers resolution planning and possibilities to address extra risks, for example by requiring supervisors to decide on capital add-ons. There are good reasons to believe in the effectiveness of our EU framework. The good qualities of Solvency 2, in particular the risk-based approach should be, to the extent possible, maintained on the international level.

For the next steps of the IAIS process, the following objectives should be kept in mind:

The level of commitment of all IAIS Members should be evaluated and possibly reinforced. If equally agreed and implemented across jurisdictions, the IAIS work may positively contribute to a global level playing field, even more in a post-Brexit situation.

Secondly, there should be the aim of further strengthening the credibility of the process. This can be done by enhancing the accountability and the transparency, not only vis-à-vis the affected insurance groups, but also vis-à-vis the legislators and, where possible, to the public. Political support cannot be presupposed for something that has been agreed behind closed doors.

Thirdly, the purpose of the additional regulation and the consistency with the domestic regulation has to be clarified. If we agree that we already have, on the level of the undertakings and groups, an effective regulation at place, we should clarify what kind of shortcomings in systemic risk coverage exist and how they may be covered by designating specific groups with additional regulatory requirements. A simple "on-top" regulation adding up to the already existing domestic requirements would be difficult to justify. ●

Jonathan Dixon

Secretary General, International Association of Insurance Supervisors (IAIS)

A global approach to addressing systemic risk in the insurance sector

As part of its mission, the International Association of Insurance Supervisors (IAIS) is committed to contribute to global financial stability. In response to the global financial crisis, the IAIS worked with the Financial Stability Board (FSB) to identify global systemically important insurers (G-SIIs) and to develop relevant policy measures. In February 2017, the IAIS announced a workplan to develop a holistic framework for the mitigation of systemic risk in the insurance sector at the global level, including the development of an Activities-Based Approach (ABA) and ways to address cross-sectoral aspects in systemic risk assessment, which will feed into the revision of the current G-SII assessment methodology. By end-2018, the IAIS will publish a holistic framework for consultation, to be adopted by the end of 2019.

"The focus of an ABA is those activities or exposures that could lead to negative externalities."

- JONATHAN DIXON

The current G-SII assessment methodology focuses on whether the failure of an individual insurer may pose a threat to the wider financial system. It does not, however, completely assess the potential (systemic) impact >>>

>>> that may stem from the collective actions or distress of insurers that are jointly exposed to certain risks. By contrast, the focus of an ABA is those activities or exposures that could lead to negative externalities to the financial sector and the real economy, independent of the failure of a single institution. This allows for:

- capturing the sources of potential systemic risk associated with the activity, taking into account the interaction between assets and liabilities; and
- identifying and, as needed, (further) developing relevant policy measures to mitigate potential systemically risky activities across institutions, including consideration of relevant risk mitigants that are available in national frameworks and firm-specific mitigating tools.

In December 2017, the IAIS issued an interim consultation paper describing a process for identifying the key elements of an ABA, based on a gap analysis and taking into account proportionality and cost-benefit analysis in respect of the scope of application. The main exposures that the IAIS has identified in its interim consultation are liquidity risk and macroeconomic exposure (leverage).

The IAIS is currently evaluating the need for policy measures addressing these and other potential exposures, based on the existing suite of IAIS supervisory material, including the Insurance Core Principles and the Common Framework for Supervision of Internationally Active Insurance Groups (ComFrame; to be adopted in 2019). Part of the existing supervisory material already fulfils both a micro-prudential and a macro-prudential purpose. Examples are requirements relating to the management of liquidity risk or the development of recovery plans. To the extent the existing suite of supervisory material does not sufficiently cover the identified potential systemic risks, additional or more detailed policy measures will be developed. As the focus is on the activity rather than the individual entity, in theory all insurers may be affected, but of course the policy measures should be applied proportionate to the potential systemic risk of the activity and take into account cost-benefit analysis in respect of the scope of application. ●

Fausto Parente

Executive Director, European Insurance and Occupational Pensions Authority (EIOPA)

Systemic risk in insurance: making haste slowly

Understanding the sources of systemic risk in insurance is in the DNA of policymakers, both for policyholder protection and for financial stability reasons. EIOPA has developed its own views on the dynamics by which the insurance sector can create or amplify systemic risk.

It is better to view the systemic importance of insurance by assessing the impact the sector may exert on financial stability in case of an adverse, triggering event, rather than through a binary approach. The initial impact will depend on the risk profile of individual companies, while the extent to which this event affects financial stability and the real economy, will depend on the existence of systemic risk drivers, as well as transmission channels.

In EIOPA's view, systemic risk in insurance can materialise in two ways, which broadly coincide with other approaches developed at international level. Firstly, the 'direct' effect, originated by the failure of a systemically relevant insurer or the collective failure of several insurers generating a cascade effect, i.e. the 'entity-based' source. Secondly, the 'indirect' effect, in which possible externalities are enhanced by engaging in potentially systemically relevant activities (activity-based sources) or the widespread common reactions of insurers to exogenous shocks (behaviour-based sources).

EIOPA sees the three sources of systemic risk as potentially interrelated sources and, therefore, not mutually exclusive. For example, a low interest rate environment (triggering event) affecting companies that offer products with a high level of guaranteed rates (risk profile) may lead to one or more insurance failures (entity-based source). Nevertheless, it could also incentivise companies to collectively "search for yield" (behaviour-based source). This example could be even further developed if the "search for yield" ends up changing the risk profile of the companies involved. In that case, we may observe a so-called 'feedback loop' that becomes very relevant for the interaction between micro- and macro-supervision.

Once the sources of systemic risk have been identified, the focus should be put on the policy responses. EIOPA is of the view that any policy responses developed to address systemic risk, should consider the insurance-specific features when it comes to defining objectives and proposing tools. This entails significant challenges.

"Any policy responses developed to address systemic risk, should consider the insurance-specific features."

- FAUSTO PARENTE

First, it requires considering and assessing the elements with a macroprudential impact that are already in place in the current microprudential framework (Solvency II). Secondly, any macroprudential framework should coexist with the microprudential framework. A way of mitigating the risk is to avoid a dual framework and integrate the main elements into Solvency II. Thirdly, the creation of a macroprudential framework in the EU should consider the ongoing international discussions on the topic.

In summary, EIOPA considers systemic risk and macroprudential policy as key topics in insurance. However, there is a need that the discussion takes place on a solid ground and following a structured step-by-step approach. As the classical saying goes, it is better to "make haste slowly". ●

Joseph L. Engelhard

Senior Vice President, Head of Global Regulatory Policy Group, Global Government Relations, MetLife

ABA: the comprehensive approach to systemic risk management

The insurance industry's ability to hold long-term assets until maturity is a stabilizing counter-cyclical force in times of economic stress. Unfortunately, the importance of that stabilizing role is getting lost in the debate over the best way to identify and manage systemic risk. As a result, some regulatory measures that introduce artificial volatility into insurance balance sheets or that exaggerate the risk of guarantees undermine the industry's ability to bolster financial stability and economic growth while at the same restricting consumers' ability to protect their retirement financial security.

MetLife has long maintained that an activities-based approach is the most effective way of identifying and managing the very limited potential for systemic risk in the insurance sector. An ABA addresses systemic concerns of any relevant activity and enables more targeted treatment of sources of systemic risk. For these reasons, MetLife was greatly encouraged by the IAIS's decision to develop an activities' based approach (ABA) as a potential replacement for their current 2016 entity-based methodology. We have demonstrated that the entity-based approach is an ineffective measure of risk (let alone systemic risk). This view is consistent with the U.S. Department of Treasury Report on Asset Management and Insurance which found that entity-based systemic risk evaluations of insurance companies are generally not the best approach for mitigating risks arising from insurance.

Despite this progress, we are concerned that timely development of an ABA may be jeopardized by misguided perceptions that an ABA's effectiveness is limited. This view appears to be based largely on the false premise that an ABA can only address aggregate exposure and propagation of systemic risk – the so-called "tsunami" risk perspective. MetLife believes an ABA addresses both domino and tsunami propagation scenarios and that counterparty exposure is an appropriate measure of potential systemic risk. Because the key drivers of systemic risk are the asset liquidation and counterparty exposure transmission channels, it is immaterial whether the risk channels are triggered by the activities of one or many firms.

"We are concerned that timely development of an ABA may be jeopardized by misguided perceptions."

- JOSEPH L. ENGELHARD

We call on the IAIS to refocus its attention on asset liquidation and counterparty exposure, both of which can be effectively addressed by an ABA. Reforms enacted in derivatives markets and the asset management industry following the 2008 crisis to address asset liquidation and counterparty exposure risks provide good precedent for insurance-specific measures. The NAIC's Macro Prudential Initiative is pointing the way forward on a workable ABA by: gathering more data on liquidity and counterparty exposures; ensuring own risk assessments capture key liquidity and capital risks under stress; ensuring appropriate controls and contingency plans are in place. This is the path to ensure all material risks are covered and would allow insurers to maintain their historical and natural ability to provide security to retirees, contribute to financial stability and finance economic growth. ●

Nina Arquint

Head Group Qualitative Risk Management, Swiss Re

ABA without consistent ICS – an extra coordination challenge for IAIS

IAIS is improving its framework for assessing and mitigating systemic risk by complementing and hopefully someday replacing the coarse entities-based approach (EBA) by a more refined and effective activities-based approach (ABA). This is welcome, as EBA completely ignores "tsunami" type risks which materialize when many small players act in tandem. Further, EBA policy measures are focused on capital, which is often ineffective in mitigating systemic risk. EBA also has a "cliff-edge" property which does not allow for proportional measures. Finally, EBA is simply inappropriate for insurers since the underlying criteria, size, is not a reliable indicator of systemic risk. Each of these weaknesses of EBA are addressed by the ABA.

However, to be effective, ABA policy measures must be based on a comprehensive supervisory framework with a clearly-defined capital and valuation standard. ABA policy measures must be applied to market participants and are therefore "micro-prudential" in their application – even if they address

"macro-prudential" concerns. Differences between local capital and valuation >>>

>>> standards fail to provide a common basis for risk valuation and therefore inhibit comparability and create an uneven playing field.

IAIS is faced with the dilemma of defining ABA measures in the absence of a global ICS which will not converge within the next seven years at earliest – if at all. At the same time, national authorities move on: EIOPA is considering its own systemic risk framework, and the NAIC is carrying out its own macro-prudential initiative. Other jurisdictions will follow. They have no choice but to base their systemic risk frameworks on their own supervisory frameworks and solvency standards. Absent guidance from IAIS, this will create arbitrage opportunities, which undermine financial stability.

"IAIS must coordinate the jurisdictions developing their systemic risk frameworks."

- NINA ARQUINT

In the near term, IAIS must coordinate the jurisdictions developing their systemic risk frameworks. In the longer term, IAIS should pursue an arbitrage-free systemic risk framework, which requires ComFrame and especially ICS to be fully accepted and converged to serve as a solid basis. Even though it might take many years until an ABA approach emerges which is completely free of arbitrage, the ABA route is still more effective than EBA. IAIS should continue to drive this critical project forward. ●

Dr. Frank Grund

Chief Executive Director, Insurance and Pensions Funds Supervision, Federal Financial Supervision Authority, Germany (BaFin)

What are the possible systemic risks affecting the insurance sector?

Subsequent to the financial crisis of 2007/08, the topic of systemic risk of the insurance sector has been extensively

discussed over the last 10 years. However, there are still no clear and simple answers to this day. In my opinion, it is crucial that we do not simply transfer regulatory measures from the banking to the insurance sector. Obviously, insurance poses a different set of systemic threats as compared to banking. Also, we are just at the very beginning of an international process of reaching a common understanding of systemic risk in the insurance sector.

What are possible threats related to typical insurance activities? The insurance industry is less prone to systemic risk due to its comparatively longer-term liabilities and assets to match their duration, hence containing liquidity risk to a certain degree. However, liquidity risk might contribute to potential systemic risk when insurers face unexpected liquidity outflows stemming from a number of sources, e.g., claims, policyholder withdrawals, etc. Can that lead to a liquidation of assets with a negative impact on asset prices and thus causing systemic concerns? Where can simultaneous activities by various insurers even increase these concerns?

"For the time being, there are more questions than answers."

- DR. FRANK GRUND

In this context, I support very much that the IAIS – motivated by the FSB – has recently consulted a public paper on an activity-based approach to systemic risk in the insurance sector. For the time being, there are more questions than answers. However, it is important to give answers, to come to a joint common understanding and to:

- identify activities that insurers engage in and that could potentially threaten global financial stability,
- evaluate existing policy measures that may help to mitigate the potential systemic risks stemming from the identified activities,
- identify risks associated with an activity that are not sufficiently mitigated by any existing policy measures, as well as
- develop proposals for new enhanced policy measures to address any residual systemic risk.

I am really looking forward to the stakeholders' comments and the final consultation, which is expected by end 2018. Hopefully then we will have an answer to the most interesting question, whether there are potential insurance activities which can have major impact on financial stability. ●

Patricia Plas

Head of Public Affairs, AXA Group

Systemic Risk – will recent developments lead to a meaningful response?

After nearly a decade of global discussions and coordinated efforts to make the financial system safer, it makes sense for the international regulation community to pause and assess the Frameworks developed so far before creating new regulation layers. No doubt the >>>

>>> subject of systemicity remains a fundamental issue around the world, important for the financial industry and its reputation, its regulators as well as national authorities. However, are we still certain that the various approaches currently under discussion across the world are leading us to the coordinated, meaningful response that we set out to achieve after the global financial crisis?

Indeed, much has already been achieved, as was pointed out during last year's EUROFI debate. This progress ranges from the vast Financial Stability Board ("FSB")-led effort on the IAIS-developed entity-based approach identifying Globally Systemically Important Insurers ("GSIIs"), to various policy measures and supervisory tools, including a cross-sectoral regulation on derivatives clearing and "shadow banking" activities.

Nevertheless, more recently, several significant evolutions have taken place throughout the world :

- In the United States, two out of the three insurers originally identified as US Systemically Important Financial Institutions ("SIFI") were "de-designated". Support from the US political administration for this label and the underlying entity-based approach has weakened considerably. The US Treasury report on non-bank financial institutions regulation in November 2017 clearly states that this designation is to be used only as a last resort, should primary regulation prove to be insufficient. Obviously, these events have had consequences on primary regulations in the US with the NAIC working on the development of a macroprudential framework as well as on US positioning at international level.
- Support for the entity-based approach has weakened even among international standard setters. On FSB request, IAIS started to explore the merits of an alternative approach, the so-called activities-based approach, over a year ago and issued a public consultation in December 2017 on the matter. In the meantime, the FSB decided to refrain from publishing a new GSII list for 2017 and mentioned that the new approach may have significant implications for the assessment of systemic risk in the insurance sector and hence for the identification of G-SIIs and for G-SII policy measures.
- In Europe earlier this year, EIOPA issued two out of three planned papers expressing its view of systemic risk and macroprudential policy. One includes a comprehensive section on the activities-based approach. Nevertheless, EIOPA, itself, points out that its "approach and position might not always be fully adherent to the IAIS [activities-based] approach" despite the "outcomes [being] broadly consistent with it".

According to standard setters, the entity-based approach largely reflects the "domino"-like impact (and systemic risk) that a failing financial institution can trigger. They are however exploring whether the activities of the insurance sector are more prone to trigger a "tsunami"-like impact, with solvent entities transmitting or amplifying a shock to the rest of the financial system and to the real economy.

Despite a recent welcome support against over-layering rules at global level, the question that comes to the fore is whether the new approach could fully replace the old one without affecting risk identification and mitigation. Regardless of the outcome of this debate, it remains instrumental for any new proposals and their implementation to be mindful of level playing field considerations and of preventing the creation of overlapping layers of requirements.

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About EUROFI

The European Think Tank dedicated to Financial Services

- **A not-for-profit organization currently chaired by David Wright who succeeded Jacques de Larosière as Chairman in April 2016**
- **A platform for exchanges between the financial services industry and the public authorities addressing issues related to the evolution of financial regulation and supervision and the economic and monetary context impacting the EU financial sector**

MAIN ACTIVITIES

The main objectives of Eurofi are to help industry and public decision-makers reach a common understanding of possible evolutions required in the regulation and supervision of financial services and to open the way to legislative or industry-driven solutions that may enhance the safety and effectiveness of the EU financial sector and its contribution to economic growth.

Eurofi acts in a general interest perspective, facilitating exchanges of views between diverse financial industry players and the public authorities. These discussions are prepared by objective fact finding and issue analyses.

Eurofi has two main types of activities conducted by **Didier Cahen**, Secretary General of Eurofi, **Jean-Marie Andrès** and **Marc Truchet**, Senior Fellows:

Events and meetings:

- **Eurofi organizes annually two major international events (the High Level Seminar in March / April and the Financial Forum in September)** gathering industry leaders and EU and international public decision makers for discussions on the major on-going regulatory projects in the financial area and the role of the financial sector in fostering growth as well as the economic and monetary environment.
- These events are regularly organised in association with the EU Presidencies in parallel with informal ECOFIN councils and in some cases with the G20 Presidencies. They are organised with the support of **Virginie Denis** and her team.
- **Additional workshops** involving the members of Eurofi are set up to exchange views on regulatory issues. Bilateral meetings are also regularly organised with representatives of the public authorities and other stakeholders (e.g. end-users, experts) to fine-tune assessments and proposals.

Research and documentation:

Assessments and proposals taking into account economic, risk and end-user impacts are prepared with the support of cross-sectoral working groups comprising members of Eurofi.

Topics addressed include prospective and on-going regulatory proposals at the EU and global levels, industry trends as well as the impacts for the financial sector of the economic challenges the EU is facing.

MAIN TOPICS CURRENTLY ADDRESSED

- **Measures and instruments needed to ensure an appropriate financing of the EU economy:** impacts of Brexit on the financing of the EU, impact of on-going monetary actions, measures to support bank financing (securitisation), diversification of the financing of SMEs and infrastructure projects, proposals for developing a long term investment perspective, climate change agenda
- **Prospects of digitalisation and fintech:** digital transformation in the banking and insurance industries, fintech and blockchain applications in the capital markets and investment, related regulatory challenges
- **Prospects of further EU integration:** implementation of the Banking Union, priorities for implementing a Capital Markets Union, possible evolution towards a fiscal union and further economic integration in the Eurozone, evolution of the EU regulatory and supervisory authorities (ESRB, ESAs).
- **Optimizing the EU financial services internal market:** payments, review of the IORP directive, regulation of CRAs, prospects of further banking integration and of digital banking
- **Evolutions of the prudential and regulatory framework of banks and insurance companies:** fine-tuning and implementation of banking and insurance prudential frameworks, recovery and resolution of banks and non-banks, culture and conduct measures
- **Capital markets and investment product regulations:** Capital Markets Union, regulation of securities, derivatives and commodities markets and infrastructures, recovery and resolution of CCPs, cybersecurity, SFT and collateral requirements, asset management regulations, investor protection regulation (PRIPs, MiFID, IMD…), regulation of shadow banking
- **Financial regulation at the global level:** feasibility of bank crisis management at the global level, coordination of capital markets regulations at the global level, systemicity of non-banks non-insurers

NEXT EUROFI EVENTS

5, 6 & 7 September 2018
Vienna - **Austria**

3, 4 & 5 April 2019
Bucharest - **Romania**

September 2019
Helsinki - **Finland**

EUROFI MEMBERS

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