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The EUROFI Magazine

TALLINN | SEPTEMBER 2017

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Tallinn | 13, 14 & 15 September

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The **Eurofi** Financial Forum

TALLINN | SEPTEMBER 2017

WHAT WAY FORWARD FOR THE EU27 AND EUROZONE?

Content

EDITORIALS & OPENING INTERVIEWS

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The Eurofi Tallinn Forum is taking place at a crucial moment for the EU and Eurozone

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

Many regulatory initiatives are being conducted at the EU level to mitigate systemic risks associated with financial activities and allow the financial sector to better support the funding of the economy, but their effectiveness may be hindered by several stumbling blocks that need to be addressed:

- Insufficient supervisory convergence and consistency in the implementation of financial rules at the EU level that requires strengthening the powers of the European Supervisory Authorities (ESAs) and reviewing their operations and governance
- Lack of confidence between Member States due to legacy issues (non-performing loans) and insufficient economic convergence among core Member States
- Difficulty to further streamline at the European level some key legal and regulatory elements such as insolvency laws which impede cross-border investment and the cross-border resolution of banks
- Possible limitations of traditional single market approaches when addressing new innovative sectors or activities (digital, climate change…), which may require a stronger focus on the emergence of EU standards and champions in addition to lifting barriers and fostering a level playing field.

Another challenge is the wish of some jurisdictions that global regulation should better take into account their own interests and specificities and should not affect inappropriately their domestic financial institutions. Although these demands are understandable, they have to be balanced with the need for international coordination which is vital for economic growth and financial stability.

Brexit is a further challenge in this context due to the importance of the City for the financing of EU economy. It is also an opportunity however for the EU27 to further develop and integrate its capital markets and increase the role they play in the financing of the EU economy.

Over 700 representatives of the EU and global public authorities and of the financial industry are gathered in Tallinn to discuss these issues and challenges, assess the progress that has been achieved and discuss openly the monetary, economic and regulatory actions that are needed to further strengthen the EU economy and financial system.

Most of the 180 speakers taking part in the Eurofi Tallinn Forum have accepted to express their views in this magazine, providing a comprehensive overview of these issues. We thank them very warmly for their thoughtful contributions and very much hope that you will read them with great interest. ●

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

David Wright

President, EUROFI

European integration and international cooperation have never been so important to deal with the growing list of major challenges

EUROFI is honoured to be hosting its Financial Forum 2017 in Tallinn, Estonia. We thank most warmly the Estonian Presidency of the European Union, the Prime Minister, the Minister of Finance and the Governor of the Central Bank for their exceptional assistance and hospitality in helping us set up this important meeting in their capital city.

By all accounts this looks like being both one of the most eagerly awaited and largest attended in the history of EUROFI events. There will be over 170 speakers over the 2 days - testimony to the growing interest and importance of these gatherings. We are most grateful for all their contributions.

We look forward to some really outstanding discussions and robust debates on the key political and financial issues facing the European Union covering the frontier policy issues; the ones that count; the ones that will make a difference to all our futures as Europeans.

EUROFI is a membership organization and this event would not be possible without the firm, loyal and enthusiastic commitment of all our Members, lead sponsors and sponsors. We thank them all most sincerely.

I also thank Didier Cahen, the Secretary General of EUROFI and his outstanding team for their tireless and impressive work.

In the last 12months, even 6 months, we can all see and feel that we are living through a period of tremendous, uncertain political, social and economic change in the EU, the United States and around the globe. Changes are happening at an accelerating and vertiginous pace. The post-war transatlantic consensus and its cast-iron commitments, led by the United States - the Western glue - is coming unstuck. The post-war Bretton Woods institutions are being challenged like never before- inter alia the World Trade Organization that, ceteris paribus, has kept global trade flowing effectively for decades. The U.S who signed and played a major part in the Paris Climate Change Agreement is now rolling back from it.

Some ugly, angry forms of economic nationalism are surfacing - including Brexit - forces that will damage not just the global and European economies but also the countries that wrongly believe in it. There is no evidence that the unilateralists are gaining or will gain any long term macroeconomic advantage. In fact I think the opposite is beginning to emerge.

Neither are the fractures, fissures of globalization - the "have" versus "have-nots" - being sufficiently repaired. If anything they are

becoming wider, spawning new waves of immigration, extremism, terrorism, racism and violence. Most dangerous of all are the heightened nuclear tensions in Korea and that long term peace in the Middle East seems further away than ever.

I draw some simple thoughts from this complex picture, from this accelerating and quickening pace of history.

First, the fundamentals, the principles of international trust, alliances, treaties and deeper European integration are needed more than ever to confront these huge challenges. These assets remain as crucial as ever. People want peace, stability and institutions they can trust and rely on because sensible, practical cooperation and integration improves the security of all.

The world needs more practicing and dedicated multilateralists and integrationists, not less. More leaders who believe in building international cooperation and friendship, not less. More inclusive leaders who respect others, who encourage diversity and religious tolerance, not less. Leaders in the true sense of the word, leaders with real moral authority, not ad-hoc panderers to narrow extremes.

Second, there is an evident need to build stronger global institutions, including global financial ones, able to more effectively deploy and enforce international rules and standards. Strong, like-minded coalitions of the willing to stand up, even isolate the backward looking unilateralists. For example by agreeing new trade opening measures and ensuring that the WTO disputes settlement remains functional and its decisions fully implemented. The EU is right to spread its bilateral trade wings to Asia and Latin America but also it must remain the strong leader to protect the primacy of multilateralism.

The EU must also seize the opportunity now to deepen its economic and monetary union - the banking union - and, pari passu, develop the new European securities and insurance unions, including devolving more supervisory and regulatory powers to ESMA, EBA and EIOPA. Capital Markets Union is barely off the drawing board; it has to accelerate and ambitious delivery deadlines should be set by the leaders of the European Union and respected. Key Commission CMU projects, like the PEPP, should be fully supported.

The European economic and political situation is favourable for moving forward - the stars are aligning. The economic context today in the EU, ex-UK, is an improving one - higher European growth, more jobs, low inflation and interest rates. The grand Eurozone bargain of much greater budgetary and structural reform discipline in return for building deeper, more powerful Eurozone institutions is within reach. The missing ingredient is political courage and determination.

Third, the EU must continually look forward and understand fully the innovative, inclusive, integrating forces of the future, such as Fintech - so the EU can be in a position to lead and shape global finance and not become the international standard laggard nor caddy.

It is perfectly possible to do this in the EU- I recall GSM standards in the 1990s emerging from the EUs research programmes - European standards that indeed became the global ones for mobile telecommunications. Or the EUs pre-emptive and bold decision to be among the first to adopt IFRS international accounting standards, a decision that virtually the whole of the rest of the world has followed, except the United States.

In financial services encouraging Fintech and Regtech developments in the EU as the Estonian Presidency intends to do, is wise and forward looking. Alongside, more efforts are still needed in the EU to deepen the availability of all forms of venture and risk capital with good policy measures and incentives.

If successful, European financial markets will become more integrated and productive, more accessible at lower cost to consumers, more transparent, harmonized and understandable thereby stimulating overall economic demand. Payments to SMEs can be much quicker. Trading across the whole of the EU, linked to e-commerce markets can become seamless and simple capturing the EUs vast potential network benefits.

Hedging can become more widely available. Behavioral economics and robo advice can guide better consumer decision making.
With one caveat - namely that any policy changes must ensure a level competitive playing field for all actors.

Fourthly, the present is urging us to think forward, more effectively and holistically, to analyse and manage risk.

Do we understand enough today about the interconnectivity of financial markets? The contagion channels? Are the relevant data harmonized and reliable? Available real-time? Are new risks building up in the system?

Is the financial system, for example, robust enough to cope with a significant long-term upward movement in interest rates? Should we be worried by rapidly growing, correlative risks in the index markets? Or burgeoning, loose car loans?

I am not confident we know or understand enough.

We must avoid a situation that by not fully understanding the complexities of the financial system we could be led, by stealth, to another global financial calamity - the political, social and economic costs of which next time will be far more damaging to all the international and European values we cherish so deeply.

I wish you all a most enjoyable, productive and thoughtful EUROFI, Tallinn. ●

Q&A

Toomas Tõniste

Minister of Finance, Estonia

Financial sector regulatory initiatives are important for the Estonian Presidency

WHAT ARE THE PRIORITIES OF THE EU ESTONIAN PRESIDENCY IN THE FINANCIAL AREA AND THE KEY CHALLENGES TO BE ADDRESSED DURING THE PRESIDENCY?

The overarching theme for the Estonian Presidency of the Council of the European Union is reflected in the motto of the Presidency "Unity through balance". The European Union and its economies are uniquely diverse. As the Presidency, Estonia aims to find a balance between different ideas and values within the union.

The Estonian Presidency has identified four priority areas to be pursued:

- Open and innovative European economy
- Safe and secure Europe
- Inclusive and sustainable Europe
- Digital Europe and free movement of data

In addition, we bring to the table our digital agenda that complements all the outlined priority areas and adds a distinctly Estonian flavour to the Presidency.

In terms of the financial sector priorities, our main focus is to further work on the Capital Markets Union and the Banking Union. Without a doubt, discussions on deepening the Economic and Monetary Union together with tax matters, will also be key priorities for us.

It is impossible to overstate the significance of the Capital Markets Union and the Banking Union, the building blocks of the future of the EMU. Resilient financial sector that is capable of providing alternative financing solutions, would be an important contributor for the overall economic development of the EU.

In addition, we expect to reach agreement on the risk reduction measures in the banking sector. This, in turn, will hopefully allow us to make progress with the European Deposit Insurance System. As for the capital markets, we have recently agreed guidance on the work plans for the coming years in the CMU mid-term review. We will also deal with the various regulations on market infrastructure, central counterparties and, last but not least, with the pan-European private pension product.

It is also our aim to leave our mark on the European tax systems by making them more viable and competitive. In the framework of the common corporate tax base, we will make every effort to also address the taxation of digital economy. Business is moving online and we firmly believe that European tax systems should keep pace with the changes.

"The financial sector priorities during the Estonian EU Council Presidency aim to further work on the Capital Markets Union and the Banking Union. Resilient financial sector that is capable of providing alternative financing solutions, would be an important contributor for the overall economic development of the EU."

- TOOMAS TÕNISTE

And finally, we have come to a point in time where we need to give serious thought to the future of the EMU. Now is the time to discuss how to shape the EMU for years to come. Estonia is honoured to be able to facilitate these discussions and help find the best way forward that will benefit all the members of the EU.

WHAT ARE THE PRIORITY ACTIONS REQUIRED AT NATIONAL AND EU LEVELS TO RELAUNCH PRODUCTIVE INVESTMENT AND TO ACHIEVE STRONGER GROWTH (3%, 4%) IN EUROPE AT A TIME OF EASY MONEY?

Firstly, we should continue recapitalising and repairing of the banking sector. In order to achieve stronger growth, we should also facilitate alternative financing opportunities for SMEs and start-ups. Secondly, the EIB has an important role to play in the economies of the EU: Member States should use the instruments provided by the EIB to kick-start investments and draw-in private sector investors. In addition, the Member States should also use this opportune moment to implement much needed structural reforms that would allow their economies to become more sustainable and resilient against any possible shocks.

HOW TO RESTORE TRUST BETWEEN MEMBER STATES, LEGISLATORS, NATIONAL REGULATORS AND MORE GENERALLY BETWEEN HOME/ HOST COUNTRIES IN ORDER TO IMPROVE THE EFFICIENCY OF THE EXISTING PILLARS OF THE BANKING UNION (SSM, SRM) AND REDUCE THE FRAGMENTATION IN THE EU BANKING MARKET?

Building up sufficient and credible buffers would be a first step in restoring trust. We also need to make sure that should there be another crisis, agreed principles are implemented, and bank supervision and resolution takes place in accordance with established rules. Also financial stability risks in Member States as well as in the whole EU (short term liquidity support, fiscal backstop in resolution and crisis situation) should be taken into account. In addition, resolution plans for cross-border banks, including systematically important subsidiaries of (host) countries, must be realistic, feasible and credible to be used in the case of failure of the parent bank or a wider banking crisis. We should not forget, however, that challening times can also provide an opportunity to analyse steps taken and adjust rules if need be. Therefore, any crisis response on EU level should be followed up by a lessons learned exercise. Only this way can we be sure that the EU can stay agile in its responses to any future crises. Overall, I find that Member States' and institutions' competencies and responsibilities are well balanced and correspond to their liabilities, and I believe we have achieved a working equilibrium.

ARE THE RECENT PROPOSALS TO DEEPEN THE EMU LIKELY TO CREATE THE CONDITIONS FOR A FURTHER INTEGRATION OF THE EUROZONE? TO WHAT EXTENT MAY THEY CONTRIBUTE TO IMPROVING ECONOMIC CONVERGENCE IN THE EUROZONE?

In my opinion, institutional integration is not a prerequisite for deepening of the EMU. Rather, it could be the outcome of integration. After all, we can choose and combine between the rules based, market based, and institutions based approaches to integration. One thing is certain, integration should be a gradual and organic evolution of the EMU.

In short to medium term we want to prioritise the completion of the Banking Union, including the EDIS, and hope to reach an agreement on a common backstop. Work will also continue on the implementation of the governance framework. This has to include improving the Macroeconomic Imbalance Procedure, as well as finding and enforcing the synergies between European Semester outputs and the reform efforts of Member States. Therefore, the real aim should be to analyse the existing framework, pinpoint its weaknesses and find pragmatic solutions.

On the topic of the Euro area budget or fiscal capacity, we need to analyse the readiness and extent the involved Member States are willing to contribute. Consequently, the solution may have to entail giving some of the currently Member States' functions to a centrally managed capacity. Do we know which functions this would include and if we are ready? I suspect we are not quite there yet.

In general I would like to repeat my predecessors' calls to rebuild European citizens' confidence in the EU and focus on implementing the existing rules-based framework diligently. Only once we have achieved these goals, can we truly talk of further integration. ●

Q&A

Ardo Hansson

Governor, Eesti Pank and Member of the Governing Council, European Central Bank (ECB)

Do not dream of new normal, but prepare for gradual normalization

WHAT ARE THE POSITIVES AND NEGATIVES REGARDING THE ON-GOING ULTRA-ACCOMMODATIVE MONETARY POLICY OF THE ECB?

We are in the middle of the largest global policy experiment in the history of central banking. Policy measures that are globally undertaken by central bankers are unprecedented. One of the major benefits of the accommodative policy stance applied by the eurosystem is the gradual increase in economic activity and inflation. In addition, low rates have delivered significant ease to the debt refinancing of governments which may have contributed to short-run political stability in some countries. Thereby besides serving our commitment to price stability, the low interest rate environment has provided additional space for fiscal policy. Our presence in bond markets has avoided the most turbulent developments.

However, large scale monetary stimulus also comes with significant risks. Interventions in the government bond markets have partially removed the market pressure on governments. Our bond purchases have put governments to certain extent into the comfort zone, which has, at least in some cases, led to less ambitious agenda for reforms.

The dynamics of asset prices must be carefully monitored. There is a potential tradeoff between financial stability and price stability. The mandate of the central banks is related to price stability as defined by consumer prices. The link between the short term dynamics of asset markets and consumer price inflation has weakened. Therefore, additional measures against unsustainable dynamics of asset prices along with crisis resolution mechanisms have the key role in mitigating the possible risks of low rates. This means that various preemptive measures in macroprudential policy are inevitable; despite the fact such measures are often unpopular.

TO WHAT EXTENT CAN LIQUIDITY CREATION BE A SOLUTION FOR RELAUNCHING CONSUMPTION, INVESTMENT AND SUSTAINABLE GROWTH IN EUROZONE COUNTRIES CHARACTERIZED BY STRUCTURAL DEFICIENCIES AND RIGIDITIES?

Every additional quarter of incoming data has confirmed that albeit very gradually, we are witnessing improved performance of consumption and investments in the euro area. The recovery in economic activity has been slower due to the high uncertainty surrounding the global and domestic economic outlook. For years, the risk assessment of the euro area's growth outlook has been tilted to the downside. It was only this June when we reached a balanced risk assessment for economic growth. Looking forward, the link between interest rates and economic activity is expected to strengthen again due to higher confidence among investors and consumers. What we have not seen yet is the pick-up in inflation. After the global crisis, the link between the performance of the real economy and inflation has been weak in almost every western country. Despite its current dormant state, the link between inflation and economic activity has not fundamentally changed.

One must carefully look at the reasons behind low wage and price pressures. First, the recovery in economic activity has been only very gradual. This implies that the lags between the increase in economic activity and inflation are also longer than usual. Second, we have seen at least some progress in the structural reforms. It is inevitable that some labor and product market reforms are somewhat disinflationary in the short term. The horizon of structural policies is longer than the medium term. Therefore one should not expect that the agenda for structural reforms is fine-tuned for monetary policy. Thirdly, the recovery of employment has been faster than expected. This also implies that some wage pressures have not built up yet as the byproducts of the limited downward flexibility of wages of the recession episode are not fully undone yet. And lastly, this crisis has proven that despite the low mobility of labor, the stakeholders in wage bargaining have perhaps perceived the potential for mobility of jobs being more acute than ever. An elevated focus on cost optimization has made employers seek alternative locations with lower wage levels. This can explain why despite cyclical recovery in output, the wage pressures are somewhat lower.

More serious issues are related to the low potential output growth in many countries. Lost competitiveness due to postponed reforms and populist policies has led to the deterioration of the potential growth. This cannot be improved by cyclical policies like monetary policy. For promoting the sustainability of growth, many labor and product market reforms are necessary. Monetary policy cannot substitute the supply side reforms.

ARE MEMBER STATES, NOTABLY THOSE RUNNING A PRIMARY FISCAL DEFICIT, SUFFICIENTLY PREPARED FOR A PROGRESSIVE NORMALIZATION OF MONETARY POLICY AND SHOULD THEY ADAPT THEIR FISCAL POLICIES CONSEQUENTLY? WHAT ARE THE EXPECTED IMPLICATIONS OF THIS CHANGE FOR CAPITAL MARKETS, BANKS AND INSURANCE COMPANIES?

It must be clear that at the end of the current cycle, the gradual normalisation of rates should be priced in. The combination of relatively promising economic variables and still very low interest rates which we see in the projections for 2019 is a snapshot of the ongoing economic recovery and do not represent the set of new equilibrium values. Going beyond, the recovery in inflation will be reflected also in interest rates. Too much emphasis has been put on the fears of policy normalisation.

The potential risks of recovery include the excessive leverage developed during the low rates period and unsustainable fiscal policy. Those risks can be mitigated by the macroprudential measures and structural reforms which elevate the potential growth and address fiscal sustainability. To reduce the fear of cliff effects of policy normalisation, one must understand that the process of normalisation of policy stance is very gradual and in fact, it has been already started. Inflation rates have been gradually increasing and it has enabled us to lower the amounts of our monthly purchases. Looking at monetary policy, too much emphasis has been put to the volumes of the asset purchases and other changes in the stance. During the extensive application of non-standard policy measures, the central bank balance sheet and excess liquidity have increased significantly. This means that not the change in the balance sheet, but the absolute level of excess liquidity is the main contributor to the accommodative policy stance in the medium term. Given the duration of government debt and the expected dynamics of longer term interest rates, at least for some time, governments will continue to enjoy the refinancing of its earlier bonds at significantly lower rates than in the previous cycle.

"Looking forward, the link between interest rates and economic activity is expected to strengthen again due to higher confidence among investors and consumers."

- ARDO HANSSON

But in many respects, the normalisation delivers an ease for the industry. The normalisation of the yield curve may even support the business of universal banking and the escape from the negative money market rates would significantly improve the performance of insurance companies and absolute return providers.

In case of significant deviations from the baseline inflation path Eurosystem stands ready to act. It must be noted that ECB has a wide range of policy instruments available, which can be used in case of necessity. ●

Q&A

Jyrki Katainen

Vice-President for Jobs, Growth, Investment and Competitiveness, European Commission

Long-term and sustainable investment for jobs and economic growth in Europe

HOW CAN THE EU BANKING AND FINANCIAL REGULATORY FRAMEWORK SUPPORT THE TRANSITION TOWARDS A LOW-CARBON, MORE RESOURCE-EFFICIENT AND SUSTAINABLE ECONOMY?

Europe faces a very big investment challenge. We will need about €180 billion in additional yearly investment to limit the increase in global temperatures to well below 2 degrees Celsius. Both public and private finance must contribute to sustainable investment.

Well-targeted public finance can help spur sustainable investment, including from private sources. The Investment Plan for Europe supports the long-term objective of decarbonising the EU economy. But this investment cannot be financed from the EU budget or national exchequers alone. The transition will not happen unless the financial sector contributes fully. For this, we need to get the regulatory environment right.

The EU is already a global leader in integrating sustainability into financial regulation. For example, as of next year, our new rules on non-financial disclosure will require large companies listed in EU markets to disclose information on social and environmental aspects of their business.

Our Capital Markets Union Action Plan calls for a strategy to unlock the potential of sustainable finance. To get there, last December the Commission established a high-level expert group. This group of 20 senior experts has been working to set out concrete proposals for reforms to our financial regulations, and to create the right conditions for sustainable investments.

We are now exploring ways to step up our ambition. For example, we are looking into better integrating sustainability considerations in the investment mandates of asset managers and institutional investors. We are analysing ways to encourage credit-rating agencies to take better account of sustainability and long-term perspectives in their ratings. And we are exploring how to further embed sustainability systematically as part of upcoming reviews of financial legislation.

There is no time to lose. The high-level group has already delivered to the Commission a first set of recommendations, the final ones being expected by the end of the year. We will act on those proposals rapidly. We must embed sustainability in the financial system for the transition to a low carbon economy.

WHAT ARE THE PRIORITY ACTIONS REQUIRED AT NATIONAL AND EU LEVELS TO FOSTER PRODUCTIVE INVESTMENT AND TO ACHIEVE STRONGER GROWTH (3%, 4%) IN EUROPE? HOW COULD THE EU INCENTIVISE DOMESTIC STRUCTURAL REFORMS AND ENCOURAGE MEMBER STATES TO MEET THEIR FISCAL AND STRUCTURAL COMMITMENTS?

The European economy continues its recovery, now for the fifth consecutive year. We must use this as an opportunity to make European economies more productive, and more investment is needed to achieve this objective. But investment is still held back by several factors, including weak global demand, the legacy of the crisis, sluggish medium-term growth prospects, and political risks and uncertainties.

The European Fund for Strategic Investments (EFSI) under the Investment Plan for Europe aims at responding to these challenges

and has already supported investment worth more than EUR 225 billion in all Member States. It is well on track to reaching the EUR 315 billion target by mid-2018.

The European Structural and Investment Funds also focus on improving the competitiveness of the EU. We are now thinking about the future Multiannual Financial Framework post-2020. The future cohesion policy should incentivise structural reforms in Member States, while keeping what is useful in the present system of ex-ante conditionality. We are in the process of exploring the best ways to do this, in the context of Reflection paper on EU Finances, which was published 28 June.

But public funding is not enough. Structural reforms must be achieved through complementary actions at EU and at country level. At EU level, we have the Capital Markets Union, the Single Market Initiative, the Digital Single Market, the Energy Union, the Circular Economy package… All these initiatives set out measures to remove obstacles to investment and improve the conditions in which firms operate. According to the European Parliament's in-house think tank, the European Commission has delivered, at the mid-term of its mandate, more than eight out of ten initiatives announced, of which approximately two fifths have reached the final stage. The European institutions are thus collectively delivering.

Member States must also do their part. Many of our recommendations in this year's spring economic package were targeted at addressing barriers to investment. These include disproportionate regulatory and administrative requirements. For many countries we also recommended opening up product and services markets, in a way to boost innovation and lift productivity growth. We need to make progress in removing these barriers.

DESPITE LASTING LOW INTEREST RATES AND THE SUCCESSFUL IMPLEMENTATION OF THE JUNCKER PLAN, NORTHERN EUROPE HAS SURPLUS SAVINGS THAT ARE NOT FEEDING INTO THE SOUTH. WHAT ARE THE CONDITIONS REQUIRED TO IMPROVE THE MOBILITY OF CAPITAL WITHIN THE EU? HOW TO ADDRESS SAVINGS – INVESTMENT MISMATCHES WITHIN THE EU? WHAT COULD THE ADDED VALUE OF EUROPE BE IN THIS RESPECT?

Despite progress made in the aftermath of the crisis, there are still significant imbalances in the EU. Countries with external deficits or debt have made progress, but large current account surpluses remain. Private debt deleveraging continues, but at a slow and uneven pace, hampered by low growth. Despite improved capital positions, the banking sector is facing challenges linked to falling profitability and a legacy of non-performing loans.

The Commission's Reflection Paper on the Deepening of the Economic and Monetary Union of last May underlines the need to move towards a Financial Union. We need to reduce and share risks in the banking sector and to provide better financing opportunities for the economy, including through capital markets. The completion of the Banking Union and of the Capital Markets Union is essential to achieve this.

As regards the Banking Union, we need to make progress on both "risk reduction" and "risk sharing". The Commission proposed a comprehensive package to reduce risks carried by banks in November 2016. In July of this year, the Council also agreed on a European strategy for non-performing loans. While making progress in reducing risks, we should also act decisively to mitigate further the links between banks and public finances. We should find an agreement on a common fiscal backstop for the Single Resolution Fund and a European Deposit Insurance Scheme (EDIS) as soon as possible. These important risk-sharing tools should be in place and fully operational by 2025.

Progress towards a Capital Markets Union is also essential to improve capital mobility within the EU. A Capital Markets Union will increase risk-sharing via the private sector and the overall resilience of the financial sector. It will also contribute to broader macro-financial stability in case of economic shocks. This applies to all EU Member States. Remaining barriers to a complete Capital Markets Union, such as taxation rules or insolvency procedures, must also be tackled, including at the national level.

WHAT ARE THE MOST APPROPRIATE INSTRUMENTS TO CHANNEL SAVINGS ACROSS EU BORDERS? WHAT ARE THE KEY OBSTACLES OR DISCENTIVES TO A FURTHER DEVELOPMENT OF CAPITAL MARKETS AND NOTABLY EQUITY MARKETS IN THE EU AND HOW TO ADDRESS THEM? SHOULD NEW INSTRUMENTS OR MECHANISMS BE PROPOSED OR FURTHER DEVELOPED TO FAVOUR SUSTAINABLE CROSS-BORDER INVESTMENT?

The crisis showed that Europe needs to develop non-bank finance as a complement to bank credit. The Capital Markets Union aims to break down barriers to cross-border investment, improve access to alternative finance, improve the ability of SMEs to tap capital markets, and put European savings to long-term productive use.

Public finance should continue to play its part. The Commission has proposed doubling the duration and the firepower of EFSI. Both the Parliament and the Council have already endorsed the proposal, which should be adopted as quickly as possible. The innovative approach of the Capital Markets Union is to blend regulation, non-legislative measures and public finance. For example, to increase risk finance, we have agreed proposals to amend the EU rules on venture capital funds. This regulatory work has been complemented by a Pan-European Venture Capital Fund-of Funds programme, for which the Commission has committed €400 million as an anchor investment.

In less than two years since the launch of the Capital Markets Union project, we have already made good progress, by delivering about two thirds of the original action plan. For example, we reached a deal to restart securitisation markets. We also proposed a new voluntary scheme to save for retirement, a Pan-European Personal Pensions Product, or PEPP.

In June we put forward a revised action plan that significantly raises our ambitions. I will just give two examples of new actions. First, we will look at ways to alleviate regulatory requirements for listed SMEs. Second, we will assess the case for an EU licensing and passporting regime for fintech activities, such as crowdfunding. We want our innovative companies to scale up in a single European market, continue developing and innovating in Europe, and compete globally.

We have a comprehensive programme of reforms, and we count on the support of the European Parliament, Member States, and market participants to turn these actions into successful outcomes. ●

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

Common rules and deeper integration for an effective and stable financial sector

HOW MAY DIFFERENCES IN THE IMPLEMENTATION OF BASEL BANKING REQUIREMENTS BETWEEN THE EU AND THE US BE ADDRESSED? REGARDING THE FUNDAMENTAL REVIEW OF TRADING BOOK (FRTB) & NSFR, THE US ARE NOT INTENDING TO APPLY STRICTER RULES CONTRARY TO THE EU. WHAT ISSUES DOES THIS RAISE? HOW TO ADDRESS THEM?

The financial crisis illustrated the international nature of our financial system, and the importance of a common approach to financial regulation. We all have much to gain from integrated financial markets based on international standards. The rules we have developed together with our international partners guarantee a level playing-field so banks can compete fairly in a stable financial system. We are strongly in favour of continuing the cooperation within the G20 and the Basel Committee.

In our Banking Package of November of last year, the European Commission proposed to introduce into EU legislation internationally agreed standards, together with targeted adaptations to make our rules more growth friendly, based on the feedback from our comprehensive Call for Evidence. We are doing this without weakening our prudential framework, and while upholding internationally agreed standards.

But for international cooperation to be effective, parties must stick to the commitments they have taken. If the G20's achievements were to unravel, we would run the risk of regulatory arbitrage and renewed instability. Changes to domestic US financial legislation would also impact other parts of the world, given the size and the importance of the US financial sector.

Among Basel standards that were already agreed upon, the Fundamental Review of the Trading Book (FRTB) and the Net Stable Funding Ratio (NSFR) are some of the most important. There can be no selective cherry-picking of measures – the set of reforms that was introduced in the wake of the global financial crisis must be seen as a whole. That being said, we have always been in favour of assessing the calibration of the FRTB and the NSFR. We performed our own assessment during the preparation of the November 2016 Banking Package, where we proposed transitional arrangements to phase in the new requirements.

WHAT ARE THE PROSPECTS OF GLOBAL FINANCIAL REGULATION IN A CONTEXT WHERE SOME JURISDICTIONS WANT TO PRESERVE THEIR OWN INTERESTS OR MAKE SURE THAT REGULATION TAKES INTO ACCOUNT THEIR OWN SPECIFICITIES? COULD AN APPROACH BASED ON EQUIVALENCE OF OUTPUTS BE A SOLUTION?

The EU is committed to the work done in the Basel Committee to complete the post-crisis regulatory framework, and we share the aim of balancing risk sensitivity, simplicity, and comparability of outcomes of capital requirement rules.

To guarantee a global level playing field, the revised rules should not lead to significantly different outcomes for different regions of the world. Structural differences between banking systems, and the way the economy is financed, have to be taken into account. The presence of residential mortgages on banks' balance sheets in the European Union, compared to a system of securitisation with the help of government-sponsored enterprises in the US, is a good example.

Prolonging uncertainties over the new framework is not good for the financial sector. The Commission will keep on working intensively to ensure a balanced solution that enhances financial stability and does not put our banks at a disadvantage compared to our global competitors.

HAS SUFFICIENT PROGRESS BEEN MADE IN THE MITIGATION OF SYSTEMIC RISKS ASSOCIATED WITH CAPITAL MARKET ACTIVITIES AT THE GLOBAL LEVEL? ARE THE MEASURES REGARDING DERIVATIVES AND DATA COLLECTION (TRADE REPOSITORIES) SUFFICIENTLY CONSISTENT AT THE GLOBAL LEVEL?

Derivatives are traded across the globe as part of integrated financial markets. A coordinated approach is therefore essential to mitigating the risks associated to these financial instruments. In 2009, at Pittsburgh, G20 leaders jointly committed to increasing the stability of the over the counter (OTC) derivatives market. The EU responded to this commitment by adopting in 2012 the European Market Infrastructure Regulation (EMIR). EMIR mitigates systemic risk by imposing centralised clearing of OTC derivatives and requiring the reporting of all derivative contracts.

A recent report by the Financial Stability Board (FSB) highlights that implementation of international reforms is well under way. More and more standardised derivatives are cleared through Central Counterparties, especially for interest rate derivatives and to a lesser extent for credit risk derivatives. Progress has also been made with regard to transparency: a number of authorities use the newly available data from trade repositories to monitor systemic risk, study market interdependencies, or detect market abuses, to name a few uses. That being said, reporting is certainly a field where further progress can be achieved, and work is currently ongoing at international level on data harmonisation and cross-border access to data.

Following these reforms, the FSB, as well as a number of jurisdictions, has embarked on reviews of the rules in place to assess whether they are fit for purpose and whether they can address emerging challenges, such as the increasing systemic importance of CCPs. This is well under way in Europe, thanks to the different Commission proposals on derivatives, including proposals on CCP recovery and resolution, a targeted reform of EMIR to achieve its objectives with less cost to Europe's companies and our economy, and with proposals on the supervision of EU and third country CCPs.

ARE THE RECENT PROPOSALS TO DEEPEN THE EMU LIKELY TO CREATE THE CONDITIONS FOR A FURTHER INTEGRATION OF THE EUROZONE? TO WHAT EXTENT MAY THEY CONTRIBUTE TO IMPROVING ECONOMIC CONVERGENCE IN THE EUROZONE?

The euro is one of Europe's most significant achievements. As the currency of 340 million people, it has brought price stability and made it easier to do business and travel. It is a symbol of prosperity for our citizens, and it should remain this way. Our determined response to the financial and economic crisis has made the EMU stronger. But there are still gaps that need to be filled. With the recovery now firmly underway, we cannot wait for another crisis to complete our EMU.

The Commission's May 2017 Reflection Paper on Deepening the Economic and Monetary Union presents a toolbox for the way forward, with a clear focus on jobs and growth, social fairness, and keeping the unity of the single market.

An integrated and well-functioning financial system is essential for an effective and stable EMU. The Reflection Paper therefore underlines the need to complete the Banking Union and make progress on reducing and sharing risks in the banking sector, with measures to make European banks even more resilient. In order to provide more diverse and innovative financing opportunities for the real economy, including through capital markets, delivering on Capital Markets Union is also paramount.

The Reflection Paper also looks at proposals to further weaken the bank-sovereign link, such as so-called sovereign bond backed securities. These instruments can help diversify banks' balance sheets and foster private sector risk-sharing, without requiring debt mutualisation between Member States or changes in the regulatory treatment of government bonds.

"We all have much to gain from integrated financial markets based on international standards."

- VALDIS DOMBROVSKIS

In the area of the Economic and Fiscal Union, the aim is to see convergence between Member States towards more resilient economic structures. This will require a continuous commitment to structural reforms, where the European Semester will continue to be the main platform. We are also exploring options for a Euro area fiscal stabilisation function, to assist euro area countries that are hit by an asymmetric economic shock too large for them to cope on their own. One option is a European Investment Protection Scheme, to protect investment in the event of a downturn.

Finally, we also need greater democratic accountability and transparency, for example by integrating intergovernmental agreements into Union law and through an intense dialogue with the European Parliament and National parliaments. ●

MACRO-ECONOMIC AND POLITICAL CHALLENGES

Content

Issues at stake

After years of crisis, euro area economies are recovering and the political situation is stabilising. This favourable environment provides a window of opportunity for improving the resilience of the EU economy and strengthening the Economic and Monetary Union.

Several challenges however need to be considered. Firstly, ultra-loose monetary conditions: although they have contributed to economic growth, their persistence increases risks for the economy and they cannot act as a substitute for structural reforms, which are needed in many EU countries to improve the business climate, raise output growth and reduce unemployment. Demography and longevity issues also need tackling. In this perspective, the EU Commission has recently proposed the creation of a Pan–European Pension Product (PEPP) in order to enhance the adequacy of retirement savings. Brexit is a further challenge due to the current importance of the City for the financing of the EU economy.

MACRO-ECONOMIC AND POLITICAL CHALLENGES

Deepening the EMU

Contributors

Klaus Regling

Managing Director,
European Stability Mechanism (ESM)

A window of opportunity to strengthen Economic and Monetary Union further

After years of economic crisis, indicators confirm a recovery with a strong positive outlook for the euro area. The favourable economic and political environment provides a window of opportunity to implement reforms and address weaknesses in the euro area architecture. These reforms should include simplifying the fiscal rules, completing Banking and Capital Markets Union, and creating a limited fiscal capacity.

A well-functioning monetary union needs a credible and sustainable fiscal framework. The euro area fiscal rules anchored in the Stability and Growth Pact were implemented in 1997. They were strengthened and revised in 2005, 2011, and 2013. The last revisions introduced improved governance structures, ex-ante coordination and tighter ex-post follow-up. These revisions improved the fiscal rules but also added to their complexity, making them harder to understand and more difficult to communicate. This complexity undermines their credibility. They should, therefore, be simplified to make them more binding, predictable and effective.

The completion of Banking Union, including the creation of a European Deposit Insurance Scheme and credible and well-functioning backstops, should also be prioritised. Taken together these reforms will strengthen the credibility of the safety net, reduce the risks of escalation in case of a crisis, ensure more long-lasting investor confidence, and better protect citizens. This step will be possible when legacy assets of the past have been sorted out. In addition, a fully fledged Capital Markets Union would increase legal certainty for cross-border transactions of businesses, investors, and savers. More cross-border investment and financing will enhance private-sector risk sharing. In addition, promotion of cross-border equity investment will reduce reliance on bank financing and further weaken the sovereign-bank nexus.

In a successful monetary union, public-sector risk sharing complements these private sector insurance channels. The experience in some countries, such as the United States, shows that market risk sharing mechanisms are insufficient. In a monetary union, countries have to weather asymmetric shocks to the economy without being able to rely on national monetary policy. Public-sector risk sharing, through a central fiscal buffer, can cushion asymmetric shocks and enhance the euro area's financial stability without creating permanent transfers or debt mutualisation, as examples in the United States show.

Some proposals for the euro area to establish a central fiscal capacity are not necessary. A facility to deal with symmetric shocks is not really needed. In case of a symmetric shock, monetary policy can intervene, countries would rely on automatic stabilisers (which are the largest in the world) and, in an extreme crisis, repeat the approach of 2008-09 to suspend the 3%-deficit ceiling for a limited time. Other proposals would overlap with mandates of existing institutions. Maintaining a stable level of investment, also in a crisis, can be managed by the European Investment Bank and the European Investment Fund in charge of the successful implementation of the Juncker Plan. Similarly, support for real convergence is the primary goal of the EU regional and cohesion funds. The EU budget has provided for decades substantial transfers of up to 3% of GDP for poorer Member States.

Instead, a useful instrument to strengthen the euro area is a fiscal capacity that can absorb asymmetric shocks. Such a capacity could take the form of a stabilisation fund or an insurance scheme. It would enhance risk sharing without creating permanent transfers or debt mutualisation. Fiscal arrangements integrating many of these principles already exist in the US with a complementary unemployment insurance and rainy day fund arrangements. The implementation would be possible without necessarily changing the EU Treaty. The size of this fiscal capacity would not overburden Member States' public finances, as 1-2% euro area GNP would constitute a sufficient buffer that could be accumulated over a number of years. The framework for such limited fiscal capacity could be designed to prevent moral hazard and free-riding. ●

Bruno Le Maire

Minister for the Economy and Finance, France

Three steps to strengthen the euro area

Europe faces many challenges. Instability in neighbouring areas has led to increased waves of migration and to unprecedented threats to our security. Our economy is finally picking up and the recovery is strong. But the legacy of the crisis is not completely cleared yet: some European countries still struggle with high levels of unemployment, productivity which is too low, fragile banking sectors, and private and public debt levels which are too high. The democratic legitimacy of the European project has been weakened by the perception the EU was not able to solve the crisis. Populism is on the rise in many countries.

The Euro area had a tough ride but both the currency and the Euro area as a whole proved resilient thanks to bold decisions taken by Member States together and a committed monetary policy. Yet it remains fragile in some respects. Although its governance has improved, there is still a lot to do to ensure the euro area makes our economies more prosperous and improves the standard of living of European citizens.

For these reasons, moving forward and transforming our monetary union into a real economic union is my priority. Our common currency is a success, it is used by 350 million people in Europe. It is a global currency. But we need to go much further and turn the Euro area into a core asset for our economic development.

To do so, we have to make sure the Euro area has the ability to properly respond to major economic shocks and to speed up convergence and adjustments between Member States. My vision for the future of the Euro area is an ambitious but balanced one. We must find ways to reduce risks to avoid moral hazard and any free riders behaviour. But we must also increase our risk-sharing capacity since our economies are deeply intertwined. In a word, we should aim at both more responsibility and more solidarity among Euro area members.

I see three steps to reinforce the Euro area's architecture.

First, we need to complete existing projects – in particular the Banking Union and the establishment of an effective Capital Markets Union. Initiatives already taken in the banking sector, as regards supervision and resolution, have been crucial to restore the financial stability in the Euro area. But we've not finished the work. We need to complete the resolution pillar as a matter of priority. We have to make progress towards a European scheme for deposits. And we need to reach an agreement on the Commission's risk-reduction package to further boost the financial resilience of our banking sector. Beyond that, and this is even more true with Brexit looming, our capital markets should be further deepened in order to ease cross-border financial exchanges and improve the financing options for our economies.

Second, we need to create a stabilization and convergence function for the Euro area through a dedicated budget for the Euro area. It will grant more stability from a macroeconomic point of view and ensure that every member country is able to face economic shocks. It must be coupled with a stronger enforcement of fiscal rules to make sure public finances remain sustainable. A Euro area budget could also help the convergence process of our economies, through investments which will boost productivity, such as R&D, human capital, youth, training, etc. This means more business, more jobs and more prosperity for European citizens.

Last but not least, our economic coordination must be reinforced. In our monetary union adjustments cannot be made through exchange rates. This is why we need to find internal adjustment mechanisms. Structural reforms are needed to improve the productivity of our economies and to ensure markets work properly. More coordination is also needed to reduce internal imbalances in a symmetric way. Wages must grow faster in countries with large current accounts in order to reduce cost competitiveness imbalances.

To put it in a nutshell, the Euro area is much stronger than it was, but more change is needed so that the Euro fully achieves its promises. The window of opportunity that lies ahead of us is unique and we must seize it.

Peter Kažimír

Minister of Finance, Slovak Republic

Aristotle was right

Two years after the Five President´s report EMU architecture remains incomplete and progress is slow. Politically, the biggest impediment to act quickly was the super election year and our worries on what it might bring. Fortunately, our fears have not materialized, apart from the Brexit referendum, which was a big disappointment. On the contrary, we see a considerable momentum building up in Europe. It´s important we use this momentum and make it count. Completing the Banking Union and setting up a genuine Capital Markets Union must be our top priority and needs to be fast tracked. Our end goal, further fiscal integration, must remain on our minds and guide our way forward. The more we discuss the future, the sooner we break the taboo and make it a part of our political agenda.

The agreement on the Banking union was the biggest European victory since Lisbon. However, our inability to complete the Banking Union is making this victory seem hollow. Endless discussions on risk reduction versus risk sharing resemble the chicken and egg dilemma. Aristotle argued that neither the egg nor the chicken came first. Inspired by Ancient philosophers I would extrapolate a lesson for Banking Union: it is neither risk reduction first nor risk sharing first – both must be pursued in parallel.

That is not to say that Member States do not have to do their homework. Quite the contrary, a credible plan and reduction of legacy issues must be developed as a matter of urgency. The 'spring cleaning' of banks´ balance sheets should be accompanied by the development of a Common Backstop to the SRF. Similarly, further risk reduction measures should be accompanied by an agreement on EDIS. The Commission´s proposal with its phased in strategy is a good starting point. With full insurance in place only as far in the future as 2024, there is plenty of time to work on sufficient risk reduction and limit moral hazard.

To break the bank-sovereign 'doom loop' once and for all we also need to address the problem sovereigns can pose for banks. To achieve this important step, again risk reduction and risk sharing must go hand in hand. Further reduction of risk would be achieved by reducing the concentration of sovereign risk on bank balance sheets. Diversification rules on bank holdings are thus necessary to increase banking sector stability. At the same time, however, such rules can limit the sovereigns 'ability to finance themselves. Sound fiscal policies and public debt reduction are a key precondition for a sound and healthy demand for sovereign bonds, but markets' are not always a wise and rational animal. Only by sharing risk in a form of a truly European safe asset can we achieve continuous market access for sovereigns in face of the diversification requirement. There is no need to jump on the Eurobond bandwagon right away, but pursuing some kind of a safe asset could be a smart way forward, even without touching the Pandora box called debt mutualisation.

"Inspired by Ancient philosophers, I would extrapolate a lesson for Banking Union: it is neither risk reduction first nor risk sharing first – both must be pursued in parallel."

- PETER KAŽIMÍR

With all that remains to be completed in Banking Union we have quite a heavy workload ahead. This along with the positive turn in the business cycle might easily make us lose sight of what lies beyond. Remaining idle, ignoring the design flaws of the EMU architecture, we will fall prey to a next crisis. Further fiscal integration must be addressed if we want to complete the EMU. There is no prescription on how to proceed. One way would be to simply return back to basics while raising resilience – reintroduce a credible no bailout rule, ensure strong national fiscal frameworks, alongside the introduction of proper fiscal capacity that a monetary union requires to cushion shock that affect even fiscally responsible members.

In most of these issues, the role of the ESM is going to be crucial. As an institution, it has been a success, acting competently and reliably through critical points in time. We can build on that success, by extending its scope of action – use it as the Common Backstop for the SRF, as the issuer of the European safe asset, even as a fiscal capacity counteracting asymmetric shocks.

The new political situation in Europe is a unique opportunity to deliver on the much needed albeit controversial changes of the EMU architecture. It is time to act and it is time to compromise. I know I am ready to. ●

Mario Centeno

Minister of Finance, Portugal

Prioritizing EMU advancement domains to increase convergence and well-being

Only one year ago it would be unthinkable to believe that the European policy debate would be focused, with a considerable degree of consensus, on the need to deepen the Economic and Monetary Union (EMU). Political challenges from within and outside the EU have fuelled this necessity: the EMU needs a set of adequate instruments to deal with short-term and long-term challenges.

The asymmetric shocks in a monetary and economic union with free movement of labor and goods and services place specific short-term challenges to an optimal allocation of resources, which are only made worse without the adequate instruments. Take the example of labor. An uncompensated shock to wages in a monetary and economic union generates temporary and inefficient flows of labor, as shown by a large literature on unemployment search models. Reforms of the EMU need to consider the development of Union level instruments. Individually, countries cannot counteract such asymmetries. Europe's recent experience, if imperfect, is proof of this.

The political economy of reforms in Europe was limited. Neither the sequence nor the depth of reforms was calibrated. The mainstream views prescribed some sort of renewed Say's Law, according to which all supply side reforms would create their own demand. If long ago economists repealed this 19th Century law, the crisis has proven this approach questionable again.

A structural reform is intended to expand the frontier of production possibilities and to improve societies' well-being. The reforms, per se, were well intentioned. However, applied in a context of crisis, they generated additional social and economic hardship.

The reform process was implemented at the same time in many countries, which reinforced the (lack of) demand dimension of the crisis. Investment recovery in the euro area waited until 2014; too long by historical standards. If price increases signal demand pressures in an economy, they are totally absent in Europe.

The bright side is that coming out of a prolonged crisis, the majority of Governments and Citizens feel the need to deepen the EMU.

Taking advantage of this requires determination and clear priorities. The reflection paper on the deepening of the EMU is an excellent base. The completion of the Banking Union should be the priority for the immediate future. It should precede the establishment of a more ambitious governance architecture. The financial fragmentation is not compatible with economic integration and growth. As it stands, the EMU is creating divergence instead of convergence.

There is a need to set up a common backstop for the Single Resolution Fund to boost confidence in the European banking system. Currently, European countries are implementing ambitious reforms to consolidate their banking systems. However, in doing so, banks have many times reduced their operations abroad. This is curtailing the creation of a single market, limiting the access to finance and the prospects of investment. Going forward in this area requires also a European Deposit Insurance Scheme, which is a cornerstone of a healthy banking system.

The state of the European institutional landscape illustrates in perfection why, as it stands, the EMU is creating divergence instead of convergence.

With confidence reinforced and clear mechanisms of shared risks and responsibilities, it would then be possible to start thinking on a more stable and complete governance architecture. One of the proposals put forward to foster the integration within the Euro area is the creation of a macroeconomic stabilization function.

This is a key instrument for the management of any monetary union, as the American experience shows. The way to move forward would be to design the simplest and most automatic mechanism possible. This automatic stabilization function should prevent moral hazards and allow for support in case of relevant asymmetric shocks or symmetric shocks with systemic nature. It should be designed to avoid permanent transfers, and to complement national schemes. An unemployment insurance scheme would work like this. It would be enacted only in exceptional times, when the national unemployment rate exceeds a threshold, and even then only at the margin. This would not consume major resources, contributing to an embryonic Euro Area budget.

As an institution and a currency, the euro is still in its infancy. We should provide it with a better institutional landscape, one that allows it to strive, not one with broken bridges or dead-ends. The citizens of Europe expect this from their leaders: a structural reform is an expansion of our production frontier, thus of the well-being of citizens. The only process compatible with a democracy. ●

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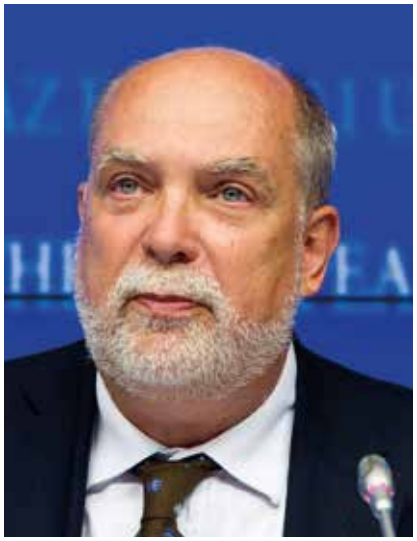
MACRO-ECONOMIC AND POLITICAL CHALLENGES

Financial priorities for relaunching the Eurozone and the EU

Contributors



Thomas Wieser

Chairman of the Eurogroup Working Group and the Economic and Financial Committee, Council of the European Union

Future E(M)U economic governance: balancing responsibilities and priorities

Sixty years after the signing of the Treaty of Rome, the European Union is reflecting on the direction that its future integration should take. Today, evaluating past achievements and considering whether present-day structures are still fit for purpose is more relevant and challenging than ever before. In recent years, the EU and its member states have seen a series of transformative events, affecting various policy areas. Popular discontent with the status quo has been on the rise.

This phenomenon is not specific to the EU. Notwithstanding certain nuances, countries all over the globe are having to respond to similar issues. This includes the challenge of attaining higher and more equitable long-term growth against a backdrop of globally integrated value chains, declining productivity and technological change.

The close interlinkages that stem from EU membership, and in particular from sharing a single currency, compel member states to coordinate their approach to these global challenges. Coordination can take many forms, and as member states review the nature of their EU partnership, they will need to agree on what can reasonably be expected at European level and what should remain a national responsibility. These two policy levels should ideally be mutually reinforcing. Balancing and sequencing individual, national responsibilities with shared, European responsibilities is a central theme in the ongoing debate on the completion of the Economic and Monetary Union (EMU).

Responding to those global challenges and reconnecting with the durable upward convergence of living standards revolves first and foremost around sound policies at national level. Member states have a vested interest in putting in place the right framework conditions for growth. This requires a continuing focus on cross-cutting policy reforms, in particular to improve the business climate, increase the attractiveness of labour as a production factor and ensure that competitiveness gains are founded on advances in productivity. A responsible fiscal policy should be geared towards a more growth-friendly composition of national budgets, counter-cyclical buffers and fiscal space permitting high-quality investment in future growth.

As it reflects social choice, the furthering of internal cohesion within economic convergence is a predominantly national responsibility. It calls for fiscal-structural reforms to tackle vested interests in product and labour markets or modernise and better target social welfare entitlements to the vulnerable sections of society.

The European dimension can reinforce national efforts. On the one hand, there is the requirement to comply with the European policy recommendation and rules. On the other hand, it provides an opportunity for a more efficient allocation

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>>> of resources by exploiting the economies of scale of the single market and tapping its still unused potential (cf. Digital, Energy and Capital Markets Union) or by pooling risks in certain areas.

The latter may require a review of existing European instruments such as the European Structural and Investment Funds (ESI) or the European Fund for Strategic Investment (EFSI). Consideration could also be given to the establishment of a new budgetary capacity funding clearly identifiable common public goods. This, however, requires that certain conditions be met and that account be taken of the limitations on further sovereignty-sharing within the existing legal framework.

Public risk-sharing, however, is not an end in itself. Its purpose is to incentivise sound national policies and act as a catalyst for private, cross-border risk-sharing. This, combined, makes the euro area more resilient.

The completion of the banking union is a case in point. A credible backstop for the single resolution fund or a European deposit insurance scheme constitute necessary but insufficient conditions for addressing the fragmentation in the European banking sector. In order for pan-European banks to take hold in an integrated banking market, further work is needed to develop a more level playing-field. This is as much about reducing legacy risks as it is about risk control, which may have to extend beyond the confines of banks' balance sheets and tackle broader areas such as the harmonisation of national insolvency frameworks or national corporate taxation.

The interlinkages between policy areas - fiscal, economic and financial - will undoubtedly represent a formidable challenge in terms of agreeing on the scope and depth of a new institutional convergence process that has to accompany revised or new European policy instruments.

In addition, in order for these initiatives to succeed, it is essential that they be supported by strong democratic legitimacy. This is necessary in order to avoid the problem of a lack of national ownership, which presently hampers the coordination of economic policies at European level. Incorporating the discussion on the deepening of the EMU into the broader debate on the future of Europe may allow making concrete progress towards this overriding objective. ●

Vittorio Grilli

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

Advancing an open and connected Capital Markets Union for European growth

2017 has seen Europe re-gain its confidence both economically and politically and it has the opportunity to show global leadership with respect to international trade and investment. Brexit has also involuntarily provided an impetus for Europe to reflect on its future. A recent series of White Papers published by the European Commission recognizes this sense of “Europe at a crossroads”. >>>

>>> The Capital Markets Union (CMU) mid-term review provides another appropriate occasion for reflection. Here too, Brexit should provide an impetus to re-focus on the development of a CMU in the EU. We know that well-functioning capital markets will positively impact the European economy, by more efficiently allocating capital and spreading risk across the Union. It will allow Europe to show its openness to international markets. European capital markets will benefit from fully leveraging the interconnectedness and depth provided by the global financial system.

In the context of Brexit, there have been calls for the creation of a global financial center within the European Union. However, the history of London has taught that such financial centers will not appear overnight, or even over a decade. If we keep Europe open and maintain momentum behind the CMU agenda, it is likely that we will see the creation of several, distributed financial centers in Europe over the medium-term. Each would compete to attract market participants by offering access to deep and liquid markets, a wide choice of suppliers of professional services, a business friendly environment and highly qualified regulators, but also in terms of quality of life, business infrastructure, access to talent and various other factors. This would be positive competition and, just like competition within the market place, would create efficiencies and drive progress, as long as it remains within common regulatory bounds. It is appropriate for ESMA to keep an eye on regulatory arbitrage to avoid "artificial attractiveness", in place of open and fair competition.

This same logic applies to competition with financial centers outside the EU. The EU should continue to rely on attracting financial services business through a competitive level playing field, which has allowed for organic growth in the past as market participants recognize the EU as an open and progressive place for their investments and activities. However, when addressing genuine concerns around regulatory arbitrage, policymakers and regulators should avoid erecting unintended trade or market barriers. An example would be the current consideration given by ESMA to allowing restrictions on the delegation of portfolio management (and other activities) from third countries. We believe this could undermine the open nature of European funds frameworks and hurt the attractiveness of the EU market, as well as its successful UCITS model.

In terms of progressing the CMU agenda, the mid-term review was an excellent start, although we would have preferred to see more concrete action on creating a CMU that is open to global finance, and helps facilitate deployment of third-country finance within the EU. We are supportive of the actions the Commission has already taken towards completing the CMU, including work on the prospectus directive and a legislative framework for securitization; or its proposal on CCP Recovery & Resolution. We welcome strengthening the effectiveness of supervision to accelerate market integration, and also welcome the proposal for a pan-European Personal Pensions Product, which could create help savers put theirs funds into long term use, if "life-cycling" is a viable default option.

Lastly, the focus on solving Europe's problems with non-performing loans (NPLs) is to be welcome. By some standards, Europe is overbanked and that the CMU agenda is aimed at tackling that imbalance. But in order to have working capital markets, you also need a healthy banking sector to underpin it. That is why the work that is currently being undertaken at the EU-level to tackle NPLs is so important. The development of a secondary market for NPLs, on which the European Commission is consulting, could act as a good fertiliser for the development of European capital markets.

Europe can look towards its future with a renewed sense of confidence. It has the opportunity to become a leader for the global economic and financial system. And true leadership means showing the way, inspiring a sense of openness and positive outlook. As we develop our capital market, we should seek its continued integration into the global financial system. ●

Vladislav Goranov

Minister of Finance, Republic of Bulgaria

EU financial markets regulations - Facilitating the market driven integration

In the field of the EU banking and financial markets integration, policy initiatives should focus on enabling market forces to work better across the EU to foster economic growth and increase the EU competitiveness while maintaining financial stability. The European policymakers should work to create conditions for financial markets integration that confers wider economic benefits. General legal principles, such as the right of establishment and free movement of capital and services, are not sufficient to ensure a good quality financial integration. There are other determinants, such as private risk sharing through capital markets, along with banking integration, indispensable for more efficient allocation of capital.

Banking union and capital markets union are the two key EU policy initiatives aimed at catalysing financial integration. They are seen as mutually reinforcing as banks and capital markets should complement each other in financing the real economy. The single rulebook for the EU banking sector has been implemented, and two of the pillars of the BU - SSM and SRM, have already been established and became operational. The CMU project that encompasses a wide range of initiatives has been launched to enhance funding and investment of firms and households, and to facilitate cross-border private risk sharing.

What are the conditions to ensure that these initiatives foster quality financial markets integration?

The EU economy is still largely dependent on bank credit and it is unlikely to quickly provide a partial substitute, especially in member states with underdeveloped capital markets and insufficient level of financial literacy. Furthermore, a more resilient banking system supports the smooth functioning of the capital market as banks are active service-providers, investors and issuers. In this context, solving the legacy banking sector problems and implementing measures to further reduce risks throughout the EU should be a priority.

The recently adopted Council Conclusions draw an action plan to tackle the main legacy issue – existing stock of NPLs in some EU member states, but further actions are yet to be undertaken on EU and national level. The risk reduction measures package is a necessary and timely legislative initiative that leads to tangible progress in the EU's regulatory framework. However, there are certain elements of the Commission's proposals for removal of national options and discretions that are subject to a profound discussion in the Council in order to keep the right balance between risk reduction, level playing field and banking integration. From the perspective of a member state with prevailing presence of foreign bank subsidiaries, it is important to ensure that EU level measures to foster cross-border banking and facilitate bank capital and liquidity management in good times do not undermine the resilience of the banking system to shocks in times of crisis. Instead of fostering financial integration, waivers to capital, liquidity and MREL requirements for subsidiaries can lead to even bigger fragmentation and regulatory arbitrage.

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>>> Further supervisory convergence could be subject to additional policy measures that lead to sustainable financial integration and increased confidence among member states, with the latter one being a precondition for advancing in risk sharing in the EU.

Economic convergence is an important element of growth enhancing financial markets integration, and contributes to reducing the inherent financial risks. It is arguable, though, which comes first as financial markets integration, on its turn, fosters economic convergence and growth. The two processes can go in parallel, and the convergence should not be seen as a precondition for the financial markets integration. As pointed out at the EUROFI conference in Malta, "Europe can have, and does have, economies that have a different degree of development, different incomes and different specialities" and this should not be seen as impediment but as essential element and a reason for a deeper integration. ●

Roberto Gualtieri

MEP and Chair, Committee on Economic and Monetary Affairs, European Parliament

Priority actions to re-launch productive investment and growth

To unleash the full growth potential of the European economy is the top priority for the European Parliament. An effective legislative framework forms the basis for a favourable environment enabling productive investment and the creation of new jobs. The creation of a Banking Union and a Capital Markets Union contributes to such a favourable investment environment.

Bank based lending remains the major source of finance in the EU. The legislative files contained in the banking package that aim to further ameliorate and strengthen the regulatory framework of the banking sector are therefore treated as a priority by the European Parliament.

Reducing high-levels of non-performing loans is also crucial to restore bank's lending capacity and to re-launch growth. A comprehensive strategy on NPLs based on national and European interventions is necessary to address both the flow and the stock problem. The creation of a well-functioning secondary market for NPL, including the creation of AMCs, is key to reduce market failures and to shrink the gap between demand and supply. As to the reforms of the insolvency framework, there is still substantial room for improvement, in particular in the area of the efficiency of insolvency and loan enforcement framework as well as in the protection of creditors. The European Parliament is ready to cooperate to the definition of the EU action plan on this issue.

However, more ambitious measures are needed to complete the Banking Union in order to increase the trust of retail savers and investors and to maintain financial stability. Notably the creation of a European Deposit Insurance Scheme (EDIS) as third pillar of the Banking Union will contribute to this. >>>

>>> Capital market based finance is a complement to the bank based financing. The CMU mid-term review identified various priority actions in order to increase the funding to the economy in the Union, to foster more diversity and resilience and to provide growing companies with more appropriate financing. In line with these priorities, ECON considers very important the review of the three European Supervisory Authorities (ESAs), including the necessary reform of competences and responsibilities to ensure the efficient supervision of the CMU. Therefore, the Commission proposal for the ESA review is eagerly awaited.

In the framework of the Capital Market Union initiatives, the Pan European Personal Pension Product proposal (PEPP) represents one of the main actions proposed by the Commission. Indeed, it will serve as an additional funding channel for long-term investment in the EU and will tackle the cross-border fragmentation in these markets.

The interim report of the High-level Expert Group on sustainable finance addresses important issues how to mobilise sustainable investment and growth in the context of the financial services regulation. The results of the interim report and the final report which is due to in December 2017 will feed into the ongoing work of ECON on this important topic.

The use of new financial technologies and the provision of innovative financial services offers opportunities to further facilitate cross-border investment and the integration of capital markets in Europe. On this topic, further to the European Parliament's report, appropriate legislative proposals are awaited in order to capture such growing benefits of technological developments as well as to adequately address possible risks arising in this context.

Nevertheless, the completion of both the Banking Union and the CMU projects would not be sufficient to re-launch growth if market failures are not properly addressed. In this regard, while the Juncker Plan is already playing an important role, the European Parliament is now working on improvements on EFSI regulation in order to promote additionality and close investment gaps by means of an improved pricing policy and an integrated and streamlined approach of blending EFSI with other EU funds. A more growth friendly fiscal consolidation, a positive fiscal stance in the euro area and a better distribution of this stance across Member States will certainly contribute to promote growth and jobs. ●

Werner Hoyer

President, European Investment Bank (EIB)

From reinvigorating to rebalancing investment in the EU

The economic recovery in the EU is gathering speed. GDP in the second quarter of 2017 was more than two per cent higher than a year before. But while consumption and increasingly exports are driving growth, investment remains subdued. The investment rate, setting total investment in relation to GDP, is still more than two percentage points below the level it had before the financial crisis broke out. Recent EIB analysis (EIB (2017), EIB Investment Report >>>

>>> & EIB Group Survey on Investment and Investment Finance) and European Commission data (European Commission (2017) – Economic forecast – Spring 2017) identified a slow recovery of investment, with different paths across sectors and countries. Years of underinvestment have created a backlog in the private as well as in the public sector. This slows growth and reduces competitiveness.

New data show that even infrastructure investment fell by about one quarter in the EU since 2009, from 2.3% to 1.7% of GDP. In most countries, the way in which fiscal consolidation was implemented constrained the public sector component of infrastructure investment. Particularly in the countries most affected by the Euro debt crisis, fiscal consolidation has led to a substantial contraction in infrastructure spending.

Reducing public investment in economically bad times is short-sighted, because it reduces future growth. But the political cost of downsizing or delaying public investment programmes is lower than the cost of cutting current expenditure programmes and subsidies. The ECB has recently flagged that the composition of the public finance has changed as a result of the economic and financial crisis: Governments have shifted limited resources away from productive spending items, particularly infrastructure and education.

Corporate investment remains weak, too. The recent EIB Investment Survey (EIBIS) shows that some 15% of companies report that their investment over the past three years was too low to ensure the future success of their business. Reported investment gaps are slightly more pronounced in the manufacturing and construction sectors.

It is even more the quality of companies' capital stock that is worrying: Only 44% of companies consider their equipment to be "state of the art". Corporate investment has now reached the pre-crisis peak in core countries, but is still well below the pre-crisis level in cohesion countries.

The European Fund for Strategic Investment (EFSI) has facilitated the observed recovery, as shown by its speed of implementation. It is one of the three pillars of the European Investment Plan and based on a smarter use of existing EU budgetary resources to leverage the EIB Group financing capacity EFSI has now reached all 28 Member States. Both small and large states are benefitting from EFSI, according to EFSI mobilised investment per GDP figures.

Accelerating the investment recovery in Member States most impacted by the financial crisis requires more than improving and easing access to finance. They also need support to build and implement a pipeline of robust and viable investment projects. Additionally, it is up to Member States to improve their investment climate by creating a predictable business environment which inspires trust in investors and projects' promoters.

Adressing the identified investment gaps and market needs will not become easier. Going forward, the EU will have to achieve even more with less budget. EFSI and other existing EU financial instruments show the benefits of a sound market-driven approach to investment with the robust backing of the EU budget.

At the same time, addressing the backlog of public investment in a geographically balanced way depends crucially on the administrative capacity of national and sub-national authorities, especially in member states not benefiting from sophisticated and mature financial markets.

It requires investing in the development of a proper capacity to identify, prepare, structure and implement investment projects, for instance by the design of national promotional banks. These institutions will be key partners for absorbing savings and finding viable investment opportunities. ●

Christian Clausen

Chairman for the Nordics, Senior Advisor, BlackRock Inc.

A window of opportunity for the EU to complete the Single Market

People only accept change when they are faced with necessity, and only recognise necessity when a crisis is upon them, EU architect Jean Monnet once noted.

The recent populist uprisings and other political strains presented both a wake-up call and opportunity for the EU to improve its governance and responsiveness to the economic ills. Europe's recent history of integration is one of big steps taken only when forced by a crisis, as epitomised by the Eurozone's repeated summits and emergency decisions during the 2011-12 debt crisis. This has fortified the region's ability to respond to countries running into economic and financial troubles. The ECB can intervene in asset markets to limit fragmentation and it now oversees banking regulation. The European Stability Mechanism provides a financial firewall by providing emergency loans to countries in need. That makes the Eurozone well equipped to handle crises in all but the largest economies.

Years of investor pessimism on Europe are now morphing into cautious optimism. Europe's economy is enjoying a cyclical upswing, supported by a still accommodative ECB. And the two largest countries and long-time drivers of integration, Germany and France are both poised to have newly legitimised governments. Newly installed French President Macron has a window of opportunity to pass labour and tax reforms needed to revive growth. Polls suggest German Chancellor Angela Merkel is poised to win a fourth term in September, with an eye to preserving her legacy as a defender of European integration. Structural reforms such as greater labour market flexibility, could unlock growth potential and raise return on equity. This could narrow Europe's valuation discount over time.

This also means politicians need to deliver. Pursuing deeper integration could involve a defence union, greater fiscal and tax coordination, and lifting of services barriers. We see progress on the European Banking Union and Capital Markets Union (CMU) as indications of policymakers' resolve.

BlackRock strongly supports the CMU agenda. Promoting capital markets and facilitating cross-border investment must remain a key objective since Europe still needs a stronger complementary financing channel to banks. Developing stronger capital markets will be a strong positive for savers and investors who should have better access to constructive long-term investment opportunities.

However, the CMU cannot just remain an action list that generates more actions. We believe that the European Commission has done very good work, and would support them progressing a number of non-legislative workstreams further (corporate bond market liquidity, more work to follow up the retail financial services Green Paper, etc.) to build on this success. We also think there should be an effort made to continue assessing the regulatory framework to ensure that existing rules further the goals of the CMU, are broadly consistent with global standards and are sufficinetly proportionate to stimulate, rather than stifle, economic activity.

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>>> Risks do of course reside and need to be carefully managed. Within the EU, these include the ECB winding back stimulus too soon, the challenge of addressing non-performing loans, the possibility of renewed political instability in Italy and the economic impact of a disorderly Brexit. But dealing with Brexit, migration and the new US administration is pushing the EU towards a united front. Chancellor Merkel pointedly said Europe must take its fate in its own hands after trans-Atlantic meetings in May.

In short, Europe may have its best opportunity in decades to push through reforms that make the EU more durable and effective. We are of the opinion that region's growth outlook is the brightest since the financial crisis and that the correct policies, in which Europe's savers and investors are central to the thinking, will deliver a brighter future for the EU. ●

Mahmood Pradhan

Deputy Director, European Department,
International Monetary Fund (IMF)

Recovery makes this a good time to reform

The euro area recovery has strengthened over the last year. It is increasingly broad-based, with the cross-country dispersion of growth rates at its lowest since the launch of the euro. The extended period of accommodative monetary policy has proved pivotal. This is complimented now with a modestly expansionary overall fiscal stance as well.

But there is no room for complacency. One big hurdle the euro area faces is high public debt levels in several countries. These countries have limited buffers to cushion against shocks and could face higher borrowing costs when the current monetary stimulus is gradually reduced, such as through lower asset purchases by the ECB. They need to rebuild buffers now and put public debt-to-GDP ratios firmly on a downward path.

The euro area also suffers from a deeper-rooted challenge: a lack of convergence in per capita income levels. Income convergence among the 12 original euro area members has stalled since the adoption of the euro. Contrary to expectations, on average, the lower income countries have not grown much faster than the higher income countries. This calls into question the promise of higher incomes through deeper economic integration, one of the original motivations for the monetary union. The lack of convergence is closely linked to slower productivity growth in countries with lower initial income levels. By contrast, the newer members with lower initial income levels—the Baltic countries, Slovak Republic, and Slovenia and others—are converging, as one would expect.

At the same time, gaps in underlying competitiveness between these 12 countries have widened in the years since the euro's adoption. In some countries wages grew faster than productivity, and this was typically associated with increasing external imbalances. Some countries then made painful post-crisis adjustments to reduce unit labor costs, largely through labor shedding that raised output >>>

>>> per worker. But further efforts are needed to fully repair the erosion of competitiveness. These efforts should focus not on further job cuts, but on productivity enhancements and wage setting mechanisms. Lagging countries, especially, need to implement structural reforms to make their economies more flexible and productive. Recent IMF research shows that structural reforms tend to have a larger impact in countries with lower initial levels of productivity, so reforms can boost productivity more in the countries that need it most.

Countries that have sizable external surpluses and ample fiscal space can also benefit from structural reforms. The share of retirees relative to workers will grow over the next few decades, so productivity and potential growth will need to rise to support these retirees. Reforms should focus on sectors where productivity has been weaker. These countries should also use their fiscal space to boost productive public spending, such as on infrastructure, education, and innovation, to raise potential growth. By boosting domestic demand, this will also promote external rebalancing.

The strengthening recovery makes this a good time to push ahead with reforms. Countries with fiscal space can mitigate the impact of structural reforms that adversely affect some parts of society in the short term. In contrast, countries with no fiscal space should ensure reforms are budget neutral and prioritize reforms that have few costs, such as product market reforms.

More could be done at the EU level to encourage reforms. Targeted support from the EU budget could be used to help incentivize reforms recommended by the European Commission. The EU should also continue pushing for greater integration of the energy, transport, and digital markets.

The recovery and recent "pro-Europe" political developments also make this an opportune time to press forward on the architecture. Completing the banking union with a common deposit insurance scheme and fiscal backstop is needed to weaken the link between banks and sovereigns. Creating a more unified European capital market would help to increase investment by diversifying financing sources. Developing a central fiscal capacity would improve macroeconomic stabilization when some countries' ability to respond to shocks is limited. This could go hand-in-hand with a reform of the fiscal rules to simplify them and make enforcement more automatic. ●

Sylvie Goulard

Former MEP, Former Minister of Defence, France

Scale matters

If we want to re-launch productive investment and achieve strong growth, we should tackle two weaknesses of the EU: persisting national fragmentation and thinking in silos.

Decades after the creation of the Single market, we still tolerate too much national fragmentation. For example, although the eurozone's banking union was a quantum leap, in the banking sector, national supervisors and national governments continue to stick to their prerogatives. Capitals are still not allocated cross borders in an >>>

>>> optimal way, interest rates remain different for companies depending of their origins. Models for banks differ considerably. Mutual trust is missing between founding countries of the European Economic Community. With Brexit, even the most pro business, pro market oriented country in Europe is about to close its borders.

Because of the lack of awareness that scale matters, growth's and job's perspectives get lost. Without common supervision, common insolvency principles nor harmonized fiscal incentives, it seems difficult to talk about a genuine "capital market union". Justice and Finance ministers are reluctant to put these key issues in an European perspective.

In some fields, progresses are made, directives and regulations are adopted but in real life, the hurdles remain. It is still difficult to sign a contract for a mobile phone in Germany with a "French" Iban (sic) or to book a holiday flat in France without a "chéquier". It is not easy neither to give cross border mortgage guarantees before buying a house in another member state. For citizens as well as companies, "Europe" is not tangible enough. They hear nice political speeches but the authorities do not always deliver.

The way the banking union was implemented allowing so much space for national differentiation, is a good example of a work done and undone at the same time. The big shift in the resolution practices was adopted without any transitional period or phasing in, encouraging ex post national interpretations of the common rules. As justified as they can be, the differences in the implementation phases increase the feeling of unfairness.

Decades after the treaty of Rome or the financial services action plan, too many rules remain different, too many regulators are more busy defending their own prerogatives than boosting cross border competition. One can even wonder if national authorities are really convinced of the benefits deriving from the single market. Some of the protectionist arguments seem to have reached moderate circles.

The second challenge requires refraining to think in silos. In Brussels as well as in the member states, the civil servants dealing with the capital market union are not the same as the ones in charge of the Juncker plan. The ones looking at the budgetary discipline are not responsible for the EIB policies etc.

Time has come to try to look at the business environment and the macro economic framework in a broader perspective. Regulation and business, rules and real economy. François Villeroy's proposal to combine efforts towards a union of investment and innovation (an up graded version of the CMU) + the reform of the governance of the Eurozone + the national structural reforms, could help going in the right direction. The exceptionally low interest rates could also be used to better prepare the future. The demographic ticking bomb of our aging societies, the vital threats climate change and the technological changes require huge investments.

The rise of global superpowers as well as the speed of developments in the fields of artificial intelligence and big data could be used to accelerate our integration. ●

Challenges for a normalization of EU monetary policy

Contributors

Sabine Lautenschläger

Member of the Executive Board and Vice-Chair of the Supervisory Board, European Central Bank (ECB)

The punch bowl problem of monetary policy[1]

Effective monetary policy requires tough decisions and getting the timing right. This is what former Federal Reserve Chairman William McChesney Martin had in mind when he quipped that the job of monetary policymakers is to remove the punch bowl just when the party is really warming up; in other words, making money more expensive just as everybody was getting used to it being cheap. He made his punch bowl remark in 1955, and not too much has changed since then.

Admittedly, comparing the situation in the euro area with a party is rather far-fetched. In the wake of the financial crisis of 2008, the euro area got stuck in a long period of low growth, high unemployment and very low inflation. So the ECB decided to spice up the punch bowl. It added negative rates on the deposit facility as well as some other ingredients, such as targeted long-term refinancing operations and bond purchases.

All in all, this approach was justified – even though I am critical of some of the unconventional tools that were used.

And the spiced-up punch bowl has had some effect: the economic recovery in the euro area has broadened across sectors and countries. Unemployment is falling, while disposable income of households is rising. At the same time, business investment is picking up. Altogether, the recovery is increasingly being sustained by domestic demand.

And monetary policy is playing its part in that process. The ECB's measures have helped to ease access to funding and bring down borrowing costs for companies and households. This, in turn, helps the ECB deliver on its mandate of ensuring price stability – that is, keeping inflation close to, but below, 2%.

It is not the job of monetary policymakers, though, to repair the economy and bring about long-term growth. That's the job of parliaments and governments. It is their responsibility to undertake structural reforms in order to ensure sustainable growth, especially in the countries that were hit hardest by the crisis. But it involves more than that. All countries in the euro area need to prepare for long-term challenges, such as ageing populations. At the same time, the design of monetary union must be improved. For example, the banking union has to be finalised, there is still room to improve the tools used by European banking supervision, and there is a need to harmonise resolution tools. And let us not forget the capital markets union, which still needs to be set up.

Just after the crisis, policymakers at all levels initiated a number of reforms which are beginning to bear fruit – growth is picking up. However, the pace of reform has slowed. There are still many areas in which reforms could help to increase employment, raise incomes and improve social fairness. A lot remains to be done, and it should be done quickly.

But the economy in the euro area is doing better and the conditions are in place for inflation to pick up and move steadily towards our goal. Eventually, the party

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>>> will get going, and we have to be prepared to take tough decisions in good time. We also have to adapt our communications accordingly. I think this is crucial because all monetary policy measures have costs as well as benefits. And the costs increase over time.

But, of course, we cannot take away the punch bowl just like that. We must carefully assess which ingredients have to be removed, and when. The order in which policy measures are introduced to take us back to a normal policy stance is just as important as getting the timing right.

At some point, the punch bowl has to go – no matter how hard that might seem for the partygoers. ●

1. This contribution was written in July 2017.

Klaas Knot

President and Member of the ECB Governing Council,
De Nederlandsche Bank

Key considerations in monetary policymaking

Since the start of the crisis in 2007, central banks have taken unprecedented measures to meet their objectives. In this process, judgment is required in order to come to a balanced decision making. Necessity, effectiveness and risks are key parameters in the decision making process.

First of all, necessity. At the start of the financial crisis, the drying up of liquidity in the banking system required liquidity injecting measures for banks. The Eurosystem came with fixed rate full allotment and long-term refinancing operations. As the crisis proceeded, the monetary transmission mechanism became hampered. Credit easing measures, such as the targeted long-term refinancing operations, have supported the bank lending channel and economic growth. As from 2014 inflation fell below target, quantitative easing (QE) was introduced in order to bring inflation back to the objective of close to, but under 2 percent. Inflation still lags behind, but the large stimulus package should be given time to transmit completely.

Second, effectiveness of monetary measures. Ultra-loose monetary conditions have contributed to inflation and growth in the euro area, by easening financing conditions for households and firms. This has stimulated economic activity. However, prolonged monetary easing comes with diminishing returns, especially in a situation of very low interest rates. Additional monetary easing becomes less effective in this situation. Moreover, growth and inflation is also influenced by structural factors. By itself, loose monetary policy is not enough to achieve sustainable economic growth. Lack of structural reforms can limit the effectiveness of the policy measures over time.

Third and final, the risk parameter relates to the unintended side-effects of unconventional monetary policy measures. The longer the ultra-loose monetary conditions persist, the larger this risk. Since loose monetary policy has stimulated risk-taking in financial markets, asset prices can grow out of synch with real economic developments. This can create imbalances, which might become unsustainable >>>

>>> once monetary conditions are normalized. Furthermore, market discipline has been reduced by the abundant availability of liquidity. This can distort the risk compass of investors and can contribute to a misallocation of resources and so undermine potential economic growth.

The readers of the public accounts will recognize that these factors form an important part of the Governing Council's assessments on monetary policy. Through the accounts this been made transparent. For example, both in our decision to raise the monthly purchase volume of the asset purchase program and in our decision to reduce the volume, the three parameters formed the basis of our judgment and decision making.

Since the three guiding parameters - necessity, effectiveness and risks – are time-varying, continuous monitoring is needed. They are an important guide for considering changes in monetary policy, both for phasing-in as well as phasing out of the unconventional measures. ●

Ewald Nowotny

Governor, Oesterreichische Nationalbank

Monetary policy is (finally) effective

At the time of writing this contribution, GDP growth in the euro area had been positive for 16 consecutive quarters and hopefully by the time this note is published information on the second quarter of 2017 would have confirmed our expectations that growth was positive for 17 quarters in a row. For central bankers in the euro system, this gives us some satisfaction, because during the crisis it was our responsibility to set the necessary conditions to restore aggregate demand in order to achieve our price stability mandate. These results show that the combination of our measures, our whole monetary policy package, was effective in fomenting favorable financing conditions in the euro area which have successfully stimulated aggregate demand.

This recovery is reflected in a variety of indicators. On one hand, we have survey data which depending on the indicator one chooses shows its highest level in 6 years and expectations of positive growth in the near future. On the other hand, hard facts such as GDP growth and unemployment data have shown also very substantial and sustained improvements for many quarters.

More importantly, credit growth in the euro area, especially for non-financial corporations which was hit hard during the crisis, has picked up thank to our credit easing measures and more importantly, credit growth rates have converged across the euro area. Also lending rates, which also diverged across countries significantly and were an indicator of increasing fragmentation in financial markets, have fallen more in vulnerable countries and thus lending rates across the euro area have decreased and converged and taking together imply very favorable financing conditions for non-financial corporations and households in the euro area. >>>

>>> In summary, the dire picture from 2014 has been replaced by an optimistic perspective of robust and broad economic growth. In fact, the worst risk, the risk of deflation was waned with our monetary policy measures.

Still we cannot declare victory yet. Despite a strong improvement in all fronts, inflation remains stubbornly low. Inflation has not reached the levels that we consider consistent with our definition of price stability and more importantly, the economic recovery as well as inflation developments still depends to a large extent on the degree of monetary policy accommodation. Thus, although we know and expect that monetary policy cannot remain accommodative forever, we still think that the announced measures are adequate at the current juncture.

Moreover, what we can also infer from reading both soft and hard data is that although we can now say our measures have been successful, it took time for monetary policy measures to work their way through the different channels of the transmission mechanism. Thus, we know monetary policy acts with some lags, it first affects aggregate demand and the labor market, eventually wages and finally it will affect prices. We are thus optimistic that although the conditions that are consistent with our mandate have not yet been reached, we are not far away from reaching our goal.

Of course, with the ongoing recovery and after so many years of very accommodative monetary policy, it is time to start planning ahead and thinking about the next phase. In the same way that our monetary policy measures were well thought and consistent as a package, removing accommodation must also be well designed, it has to be gradual, clear and consistent with our reaction function and our forward guidance.

While in theory we know well under which circumstances we can start removing monetary policy accommodation, in real time it is challenging to know when the optimal time has arrived. On one hand, there is the risk that if we retire accommodation too early we risk choking the recovery. On the other hand, there is the risk of acting too late and letting imbalances accumulate.

Thus, we have to constantly assess the situation and be ready to act, but without haste and without creating overreactions in the financial markets. ●

Jordi Gual

Chairman, CaixaBank

Monetary policy and financial stability

There is no doubt that the ECB's expansionary monetary policy has achieved two fundamental goals: taming episodes of financial turbulence and providing support to the economic recovery of the Eurozone. However, extraordinarily low interest rates –in fact, negative in real and nominal terms– and flattened yield curves also have well-known negative side effects and potential implications for financial instability. As major central banks step up their design of strategies for monetary policy >>>

>>> normalization, it is key that they take into account a medium-term perspective and weigh on these risks.

The clear improvement of the European economic outlook over the past few quarters strengthens the case for monetary policy normalization. The recovery is gaining resilience and appears widespread across countries and industries. Deflation risks are no longer a concern and inflation, although it remains well below target, is set to pick up at a gradual pace as labor market slack declines and indirect and second-round effects of recent low inflation rates fade out.

In this context, the ECB has already started to change the tone of its communications. There is a widespread consensus that the central bank is likely to announce, before the end of the year, some form of tapering of the quantitative easing program, something that will mark the beginning of a gradual process of normalization of an extraordinarily loose monetary policy.

Nevertheless, this normalization process will be different from a traditional cycle of interest rate hikes. Central banks currently have a remarkable presence in markets, owing to the implementation of unconventional tools. As a result, policymakers face the challenge of designing a strategy for the withdrawal of the stimulus that does not unleash disruptive market movements.

Moreover, the prevalent view in central banks emphasizes the risks of tightening too much, too soon. This is influenced by the lack if inflation pressures and a belief in a "new normal" –a new environment shaped by structural shifts (such as technological change and population aging) that may have led to persistently lower interest rates. Seen through these lenses, low policy rates and unconventional tools, such as public and private debt purchases, are treated as instruments that will need to be used on a recurrent basis in the future.

However, there is an alternative hypothesis that notes that the Great Recession was preceded by a large increase in indebtedness. In fact, global debt is still on the rise –the debt supercycle continues untamed– and its burden acts as a strong drag on the cyclical recovery. Furthermore, taking a long-run perspective, the interaction of lax financing conditions and high debt-to-income ratios sets the stage for a greater misallocation of resources and a higher frequency of bubbles and financial instability episodes. Thus, debt also poses a drag on long term growth.

Over the past years, we have learnt that an approach for monetary policy that takes a neutral view on the formation of bubbles and focuses instead on picking up the pieces after bubbles burst can be very costly. On the other hand, the effectiveness of the new macroprudential policies still remains untested.

That is, if the prevalent view is mistaken and we are not in a "new normal", a slow normalization of the monetary policy reinforces an environment of large risks for the international financial system, which could also result in large costs for the economy over the longer term.

Giving these uncertainties, policymakers should rethink the optimal conduct of monetary policy to incorporate a better management of risks. The BIS has often made the point that monetary policy should not only focus on activity and inflation –the traditional mandates– but also target financial stability. Now that the economy has firmed up and we are at the beginning of policy normalization, embarking on this process with a long-term view will be key to avoid past policy mistakes. ●

The economic, financial stability and trade implications of Brexit

Contributors

Levin Holle

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

Europe after Brexit – preparing for a new framework for financial services

Given the close integration of financial markets under the current internal market regime and the relevance of London as leading financial market place for the EU economy - and even more so for the UK economy - , it is obvious that financial services will be one of the areas strongly affected by Brexit. Ahead of talks on the future relation between the EU27 and the UK, both sides have made their fundamental positions clear: While the UK aspires to full freedom for trade in financial services, it does not intend to remain part of the internal market and to accept the accompanying obligations. The EU will not grant Member-State-like access to the UK in specific areas and without acceptance of the fundamental elements of the internal market, namely the acquis communautaire, all four freedoms and the jurisdiction of the European Court of Justice. Therefore, following the eminently political character of the negotiations, we don't know how tomorrow's framework for market access for financial services will look like. But we must prepare for a situation in which it will be fundamentally different from today's. Market actors have understood that waiting for full clarity would bring its own operational risks, and begun to prepare for this new, yet uncertain framework; in particular, some decisions to relocate part of their business to the EU27 have already been communicated. Those who have not taken up preparations should do so expeditiously, assuming their responsibility towards stakeholders and clients.

We expect that EU-27 financial firms and infrastructures will be able to provide the necessary services to European clients. Nevertheless, London will remain a relevant financial center, both worldwide and for EU businesses, taking into account the competitiveness of London based service providers. Germany continues to support a cooperative solution for mutual market access, which would allow for more efficient and stable financial markets than a unilateral approach. But not only will the EU insist on its fundamental principles and the indivisibility of the common market. Also, an interconnected market needs a common stability framework which goes beyond international standards where appropriate. We cannot afford risks from the London financial center to threaten financial stability in the EU. Therefore, cross border provision of financial services from London will require common high regulatory standards and a strong supervisory cooperation, including direct competences of EU supervisors with regard to UK financial firms where necessary.

The reduced role of London as financial center comes as a challenge and a chance for the EU27. We will continue our work towards stronger and more resilient European capital markets. EU27 financial centers will cooperate and compete at the same time. We must ensure that competition is on the best ideas, best infrastructure and best economic conditions, not on regulatory or supervisory laxity. This may include an enhanced role of European Supervisory Agencies in clearly defined cases where necessary to ensure a common view on relations to third countries. But an enhanced or centralized supervision is not a panacea or an end in itself. And it must not serve as a substitute for more ambition in the field of harmonization and implementation of substantive legislation. ●

Laura Ahto

Chief Executive Officer, BNY Mellon's European Bank

Brexit and Financial Markets – The issue of trust

There is a well-known Dutch saying to the effect that trust arrives on foot, but leaves on horseback.

This saying is relevant for banks, especially since the financial crisis. This saying is very relevant for BNY Mellon as we see ourselves as a "steward of trust". This saying is also particularly relevant for Brexit.

The ongoing Brexit negotiations highlight both the need for trust, and the need for an institutional framework so that trust between the UK and the EU27 can be maintained and developed.

Brexit, and the current uncertain state of the Brexit negotiations, create the risk for major economic damage, and for major disruption to the provision of financial services on which economic agents depend.

In this serious situation, we need to be very clear about the origins and consequences of our actions.

We are faced with the prospect that in March 2019 use of an asset manager or of a CCP located in London will be desirable both from an end user perspective (for reasons of efficiency, and of quality of service) and from a regulatory perspective (as contributing to a stable and efficient and integrated pan-European financial market).

But that in April 2019 such use of an asset manager or of a CCP located in London will be prohibited on grounds that are still difficult to comprehend, and even more difficult to explain to an outsider.

What we need is very simple to articulate. We need an appropriate transition period so that all market participants across Europe can adapt their service arrangements so that they and their clients do not suffer major disruption, and we need an institutional framework that allows for the continued participation of EU27 and UK entities in pan-European and global financial markets.

This brings me back to the issue of trust.

We need trust so that the negotiation process can reach an appropriate outcome; we need trust so that the negotiated outcome will allow for the creation of an institutional framework that can supervise integrated financial markets, and that in turn can contribute to increasing trust between EU27 and UK regulators and supervisors.

We are in a situation in which the little trust that there is is rapidly disappearing. This is because Brexit has an inbuilt logic of disaggregation and separation. And because we are in a conflictual negotiating process that places a premium on tough public positions in order to place the opponent under pressure.

We need to see how we can slowly rebuild trust. I would urge that both EU27 and the UK publish public statements stressing their commitments to integrated pan-European and global financial markets, their commitments to building appropriate mechanisms to manage the systemic and other risks associated with such markets, and their commitments to creating the governance and jurisdictional rules to allow such mechanisms to operate.

This would be a first step in what will be a long, but necessary, journey.

Katharine Braddick

Director General, Financial Services, HM Treasury

Building growth and resilience through regulatory cooperation

In the decade or so since the financial crisis, regulators, governments and central banks have focused continuously on these three values: resilience, growth and cooperation. In the immediate storm of the crisis it was resilience that was the focus, supported by existing but also developing cooperation between supervisors as they addressed the myriad challenges of the different crises that unfolded within and between jurisdictions. As stability was gradually re- established, growth became the priority in public discourse and public authorities had to cooperate to find the balance between consistent application of standards and fostering a financial sector that could support growth.

A decade on, we must continue to prioritise sustaining the open and stable system we have built since 2008. Strong standards and open markets foster resilient financial institutions and the efficient flow of finance. In this way, we contribute to strong and sustainable growth in our own nations but also in our regions and across the wider global economy.

The UK, together with partners in the EU, has been a leading proponent of sound regulation. We have a major stake in an open and resilient financial system. We are committed to the continued strengthening of international regulatory cooperation. This reality informs our thinking as we undertake the challenge of withdrawing from the EU.

The UK Government has been clear that it is seeking a deep and special partnership with the remaining EU. It is important that the UK and EU, with our common values and standards, continue to work closely together to further enhance the strong international rules we have forged together. It is vitally important that the continent remains a vibrant and globally connected economic bloc.

And we must guard against the potential pitfalls. The UK's withdrawal should not increase risks to taxpayers from the activities of the financial sector; nor should it increase financing costs for businesses and households in the markets served by firms located in the UK. Fragmentation of markets, and complexity of process and lack of certainty in the operation of decisions affecting market access, would all increase the risk of such harms occurring.

Our solution is for the UK and the EU to agree a comprehensive and mutually beneficial trade agreement that incorporates arrangements for cross border provision of financial services, supported by a transitional mechanism to minimise disruption and avoid cliff edges. The Chancellor outlined three principles for this deal earlier this year:

- the UK and EU should create a new process for establishing regulatory requirements for cross border business between our two jurisdictions. This must be evidence based, symmetrical and transparent and it must reflect international standards.
- We must ensure reciprocal and reliable cooperation arrangements that prioritise financial stability. These must enable timely and coordinated risk management.
- These arrangements should be permanent and reliable for the businesses regulated under them.

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>>> The UK Government has already started the process of replicating EU standards for financial services in domestic law so that on the day after our withdrawal we will have an identical set of standards to those that applied on the last day of our membership. For negotiations to succeed, we must approach them constructively and with the shared objective of achieving a joint solution that supports strong and stable growth. The beneficiaries of that successful negotiation are not ultimately regulators and finance ministries but citizens, households and businesses in the UK, the EU and beyond. ●

Sylvie Matherat

Chief Regulatory Officer and Member of the Management Board, Deutsche Bank

Brexit one year on – meeting the challenge of uncertainty

More than a year has passed since the British vote to leave the EU took place. Whilst some assumptions about the future set-up of the financial industry have come into focus, other elements of the future of cross-border financial services are still shrouded in fog. With less than 18 months to go the challenge for the sector is how to balance continued political uncertainty with practical timeframes required to restructure business, move balance sheets, repaper clients or relocate people.

The political negotiations only started in earnest in June 2017 and in the absence of clarity, firms have had to plan for the worst-case scenario of a "hard" Brexit with no clear deal on future trade in financial services and the UK operating as a third country from March 2019 on. Such a "cliff edge" outcome would pose challenge for the EU 27 in how to avoid increased costs and inefficiencies associated with fragmentation and disruption of cross-border services. Without clarity in soon, financial services firms will be forced to start to adjust based on those contingency plans, risking a suboptimal outcome for Europe.

Coordinated action and clarity are essential to safeguard financial stability and to ensure that EU based financial services firms can continue to compete on a level playing field internationally.

"Coordinated action and clarity are essential to safeguard financial stability"

- SYLVIE MATHERAT

To mitigate short-term financial stability risks decisive action by policy makers and the EU authorities is required in the following areas:

- As the Article 50 timetable expires, firms will need to have confidence that existing contracts will continue to be effective, that they will be able to access key financial market infrastructures as well as client data. A useful first step would be the completion of a supervisory Memorandum of Understanding that should be possible to conclude in parallel with political negotiations.
- Transitional arrangements will also be essential to provide relief. Early clarity on transitional arrangements and grandfathering is imperative to avoid the costs of rushed relocation, remove pressure on supervisors around authorisation and disruption to clients.
- The future framework for clearing in Europe must be defined in a manner that ensures efficient and reliable services for corporates in the EU 27. A model of joint supervision of non-EU CCPs that provides assurance for >>>

>>> EU regulators and central banks seems a positive approach. The timely conclusion of the commission proposal on third-country CCPs is critical.

- EU 27 financial markets will need to balance the partial loss of London as an on-shore financial centre. The building blocks are already there in form of the Banking Union and the SSM. But the EU needs to move further in strengthening the Capital Markets Union to develop marketbased financing and to provide new channels for more EU firms.
- Economic stability and growth requires a level playing field for the European financial industry and Brexit is not the only source risk for fragmentation of financial markets. In the face of Brexit, EU regulators must focus on greater harmonisation of rules within Europe and ensure a coordinated approach to the implementation of new requirements internationally. ●

Neena Gill

MEP, Committee on Economic and Monetary Affairs, European Parliament

Brexit on the horizon: avoiding the hard storm

Brexit means Brexit, Theresa May told us just over one year ago. It did not take long for this hollow rhetoric to collapse like a house of cards. A hard Brexit is defined by a complete severance of all relationships with the EU. That means the Court of Justice, various supervisory agencies, the Single Market and the Customs Union. Given the minority government's poor election result, how far it is possible for it to carry through a hard Brexit remains an open question.

Nonetheless, the concrete impact of the UK referendum decision is already felt by the man and woman on the street. The purchasing power of the ordinary Brit is decreasing with lower pound, increasing inflation and the recent OECD figures confirm that wages have stagnated. Meanwhile, ironically while Britain prepares its exit, the economic prospects of the 19-nation Eurozone have brightened.

The Brexit negotiations show no early signs of soothing prospects of a bleak economic downturn in the UK. The first proposals made by the UK government, in particular the offer on citizens' rights are particularly unhelpful, as they risks to cause a brain drain, also for the financial sector. The office of national statistics reported earlier this year that 12% of the staff in the UK's financial and business services sector are foreign nationals, including 382,000 from the EU.

At the same time the EU, and in particular the Commission, seems to be taking a very hardline approach itself. Firstly in terms of equivalence and secondly in terms of CCPs.

In February, the Commission released assessment of its equivalence decisions in financial services policy. The note clearly outlines a stricter approach from the Commission on its third country equivalence assessments. After the UK government itself has ruled out access to the internal market for the UK financial sector based on EU pass porting rights, a stricter interpretation of the third country equivalence rules by the European Commission risks making a hard Brexit the reality for the UK financial sector. However, it is more than obvious that such an approach is economically counterproductive, for the UK as well as for the EU, and this in particular in a period of slow economic growth. Given at the point of leaving the EU, the UK will 100% equivalent, it is a question of how the two parties set up a framework for divergence.

The second striking example of this possible negative economic impact of a hard Brexit is the recent Commission proposal to strengthen the supervision of central counterparties, which threatens to impose a location policy to CCP's based in London clearing euro denominated derivatives. There is a wide agreement that financial stability needs to be guaranteed for the UK and the EU27. However, if the real political objective to do this involves enhancing the supervisory framework of systemic risky CCP's, co-legislators ought to focus on making a proper supervisory cooperation work between the ECB, the Bank of England and ESMA. Obliging some clearing houses to be located in the Euro area goes against market mechanisms and is a protectionist approach. It could be that the threat of location policy is simply a negotiating position inspired by a minority of Member States, but one which risks to come at a high cost. Indeed, it would potentially increase initial margin requirements by an average of 30% for EU clearing members and creating a recurring structural market fragmentation costs of around €90 billion over five years. As the EU is known to be economically sensible, I look forward to a more balanced outcome, which could be inspired by the USA practice which does not require US dollar denominated transactions to be cleared in the USA.

"The threat of location policy is simply a negotiating position inspired by a minority of Member States"

- NEENA GILL

To avoid the negative consequences of a hard Brexit, both the UK and the EU need to soften their approach. The EU should give special status in equivalence, so that it is not treated just like any other third country. In return for these idiosyncratic advantages, the UK must accept supervision from EU agencies and jurisdiction from the European Court of Justice.

The tit for tat approach of some EU countries looking to divide up the UK financial sector will ultimately damage both economies in the long run. It is only through a collaborative compromise which recognises the value of each side that will result in a softer Brexit which will protect jobs, industry and innovation across the continent. ●

Colin Ellis

Managing Director, Chief Credit Officer EMEA, Moody's Investors Service

Europe must decide what kind of financial services sector it wants after Brexit

The treatment of financial services is one of the biggest unanswered questions remaining in Brexit negotiations and the EU27 should avoid erecting barriers for this sector.

The UK government has made it clear that it wants full control over immigration and freedom from the ECJ. This implies that the UK will not remain a member of the single market, or even the customs union.

A deal could still be done that minimises disruption to UK-EU trade. Establishing a free trade agreement for goods should be eminently possible, although that is not the same as frictionless trade. But some of the biggest questions around Brexit relate to services and financial services in particular, where many firms are already preparing for a worst-case scenario.

For Europe as a whole, funding is not the priority. The EU has been running a current account surplus since 2012, which has increased almost continuously. That means the EU is a net exporter of capital; there is no shortfall, in aggregate, to fund domestic investment. Its interest in financial services is therefore more about the provision of services and expertise, including the means of optimising the allocation of capital within the EU.

London is, by far, the current market leader in financial services in Europe; no other city comes close. And although some firms have started moving activities and employees from London to EU destinations – unsurprisingly often tied to the parent firm's own location – activity is already also leaving the UK to go to New York and in some cases Asia.

The question is: what kind of financial system does Europe want post-Brexit? The answer was unclear even before the referendum, given Europe's desire to balance financial stability, national sovereignty and higher growth. Indeed, the lack of transformative progress on the Capital Markets Union illustrates these tensions.

The EU27 may have little interest in capturing such business from the City as clearing Australian transactions or facilitating Asian derivatives trades. But it will need resources and expertise the City already has if it is serious about relying less on banks to finance growth. A healthy capital market requires advanced physical infrastructure, deep and stable networks among market participants, and expertise across a range of financial products. More importantly, it also requires a degree of innovation and creativity that cannot be forced by public authorities.

"The broader risk from an internal-facing approach to the financial sector is the EU could become a 'walled garden' in the minds of international investors"

- COLIN ELLIS

The broader risk from an internal-facing approach to the financial sector is the EU could become a 'walled garden' in the minds of international investors – particularly if accompanied by shifts to existing equivalence standards with the US and Australia in an effort to create barriers for the UK. Policymakers may choose this; but ultimately it could dampen economic growth on the continent.

London's resources and pool of expertise in financial services will certainly be diluted and diminished by Brexit. But it will retain considerable advantages and remain an international hub. It is in both sides' interests to pursue a new form of cooperation and oversight. It may still be possible to share the cake, and then eat it. ●

Joe Cassidy

Partner, KPMG UK

How Brexit friction will have a cost

In a world where mobile technology, driverless cars and Artificial Intelligence are promising to make our lives easier, cheaper and more integrated, Brexit stands out in contrast. It re-introduces frictional costs, complications and latency in supply chains that years of economic convergence have helped to eradicate.

For many large pan-European businesses, the re-configuration of their respective supply chains will inevitably result in an impact on their primary revenue streams, and a reticence to commit investment in the short term until the fog of uncertainty created by the Brexit negotiations clears.

These businesses will face disruption to how they manufacture and sell products to different markets and also deal with possible changes to regulations in their core businesses. For example, under a hard Brexit the travel industry could see fundamental changes over changes to freedom of travel, the open skies agreement and the Schengen Agreement.

All businesses want the ability to be able to trade as freely as possible. Whether it is a car manufacturer in the heart of Germany, a French Cosmetics Business or a UK TV Production company, businesses want a market that allows goods, services and content to be traded freely. New customs duties and complications will disrupt that and lead to higher costs – for businesses and ultimately end consumers.

The Financial Services industry is rightly proud of its role in helping corporates and consumers fulfil their aspirations be they in trade and growth, wealth >>>

>>> protection and creation, social mobility and insurance. However, Brexit disrupts that role; not necessarily in a positively disruptive way which reduces costs and improves competition and choice. But in a potentially negative way through increased frictional and fixed costs, the duplication of infrastructure and capital, all of which further raise the barriers to entry to the Financial Services industry – and ultimately reduce competition and choice.

"The role of the Central Banks and Regulators across the broader continent of Europe will be key in ensuring stability, and bringing logic and economics to the table over emotion and politics"

- JOE CASSIDY

While much will depend on the shape of any final deal, and the nature and term of any transitionary agreement, Brexit is already making an impact. In the UK, corporates are holding more cash, fearful of investing until there is clarity on the shape of the final exit. The weaker pound is already "top of mind" for UK consumers taking foreign holidays, and over the next 3 months these same consumers will start to see to see the true cost of goods as FX hedges expire. Inevitably, the politicians are talking about the need for a "pragmatic Brexit", and a "long bridge" to the future.

In the EU, whilst tourists to the UK benefit from the pounds weakness, the concerns being raised by Corporates centre around supply chains - both in the logistical physical sense of manufacturing, and in the Financial sense where access to hedging, capital raising and investors will be disrupted.

Through all of this, the role of the Central Banks and Regulators across the broader continent of Europe will be key in ensuring stability, and bringing logic and economics to the table over emotion and politics. Ten years on from the start of the financial crisis, regulation is still driven by the need to avoid a similar crisis. Brexit brings different threats, and never has there been more of a need for regulators and the industry to work together to ensure the best possible outcomes for Europe citizens and businesses. ●

Longevity and ageing: opportunities and challenges associated with the PEPP

Contributors

Gabriel Bernardino

Chairman, European Insurance and Occupational Pensions Authority (EIOPA)

A Pan-European Personal Pension Product – What is in it for the European citizen?

Addressing the needs of a changing economic and demographic environment in the European Union alongside the long-standing challenges of ensuring sustainable, adequate retirement income of future generations, the European Insurance and Occupational Pensions Authority (EIOPA) developed a Pan-European Personal Pension Product (PEPP) and welcomes the European Commission's decisive initiative to introduce a truly European, complimentary personal pension product.

The PEPP, as a Pan-European product, is an important instrument to support mobile European citizens and workers to continue saving for their retirement income whilst moving from one Member State to another. Currently, mobile workers may own a number of small, often individually negligible, pension claims all over the European Union, unable to benefit from economies of scale and efficient asset management of bigger asset portfolios. Similarly, a significant number of citizens in the European Union do not have access to appropriate retirement savings products, due to highly fragmented markets as well as opaque, complex and consequently often unattractive individual pension products.

EIOPA believes the PEPP can overcome these hurdles and enable important individual savings for future retirement income, closing the ever-widening pension gap. The PEPP is designed to be a safe, transparent and cost efficient retirement savings product, which builds on a good balance of standardisation of important product characteristics and flexible elements to accommodate national and individual preferences. Overall, it is crucial for the product to enable cost efficiencies and economies of scale, achieving good, long-term sustainable returns and eventually good outcomes for future retirement incomes.

In order for PEPP to become and remain a successful quality product for individual retirement savings, three points will be important to consider:

1. The right balance between standardisation and room for innovation in the further regulation, in particular as regards investments and the necessary protection of savings
2. Access to long-term, sustainable and attractive investments to enable good outcomes for future pensioners
3. A centralised hub for authorisation of and information on PEPPs.

According to the European Commission's proposal, EIOPA would take on the responsibility to ensure fully consistent quality criteria for the authorisation, licensing and therewith pass-porting of PEPP's. EIOPA's mandate to promote supervisory convergence throughout Europe entails that close cooperation with and amongst national supervisory authorities is of importance for the proper functioning of the European internal market. EIOPA is of the view

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>>> that stronger coordination in view of the development of supervisory plans and practices for PEPPs is needed to support the initiative of a truly pan-European product.

Setting consistently high-quality standards for the authorisation of PEPPs is key to the success of PEPP in terms of consumer's acceptance and promoting trust in PEPPs. Further, standardised, comparable and relevant information about available PEPPs need to be easily accessible to consumers to make well-informed and conscious decisions about their plans to save for retirement.

The information about PEPPs has to be relevant. Therefore, specifically tailored, pension-focussed disclosures for the pre-contractual and the regular benefit statements are needed. EIOPA welcomes the European Commission‘s initiative to explore the best way to proceed to collect, analyse and report on cost and performance indicators of pension products. Outcomes of this initiative will enhance the proposed disclosure requirements for PEPP. Similarly, the supervisors will need to receive relevant information about PEPP providers and products to enable consistency and transparency. Therefore, the development of standards around reporting to the supervisors will be equally important.

The European Commission’s legislative proposal for a PEPP is a courageous and - from EIOPA’s perspective - right step to make a difference to European citizens’ lives by securing adequate retirement income and to complement the Capital Markets Union. EIOPA’s contribution to implement, to authorise, to monitor and to inform consumers about PEPPs issued by different providers in all the European Union Member States, as well as its central role in ensuring sound and effective supervision shall secure PEPP’s promising potential to truly create a Single Market for personal pension products for the benefit of European citizens. ●

Nathalie Berger

Head of Unit Insurance and Pensions, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Towards a Pan-European Personal Pension Product (PEPP)

In today's rapidly ageing Europe, today, only 27% of citizens aged between 25 and 59 years hold a personal pension product, with wide variations between Member States. A recent public consultation confirmed strong interest by potential savers to have access to a personal pension product with EU-wide coverage, some portability and elements of flexibility to allow savers benefiting from optimum conditions.

The EU personal pensions market is highly fragmented, which prevents providers from maximising risk diversification, innovation and economies of scale. This contributes to lack of liquidity and depth in capital markets compared to other jurisdictions like the US. National markets are also characterised by a narrow range of providers and some existing personal pension products are seen by savers as having insufficient features. >>>

>>> A flagship initiative of the Capital Markets Union Mid-Term Review, the proposed PEPP Regulation, accompanied by a Recommendation to the Member States on the tax treatment of personal pensions products, seeks to unlock major market potential, offering new types of potential providers a pan-european market for a new voluntary product. The PEPP Regulation creates does not replace or harmonise existing national personal pension schemes, nor create any obligation to develop such a product; it offers market players and consumers a new enabling regulatory framework.

To build up a new innovative and competitive PEPP market, the Commission proposes that, in addition to insurers and pension funds running occupational schemes, financial institutions such as banks, asset managers, and certain investment firms should be allowed to manufacture and distribute PEPPs. This will not only meet the demand of many EU savers, but also contribute to channelling investment into EU capital markets, in line with CMU.

The PEPP Regulation not only sets the key features of the product, it also provides key rules which will make it modern, innovative and cost efficient. Hence, once authorised by EIOPA, a PEPP could be sold on a pan-european basis. An innovative product, the PEPP matches EU's digital ambitions, as consumer information will by default be provided electronically. Reporting costs will be cut down through standardisation.

The Regulation ensures an appropriate level of investment freedom for PEPP providers. Whilst assets must be predominantly invested on regulated markets, as very long-term investors with low liquidity risks PEPP providers will be able to invest in instruments that have a long-term economic profile and are not traded on regulated markets, MTFs or OTFs, within prudent limits.

They are encouraged to allocate a sufficient part of their asset portfolio to sustainable investments in the real economy with long-term economic benefits, in particular to infrastructure. Importantly, PEPP providers will be able to benefit from the advantages of international diversification.

As a retail investment product with an explicit retirement objective, the PEPP is a simple product – with up to five different investment options, including a default investment option ensuring capital protection for the PEPP saver. It protects consumers adequately at all stages of the process, both pre-contractual and during the accumulation and decumulation phase, with specific rules on information and advice.

It is transparent – a major source of concern for today's savers - and allows competition, through the possibility to switch between providers. A major innovation, the PEPP will be portable, through the establishment of national compartments. PEPP providers will have the choice of proposing different types of decumulation, through annuities, lump sums, regular withdrawals or a combination of different options.

Against this background, the tax treatment of the PEPP will be of major importance. This is why the Commission invited Member States to grant a PEPP the same tax advantages as those granted to national personal pension products, even where a PEPP may not meet exactly the national tax criteria for favourable tax treatment. Where several tax schemes exist, the Commission invited Member States to grant the PEPP the most advantageous tax regime available. In order to accelerate the creation of a single market for personal pensions, Member States are also encouraged to exchange best practices with a view to aligning their national criteria for granting tax incentives as much as possible and facilitating, in practice, the portability of such products.

The draft PEPP Regulation is now being considered by the European Parliament and Council with the objective of adoption before the end of the current legislature. ●

Willem Evers

Head of Department, General Policy Department, Supervisory Policy Division, De Nederlandsche Bank

Proposed PEPP regulation: the devil is in the detailsprotection now

On June 29th, the EC published its long-awaited regulation proposal for pan-European Personal Pension Products (PEPP). Although political attention may be attracted by the accompanying Commission Recommendation on the tax treatment of PEPP, let me focus my appraisal on the content of the regulation itself. First from a specific Dutch perspective. Second, from a European perspective.

PEPP from a Dutch perspective

The spirit of PEPP is to create a personal pension product that is standardized across Europe, that can be offered by providers across the whole of Europe, and that is portable for savers across the whole of Europe. As an addition to the pallet of third-pillar pension products, its added value to the well-developed Dutch pensions market will be limited. Dutch savers have multiple options available to make voluntary additions to their pension savings via pension products offered by life insurers and blocked bank accounts. Mind you, this would be in addition to the € 1.4 trillion of assets under management by second-pillar pension funds.

"PEPP's prospects hinge on its attractiveness for potential providers."

- WILLEM EVERS

In contrast to the spirit, the letter of PEPP –if hypothetically adopted in unchanged form– would have a major impact indeed. PEPP can be provided –amongst others– by IORPS (art 5(1)c), and PEPP providers have the option to offer coverage of biometric risks (art 42). The former allows Dutch pension funds to provide third pillar products, which Dutch law explicitly prohibits under its task and domain demarcation, a center piece of the collective execution of second pillar pension provision. The latter does not forbid Dutch Pension Premium Institutions (PPIs) to assume biometric risks, which Dutch law explicitly does. Since the letter of PEPP so starkly differs from its spirit as laid down so clearly in the explanatory memorandum, we'll work on the assumption that the letter will be adapted to maintain the spirit.

PEPP from a European perspective

In many less-developed European pension markets, PEPP may be a useful addition. It adds an option for potential savers where few if any are available. It allows providers to operate on a European scale, potentially stimulating cross-border competition and adding to the (cost efficient) options for savers.

However, PEPP's prospects hinge on its attractiveness for potential providers. Adequate tax incentives are essential for a competitive proposition. In addition, another devilish detail pops up. Namely that of being required as a provider to open a PEPP compartment for each Member State, with full legal and advisory capacity to operate each compartment commensurate local social and labor law and fiscal rules. An understandable product feature to ensure portability across the Union. But a hurdle for providers contemplating the launch of a PEPP. This may be a surmountable hurdle for a prospective provider when savers are expected to queue up to get their PEPPs. However, being a voluntary pension product, this may prove too optimistic a scenario. ●

Paolo Federici

Managing Director, Head of Northern Europe, Fidelity International

The Pan-European pensions product - a future European success story

The Capital Markets Union (CMU) is one of the European Union's key initiatives, and the Pan-European Pension Product (PEPP) is in turn a very important part of the CMU. The discussion around PEPP takes place at a crossroads in European history, when the UK with its financial center is preparing to leave the EU. It is thus important that the PEPP initiative is brought to a successful conclusion.

As the Estonian EU Presidency leads the discussions in the Council, and the Europen Parliament is working on its report, Fidelity International and other future PEPP providers actively engage in a constructive dialogue with policymakers. We share a common goal - to craft a simple, transparent and safe pan-European private pension regime, which properly framed has all the prerequisites to develop into a success story along the lines of UCITS.

While some Member States (MS) already have well developed national private pension systems in place, other MS do not. As a consequence of this and other factors, far too much of EU household assets are held in deposits or cash, yielding low or even negative interest, or in volatile assets such as real estate.

This European habit of not investing in capital markets, which is different from the tradition e.g. in the United States, has led to a situation where access to long-term capital for SMEs, infrastructure projects, and sustainable investments is less than optimal. >>>

>>> While the PEPP may not on its own be the solution to this challenge, it is an important step in the right direction. Properly drafted and treated fairly e.g. from a national tax incentive perspective, it could without affecting other existing pension schemes be an attractive alternative for the 73% of the European population in working age that have not yet signed up for a long-term private personal pension plan or product.

PEPP will be important not least to young people, self-employed and others that may not have access to corporate pension plans, as we see the "pension gap" grow and state pension systems becoming unsustainable against the backdrop of an ageing population in Europe.

The PEPP will already from the outset be framed with a pan-European vision and audience in mind. PEPP will as such be interesting to the more than 11 million Europeans of working age who presently reside in another MS than their home MS. PEPP may also raise the share of private personal pensions sold cross-border to non-mobile workers, from today low numbers.

It is against this background the Commission's estimate, that the capital managed in PEPPs in a positive scenario could reach €700 billion by 2030, should be considered. Some €28 billions may by then also have gone from PEPPs into alternative investments, with an additional €14 billion invested in unlisted infrastructures.

"... the Pan-European Pension Product (PEPP) is in turn a very important part of the CMU"

- PAOLO FEDERICI

The size of investments in PEPPs will of course be up to future PEPP savers to decide, but important is that savers will be well informed about key aspects, so that they know what different PEPPs are on offer, what the potential risks and returns are, and what different risk mitigation techniques such as life-cycle strategies used by asset managers means.

Against this background, there is no reason why the PEPP could not, with genuine efforts to make the system as digital, flexible and streamlined as possible, with proper consultations and consumer testing along the way, be a future European success story walking in the footsteps of UCITS. ●

Xavier Larnaudie-Eiffel

Deputy General Manager,
CNP Assurances

PEPP must be a true pension product that provides value for EU citizens

The European Commission published in June a proposal for a Regulation on a Pan-European Personal Pension Product (PEPP). The main objectives are to incentivize citizens to save more, thereby helping member states to address the pension-saving gap, and to contribute to channeling more private savings to long-term investment projects, which is a key aim of the Commission's Capital Markets Union project.

While fully sharing the Commission's goals, I have some reservations about how they have been translated into the proposed Regulation.

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

"The PEPP will only achieve its objectives if it is a true, long-term pension product."

- XAVIER LARNAUDIE-EIFFEL

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

Precisely to increase competition, the EC has introduced the possibility for the PEPP to be distributed >>>

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

Harmonized distribution and information requirements are also part the EC's proposed regulation. While I strongly support moves by the EC towards a more digital-friendly approach to the provision of information to PEPP savers, neither the PRIIPs Key Information Document nor the IORP II Pension Benefit Statement are a good starting point for information disclosure for personal pensions. To have a clear and demonstrable benefit to consumers, pre-contractual and ongoing information requirements must be tailored to the specific nature of the PEPP.

I commend the Commission for launching this debate. The journey has just started, and the insurance sector is keen to be part of all the discussions that will take place in the coming months. ●

Guillaume Prache

Managing Director, Better Finance

The ideal PEPP for EU citizens

Pan-European Personal Pension (PEPP): a must for future European pensioners

With a global pensions gap now estimated at $ 70 trillion and forecasted to jump to $ 400 trillion by 2050, a simple, cost effective, performing and open pan-European personal pension is an absolute must. Therefore, the June 2017 Proposal for a European Regulation creating the PEPP is most welcome. Indeed, saving early and significantly is not enough. Although often overlooked, positive net (after charges) real (after inflation) returns are even more essential for pensions adequacy.

Why returns are essential to pension adequacy

Simple example (assuming no inflation, saving 10% of income for 40 years, 30-year life expectancy at retirement):

- with zero annual net real return: 12% replacement income only;
- with 8% annual net real return: 49 % replacement income.

Clearly, saving early and significantly does not work without decent long term net real returns. Independent research clearly identifies the key pre-requisites to get these crucially needed long-term returns: overall fees must be kept low, and allocation to diversified equities must be strongly favoured. The future PEPP must fill these two over-arching conditions.

A must for the European economy

PEPP is also the single best solution among all "CMU" initiatives and elsewhere to initiate a much needed "re-equitization" of the EU economy. PEPP is indeed is the best tool to foster retail equity investments: it is very long term, hopefully as tax incentivised as exiting national personal pension products, and allows for diversification, and also protection via the safe and simple default investment option.

Key conditions for pension savers

- a simple and safe default investment option that provides a minimum guaranty not to lose the purchasing power of pension savings at retirement and then during the "decumulation" phase (not a highly misleading "nominal" capital guarantee that is likely to rip-off savers over the long term). Some providers cry that this is impossible to offer although long inflation-linked bonds already exactly do that, and French banks are even providing this guarantee to a short-term savings product (the highly popular "livret A"). This option should be safe and simple enough to be subscribed without advice, and intermediaries should put in writing why they advise their clients not to take this option. For this option, a fee cap could be considered, at least at the beginning.
- With this safe and simple default option, all other alternative investment options must be totally free, allowing life cycle ones but also direct investments in equities and index ETFs: a diversified portfolio of equities is less volatile over the long term than a fixed income one and historically always much more performing, when free from multiple layers of fees – too often to be found in "packaged" retail products.

"PEPP is also the single best solution among all "CMU" initiatives and elsewhere to initiate a much needed "re-equitization" of the EU economy"

- GUILLAUME PRACHE

Therefore, the EU Authorities would be wise to avoid any highly misleading purely nominal capital "guarantee" for the default option, and the unnecessary and value-destroying constraints imposed on all the other options. These are the conditions for the PEEP to become an effective tool to help reach pensions adequacy in the EU. ●

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GLOBAL REGULATORY AND SUPERVISORY COORDINATION

Content

Issues at stake

Cross-border capital flows and open markets at the international level are essential for achieving sustainable and balanced growth. This requires notably effective global regulatory and supervisory coordination in order to preserve a level playing field across financial markets and mitigate the risks associated with global firms and highly interconnected activities such as derivatives.

A challenge however is the wish of some jurisdictions that global regulation should also take into account their own interests and specificities and should not affect inappropriately their domestic financial institutions.

Q&A

Christopher J. Giancarlo

Acting Chairman, U.S. Commodity Futures Trading Commission (U.S. CFTC)

Working with Europe to ensure the health, durability, and vitality of the global derivatives markets

WHAT REQUIREMENTS OF THE DODD-FRANK ACT IMPLEMENTED BY THE CFTC MAY NEED TO BE REVIEWED AND WITH WHICH OBJECTIVE? COULD THIS AFFECT SOME RULES DERIVED FROM THE G20 COMMITMENTS FOLLOWING THE 2007 FINANCIAL CRISIS?

I am a long standing supporter of the swaps market reforms set forth by the G-20 Leaders in Pittsburgh in 2009 and later incorporated into U.S. law by the Dodd-Frank Act. I also have been clear that I have had concerns with how portions of Dodd-Frank have been implemented, most prominently in how the CFTC promulgated its trade execution rules.

In the wake of the financial crisis, the CFTC and other financial regulators worked at a breakneck pace to implement Dodd-Frank's mandates. In this rush, the CFTC may have fallen short in properly implementing and designing some of these rules. I am concerned that the impact of flawed implementation has been to make our markets more fragmented, more concentrated, less liquid, and less supportive of economic growth and renewal than in the past.

Regulators have a responsibility to check and correct our work when we find our efforts have missed the intended mark. As our experience with swaps market reform grows, the need to improve the effectiveness of our rules becomes more pressing. One my priorities at the CFTC is to see that the reforms of U.S. and international derivatives markets are working better to serve the needs of the real economy.

Specific examples of where I would like to see rules reviewed and improved include the areas of swaps data reporting, swaps trading, and the supplementary leverage ratio.

To this end, the CFTC in July 2017 announced a review of swaps reporting regulation to ensure the effectiveness of the rules and reported data. The goal of this review is to ensure that swaps market regulators receive accurate, complete, and high quality data on swaps transactions to perform regulatory oversight.

My analysis of flawed implementation of the swaps trading reforms is set out in a White Paper[1] published in January 2015. The White Paper explained the fundamental mismatch between the CFTC's swaps trading framework and the distinct liquidity, trading, and market structure characteristics of the global swaps market.

I believe the CFTC's approach to swaps trading is highly over-engineered, disproportionately modeled on the U.S. futures markets, and biased against both human discretion and technological innovation. Therefore, the CFTC will begin the process of carefully reviewing our current swaps trading framework and addressing its shortcomings.

The application of the supplementary leverage ratio (SLR), derived from Basel III's leverage ratio, to swaps clearing also needs to be reexamined. The SLR imposes unnecessarily high capital costs relative to default risk on clearing firms, results in higher capital requirements for derivatives activities relative to risk-based capital requirements, and may adversely impact the availability of central clearing, particularly in times of stress.

In a further effort to examine the effect of post-financial crisis rules, I also recently announced the launch of a new initiative called Project KISS. It stands for "Keep It Simple, Stupid." The aim is to take existing CFTC rules as they are and determine ways to apply them simply, and with less of a burden on the economy.

WHAT ARE THE FUTURE PROSPECTS OF GLOBAL REGULATION AND COORDINATION IN THE FINANCIAL SECTOR AND IN WHICH AREAS ARE THEY ESSENTIAL? SHOULD AN APPROACH BASED ON THE EQUIVALENCE OF OUTCOMES BE FAVOURED AT THE INTERNATIONAL LEVEL?

It is essential that the CFTC continue to work with its overseas regulatory counterparts and in the various international standard setting bodies to ensure the health, durability, and vitality of the global derivatives markets. By their very nature, swaps instruments trade in global markets. They allow agriculture producers, industrial manufacturers and financial service providers in the United States, Europe and elsewhere to transfer or bear exposure to the risk of variable commodity prices, foreign exchange, interest rate or counterparty credit default in marketplaces around the world. A well-working global derivatives market is essential to a healthy global economy.

As our regulatory counterparts continue to implement swaps reforms in their markets, it is critical that we make sure our rules do not conflict and fragment the global marketplace. That is why the CFTC should operate on the basis of comity, not uniformity, with overseas regulators. The CFTC should move to a flexible, outcomes-based approach for cross-border equivalence and substituted compliance.

HAS SUFFICIENT PROGRESS BEEN MADE IN THE MITIGATION OF SYSTEMIC RISKS ASSOCIATED WITH CAPITAL MARKET ACTIVITIES AT THE GLOBAL LEVEL? WHAT PENDING ISSUES MAY REMAIN TO BE ADDRESSED?

Although substantial progress has been made in the mitigation of systemic risks, work remains to be done. At the heart of the 2008 financial crisis was the inability of regulators to assess and quantify the counterparty credit risk of large banks and swap dealers. The regulatory solution was to establish a robust system of swaps data reporting. Unfortunately, the swaps data reporting system, as currently operating, still cannot provide regulators with a comprehensive picture of bank counterparty credit risk in global markets. This issue must be resolved. I fear that the CFTC and its overseas regulatory counterparts acting independently will continue to struggle to achieve the important objective of full visibility into swaps counterparty exposure. What is needed is a concerted and cooperative effort by regulators, market participants, and others that draws on the emerging fields of big data analysis, network science, and financial cartography. To this end, the recently announced CFTC review of swaps reporting regulation aims to ensure the effectiveness of the rules and reported data.

"Reorienting financial regulators to be conscious of enormous changes taking place in global markets and to embrace technological developments must be a priority."

- CHRISTOPHER J. GIANCARLO

Another pending issue to be addressed is interdependencies in the central clearing system resulting from the global push to clear derivatives transactions. The central clearing system is characterized by financial resources and exposures concentrated among a small number of CCPs, a pattern of interconnectedness across the different CCPs, and its global nature. These characteristics suggest that a shock to one element of the CCP network could likely have significant consequences for the rest of the network. Although studies and other work has been done concentrating on strengthening the resilience of individual CCPs, further efforts are needed to understand and respond to the implications of central clearing on the financial system.

Lastly, reorienting financial regulators to be conscious of enormous changes taking place in global markets and to embrace technological developments must be a priority. Technological developments such as distributed ledger technology and algorithmic trading could have many promising benefits for the financial marketplace and financial regulators and will change the way our markets operate. Market regulation by the CFTC must catch up and keep pace with these developments. Relatedly, advances in technology could make the financial markets more vulnerable to cybersecurity risks. Part of the reorientation must include awareness of the future threats of cybersecurity and appropriate information sharing about cyber threats with our financial regulatory counterparts. ●

1. See generally J. Christopher Giancarlo, Pro-Reform Reconsideration of the CFTC Swaps Trading Rules: Return to Dodd-Frank, White Paper, Jan. 29, 2015, http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/sefwhitepaper012915.pdf.

Efficiency of G20 financial reforms and future prospects of global coordination

Contributors

Ryozo Himino

Vice Minister for International Affairs,
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From static regulation to dynamic supervision

Speaking about the finalization of Basel III, Chairman Stefan Ingves of the Basel Committee on Banking Supervision said, "It is time to get the job done, to move forward, and focus more on supervision and implementation." I fully agree with him.

There are two reasons why I believe we should now focus on supervision. First, we need both financial stability and sustainable growth, but regulation alone cannot attain them. If we are to rely solely on regulations for stability and require banks to hold buffers which can withstand every possible tail event, such would stifle banks' intermediary functions and would not be optimal for the long-term growth of the economy. It could also foster arbitrage and undue accumulation of risks in toxic form of shadow banking, and thus can make the financial system more vulnerable.

Second, supervision can play roles which regulation cannot play. Financial institutions that have survived the global financial crisis have done so not necessarily due to the size of their capital or liquidity buffers but largely due to their solid risk governance, which allowed them to flexibly change their course of business, responding to early signs in the marketplace. Monitoring financial institutions' risk governance is an important task for the supervisory authorities. Also, supervisory activities check if new business schemes, such as subprime loans, entail risks not captured by existing regulations. We need supervision to find if regulations provide perverse incentives for banks and induce them to accumulate excessive risks.

It is not easy to monitor the adequacy of banks' risk governance, hidden risks in new products or accumulation of risks resulting from perverse incentives provided by regulations. Supervisory authorities can thus be tempted to rely on simple and mechanical regulations rather than assume these difficult tasks.

Yet I would call it moral hazard if supervisors rely on regulatory buffers to alleviate their own supervisory responsibilities. Authorities might let imbalances grow, hoping Basel III will protect the system, but no amount of bank capital is enough if the economy accumulates major imbalances. Micro-prudential supervisors monitor changes in behavior of banks and customers. They have an important role in identifying early signs of imbalances and in alarming bank management about emerging vulnerabilities.

In short, we must explore the best mix of supervision and regulation if we are to minimize the unintended consequences of regulations and to prevent the accumulation of excessive risks and imbalances.

There may be another important potential role supervisors can play.

The regulatory community has addressed fault lines that caused the global financial crisis: weak regulatory standards, weak resolution framework, vulnerable

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>>> derivatives market and toxic form of shadow banking. The biggest fault line, however, is yet to be addressed.

The biggest driver behind the last crisis was the US leveraging. During the six years from 2001 to 2007, the ratio of credit to the non-financial sector to GDP rose by 39 points (from 190% to 228%) in the US. During the seven and a half years from 2008 to mid-2016, the same ratio for all BIS reporting countries rose by 44 points (from 202% to 246%). We are witnessing global leveraging as rapid as the one we saw in the United States during the period of irrational exuberance.

Post-crisis, countries needed rapid debt growth to sustain mediocre economic growth. This situation should be even more problematic than the pre-crisis combination of rapid economic growth and rapid debt growth. The issue, therefore, may be the quality, rather than the quantity, of financial intermediation.

Bank supervisors monitor micro behavior of a bank and how it discharges its financial intermediation function. They can initiate dialogue with bankers to explore ways to enhance the quality of financial intermediation, so as to contribute to a better balance between debt and growth. ●

Sharon Bowen

Commissioner, U.S. Commodity Futures Trading Commission (U.S. CFTC)

The G20 reforms: building on the gains we have achieved[1]

We have come a long way since the 2008 crisis. The crisis hit our economies like a hurricane, and revealed major weaknesses in our systems. But, collectively, our governments acknowledged the damage, looked it squarely in the face, and made strong, intentional decisions to reshape our economies and the global market. And we have made great strides.

One improvement is the expansion of clearing of standardized derivatives, which allows for the efficient management of collateral while providing regulators with clear, timely visibility into these markets. Clearing today provides much needed transparency into markets that were very dark prior to 2008. The establishment of derivatives reporting is another significant step forward. In the U.S., as in many of your jurisdictions, all swaps transactions must be reported to a trade repository. Moreover, our agency has worked with other regulators, including through the CPMI-IOSCO Data Harmonization group and the FSB Working Group on UTI and UPI Governance, to harmonize this data. We have also established swap trading platforms and instituted internationally-coordinated rules on margin.

We have come a long way. Let us not go back. We have negotiated important international agreements to coordinate our oversight, such as equivalence. Let us not undo those gains. Instead let us continue to build on the cooperation that we have begun, and expand it to other areas in which there is a pressing need for vigilance and coordination. >>>

>>> One such area is securing our execution platforms, which are largely electronic markets. There are two potential threats to safe and sound electronic markets – cyber breaches and unbridled algorithmic trading. Financial firms are facing an unrelenting onslaught of attacks from hackers with motives ranging from petty fraud to international cyber-warfare. Last December, our agency released two rules which, among other things, mandate various cyber testing requirements and require individuals at the highest level of management to review the cyber infrastructure[2]. We need to continue to work together across jurisdictions to strengthen our cyber-resilience.

To protect against the threat of market disruptions and price distortions, our agency proposed an automated trading rule, "Reg AT," to better supervise high-frequency trading systems and provide safeguards such as registration of significant algorithmic traders and institution of pre-trade risk controls.[3] We need to work together to coordinate our efforts in these interconnected markets.

Last, we also need to establish strong governance rules in all of our jurisdictions and harmonize our enforcement. As regulators, it is in our best interest to share information about potential bad actors that are moving from market to market harming customers, lessening efficiency and bringing otherwise functional markets into disrepute.

In conclusion, we are, in many ways, better protected today than we were prior to 2008. But we have more to do in order to give the people within our jurisdictions the economies that they deserve. We need to protect our clearing gains, further harmonize reporting, develop robust international rules on cyber security and high-frequency trading, and establish governance and enforcement efforts that will really ignite culture change on all the "Wall Streets" in our jurisdictions. To accomplish that we must harmonize - but harmonize up, not down! Working together, we can coordinate a set of standards that will prevent us from repeating the crises of the past, and provide a much stronger foundation to better withstand the inevitable crises of the future. ●

1. DISCLAIMER: The views expressed are that of Commissioner Bowen. They do not reflect the views of the other Commissioners or staff.
2. See "CFTC Approves Final Rules for System Safeguards Testing Requirements ...," available at http://www.cftc.gov/PressRoom/PressReleases/pr7442-16.
3. See CFTC Unanimously Approves Proposed Rule on Automated Trading, available at http://www.cftc.gov/PressRoom/PressReleases/pr7283-15.

Corso Bavagnoli

Assistant Secretary, Financial Department of the French Treasury, Ministry of Economy and Finance, France

Much-needed financial sector reforms have successfully taken place

A decade after the crisis, much-needed financial sector reforms have successfully taken place. Now the consistency of their implementation becomes the key objective.

Ten years have passed since the outburst of the great financial crisis that made it necessary to overhaul the international financial regulation, and led to rethinking its governance and practices. The Financial Stability Board was established by >>>

>>> the G20 in 2009 to reach that objective. It is now possible to take a step back and examine what the global regulatory community and FSB have achieved so far, and what has been learnt from this process regarding how to enhance international cooperation in financial regulation.

The amount of regulatory progress that has been achieved since 2008 is quite considerable. Among many reforms, I would stress that banking reforms, including the introduction of capital requirements much more stringent than before the crisis, notably liquidity and solvency ratios, mean that financial institutions are today significantly more robust and better able to cope with financial instability.

Another strong area of reform has been OTC derivatives markets, where new clearing and reporting requirements contribute to the improved resilience of the financial system. Moreover, the FSB assessment on shadow banking indicates that the toxic forms of market-based finance activities have been addressed through dedicated reforms. Whether that judgement is premature or simply too optimistic remains an open question.

That is not to say that the agreement of international standards can be considered a finished job. More significantly, as the financial environment is constantly evolving, international financial regulation needs to evolve as well. But currently, the focus of international financial regulation is clearly shifting towards implementation.

The consistency of implementation has become key for the future, notably with regards to the aspiration for some degree of unilateral deregulation that has taken foot in some regions of the world and may lead, if confirmed, to threaten the implementation of international standards that were commonly agreed by all G20 authorities.

French and European authorities are strongly committed to preserve and improve the levelling of the playing field through the implementation of financial reforms. The calibration of Basel standards crucially needs to translate into proportionate requirements, without a significant increase in capital requirements in any region of the world. For some jurisdictions to go ahead with deregulation proposals may cast a doubt on their willingness and ability to commit to enforce future standards currently under elaboration.

In any case, a unilateral implementation of Basel standards, like the FRTB, that would increase the cost of some activities for European institutions and would make them noncompetitive against their international counterparts, should be avoided.

The issue of consistency is all the more relevant than it dictates the meaningfulness of policy evaluation exercises. In keeping with the increased relevance of reforms implementation and evaluation, the FSB has produced for the G20 leaders a framework for the assessment of financial reforms. This is an important, concrete step forward. This framework will provide national authorities and standard-setting bodies with a tool to monitor the consistency of implementation across jurisdictions and enable them to effectively draw substantiated, fact-based lessons on what reforms work and how they could be tailored or fine-tuned.

Looking further still, striking the right balance between financial stability and driving the economy to more growth and employment objectives lies at the heart of financial regulation policy. A decade after the beginning of the crisis, the most ominous threats to financial stability (bank buffers in case of shocks, shadow baking activities, derivatives markets) are far better regulated. But low growth and employment issues are still very prevalent, especially in Europe. Future international financial regulation should make these core objectives in the coming years. ●

Andrei Magasiner

Corporate Treasurer, Bank of America

Addressing divergences in regulatory reform and the way forward

Higher capital and liquidity, stress testing, resolution planning, and other regulatory reforms put in place after the financial crisis have led to a more stable and resilient financial system. Many of these regulations were driven by agreement at the international level.

However, developing common frameworks which suit banks and exposure types across jurisdictions is not an easy task, as seen for example in the differences in the implementation of Basel banking requirements between the US and EU. US regulators have 'gold-plated' certain rules, such as the supplementary leverage ratio buffer and GSIB surcharge, to be more stringent than the Basel framework. The EU has sought to tailor regulations to take into consideration the diversity of its banking organizations and mitigate impacts to end-users, for example in its CVA exemption. Additionally, large EU banks primarily rely on modelled risk-weighted assets approaches, while US banks are also subject to a standardized approach floor.

The Basel III reforms or "Basel IV" package is one means to address these jurisdictional differences, through the setting of an appropriate standardized output floor and recalibration of RWA calculations. But the delays in finalizing the framework have highlighted the difficulty in achieving the appropriate balance and agreement, especially as the financial system has strengthened with a renewed focus on accelerating lending and growth.

Another avenue to address jurisdictional differences is through initiatives to review regulations to determine if there have been any unintended consequences and inefficiencies. The US Treasury reports in response to President Trump's executive order seek to take a fresh look at the post-crisis reforms. The Financial Stability Board's framework for post-implementation evaluation is another example.

National efforts can contribute to this work, as individual jurisdictions review the regulations in place and determine what rules may need to be recalibrated, what rules may be duplicative with one another and what additional reforms may be warranted to address continued areas of weakness. Robust cost-benefit analyses that examine market liquidity and impacts on lending should be done locally as well as globally.

These reviews will help to address differences in existing jurisdictional implementation as well as ensure that new reforms coming into effect remain appropriate. Implementation timelines of previously finalized regulations such as the revised market risk rule (i.e. FRTB) should also be reassessed to ensure they are phased-in consistently.

While recent events may have brought into question the future prospects of global financial regulation as some jurisdictions look to preserve their own interests and tailor regulation to meet their own specificities, global coordination of financial regulation continues to be needed. It helps to create a level playing field for market participants by defining a common set of requirements and timelines, helping to protect

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>>> and promote financial stability globally. Consistent minimum requirements across jurisdictions also bolster the argument for substituted compliance of home country rules.

Beyond regulation, more trust and cooperation is also needed in supervision and resolution. This will mitigate damaging trends towards fragmentation, such as under the EU's proposal to require intermediate holding companies and the Federal Reserve's enhanced prudential standards for foreign banks. Paraphrasing comments in the recent FSB update to the G20, an open global financial system that fosters cross-border investment is needed for strong, sustainable and balanced growth across the G20.

Overall, in order to maintain the strength and resiliency of the banking sector, properly calibrated global minimum standards must be finalized and implemented concurrently and continued global coordination is necessary to achieve this goal. ●

Olivier Guersent

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

Global banking regulation, risk sensitivity and the way forward

In recent months, concerns have arisen that the future of international cooperation in banking regulation may be under threat. To a large extent, this is the result of some of the rhetoric - and also early initiatives - coming out of one large jurisdiction on this issue, seemingly driven by the perceived national interest and certain local specificities of markets and institutions. The recent recommendation by the US Treasury to delay the implementation of new key Basel standards, namely the Net Stable Funding Ratio (NSFR) and the Fundamental Review of the Trading Book (FRTB). And the failure - so far - to reach an agreement on the finalisation of Basel III probably has not helped to ease these concerns.

From a European perspective, doing away with regulatory cooperation would be very risky. 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. At the same time, specificities of certain jurisdictions need to be accommodated. There are ways for this to be done without undermining the integrity of the overall framework.

In fact, the risk sensitivity embedded in the current regulations ensures that many differences between jurisdictions are automatically reflected in banks' prudential requirements, in particular by allowing the use of internal models: If risks differ across institutions and jurisdictions, different capital requirements will apply. Like this we can ensure that bank capital rules can be applied consistently across jurisdictions and that at the same time certain unique characteristics of specific financial markets and institutions can be reflected. And we also provide adequate incentives for banks to efficiently manage their risks. In other words risks sensitivity, when adequately supervised, ensures that the same risks are treated the same way but also that different risks are treated differently across banks and across jurisdictions. >>>

>>> Therefore, in the ongoing discussions to finalise Basel III, the Commission has put much emphasis on maintaining an appropriate degree of risk sensitivity in the framework. For example, this has been the case in the area of mortgage lending. Similarly, we believe that the correct treatment of specialised lending exposures is important, as we may otherwise impact flows of finance to key areas such as infrastructure. At the same time, in Europe we are working hard to address certain weaknesses of internal models from the bottom up, in particular through initiatives by the EBA and the ECB's Targeted Review of Internal Models (TRIM).

Of course, there are situations where further adjustments in the local implementation are needed. In Europe, for example, the Commission proposed in November last year that financing for certain low-risk infrastructure investment should receive more favourable regulatory treatment than what is currently foreseen in the Basel framework. However, whenever we propose such adjustments, not only do we base them on solid impact assessments, but we also design them in such a way as to avoid an undue impact on the international level playing field, notably by limiting their scope and/or duration. And overall, I think it is fair to say that nobody implements international standards as comprehensively as we do in Europe.

Like Europe, other member jurisdictions may at times also see the need to make similar minor adjustments. However, if there were excessive delays in the implementation of key standards, such as the NSFR or the FRTB, or even an outright failure to implement them, this would obviously be a source of great concern, especially if coupled with competitive deregulation.

This said, in July, the G20 leaders reaffirmed the need for international standards in financial regulation; and we are also making progress in the negotiations to finalise Basel III. Therefore we remain hopeful that our main international partners still broadly share our view that international cooperation benefits all jurisdictions, collectively and individually. ●

Philippe Bordenave

Chief Operating Officer, BNP Paribas

G20 financial reforms: time to shift to a new agenda?

Ten years after the beginning of the financial crisis, according to Mark Carney in his FSB letter to the G20 July 2017 meeting in Hamburg, "the largest banks are considerably stronger, more liquid and more focused." Indeed, on both sides of the Atlantic, policy makers have reached the conclusion that additional capital requirements are no longer justified, and would even be detrimental to growth. This view has been repeated by the G20, from Huang Zhou to Baden-Baden and Hamburg.

However, the BCBS has stubbornly continued to make proposals that go significantly beyond the original goals of "finalizing Basel III". The lack of consensus at recent BCBS meetings is the evidence of the growing discomfort of regulators, given the disconnect between the G20 mandate and the technical proposals that have been put forth until now. >>>

>>> As outlined by many European authorities, the legitimate goal of "reducing excessive RW variability" could be much better achieved by a consistent review of internal models, as per the ECB TRIM process, rather than by an output floor, which removes risk sensitivity, even if calibrated at a 70% level, as it will impact banks with large low-default portfolios, now stigmatized as "outliers"!

Indeed, rather than concentrating on the level of the output floor, the finalization of Basel III should in my view focus on fully meeting the three fundamental principles outlined by the G20 in its original mandate.

Firstly, the proposals need to maintain risk sensitivity for all portfolios, which is not the case for at least three important issues:

- Risk weights on residential mortgages cannot be based on an identical standard across jurisdictions, irrespective of the existence of guarantee schemes, dual recourse on the property and the borrower, creditor historical behaviors, etc…
- Sensitivity to risk mitigants such as guarantees and collateral must be preserved for corporates and specialized lending to induce banks to finance the real economy while keeping a low risk portfolio.
- While the operational risk charge may need to be revisited, the newly proposed standard method is less risk sensitive than the previous one, which should be preserved. This means also that loss history should not be a mechanical input for capital charges, whether in Pillar 1 or Pillar 2.

Secondly, the standards must respect the mandate of not inducing any significant capital increase for banks. This does not seem to be the case at a global level and is particularly striking for certain activities such as specialized lending and market activities. Market activities have already experienced a massive increase in capital, liquidity and collateral costs since the financial crisis and would suffer a new huge increase if the Basel Committee proposals were to be implemented. Moreover some parts of the FRTB, consisting in a complete overhaul of existing methods, have been reopened by the BCBS as it eventually acknowledged that they simply do not work! In that context, the US Treasury has recommended "delaying implementation of FRTB and NSFR until they can be appropriately calibrated and assessed." Such a recalibration is crucial in Europe as well, if we want the Capital Markets Union to become a reality.

And thirdly, Basel III must ensure that a level playing field is maintained across jurisdictions that have different financing models and that the distribution of impacts is relevant from a financial stability perspective, notably by increasing capital charges on risky portfolios rather than on "low default" portfolios.

These issues, if not addressed at Basel level, will have to be addressed in each jurisdiction which will inevitably lead to various regional deviations from the standards and to implementation delays. This will be particularly the case in Europe, where banks carry on their balance-sheets the lion share of the financing of the economy as there are no "Government Sponsored Entities" to help them to unload low risk assets.

After having allocated very considerable resources to regulatory compliance, banks should now be enabled to focus fully on their core mission of serving their clients' needs in the digital era, which requires massive investments, and to adapt to the new environment of ultra-low rates and high cyber risks.

It is then time in my view for the G20 to focus now on emerging risks such as vulnerabilities in the shadow banking, and cyber risks, which may be the source of the next crisis.

Specially the focus should shift to the liquidity risks of non-banks, notably in the perspective of rising rates and exit of quantitative easing in the US and in Europe. As new asset classes are progressively shifting from banks to non-banks, including long term lending, establishing robust management principles to avoid excessive pro-cyclicality appears essential to protect both investors and borrowers in the coming years.

The use of new technologies, and in particular of digital technologies, simultaneously creates new opportunities and new risks, of which cybersecurity and inappropriate use of personal data are among the highest. >>>

>>> The increase in cybercrime has several causes, among others: the dramatic increase in the use of Internet, in particular with mobile devices; the still somewhat unhindered access to banks' infrastructures by non-regulated third parties; and the generalized use of clouds to store data. As a result, cybersecurity has been identified as a major systemic risk for the financial sector by public authorities – notably in the USA. Trust is a key value and essential for the banking and financial sector. Our customers are rightly concerned by the cybersecurity issues as well as by the potential misuse of their personal and confidential data.

The "same services, same regulation" principle should apply to all actors, without any exception, whether banks or new entrants coming from the digital world. When cybersecurity is concerned, the highest standards should be required, irrespective of the service provider. ●

Markus Ferber

MEP, First Vice-Chair of the Economic and Monetary Affairs Committee, European Parliament

The global agenda of financial services regulation

Since the inauguration of the new US administration, progress in international fora dealing with financial services regulation has largely stalled. The negotiations in the Basel Committee for Banking Supervision on the finalisation of Basel III are stuck and recent recommendations of the US Treasury call into question the United States' commitment to previous international agreements. The last weeks have proven that the US administration's 'America First' policy arguably also applies for financial services and banking regulation. In fact, the US Treasury is not even trying to conceal this as they clearly state in their recommendation that "international regulatory standards should only be implemented through consideration of their alignment with domestic objectives." The new stance by the US administration makes international negotiations exponentially harder.

In light of rapid technological change and its impact on financial markets, cooperation in international financial services regulation has become a key issue. The financial crisis of 2008/2009 and all its ramifications have clearly shown that financial crises do not stop at national borders and, therefore, there is a strong case for international cooperation. This is even more so as we are currently witnessing a couple of big shifts in financial markets that might - at least to a degree - result in traditional players that used to be the subject of financial regulation loosing influence and relevance.

One of those shifts is the impact of technology on financial markets and the emergence of FinTechs that capture an increasingly large market share in certain sectors such as payment services. Another is a shift of investment strategy by many investors that switch from active investing trying to beat the market to passive investment strategies that just try to mimic the performance of an index. Both developments do not fit well into traditional concepts of how financial markets work and would therefore be worthy of international discussion.

Given the uncertainty created by the new US administration and the trust that has been destroyed in just a few months, finding credible international agreements on those pressing issues will be substantially more difficult to achieve in the future. ●

FURTHER INTEGRATING EU BANKING AND FINANCIAL MARKETS

Content

Issues at stake

Completing the Banking Union and setting up a genuine Capital Markets Union are key priorities for improving the resilience of the EU economy and fostering growth. Well-functioning and integrated EU banking and capital markets would indeed improve the mobility and allocation of capital, provide growing companies with more appropriate and diversified financing, notably equity financing, and enhance private risk sharing.

A prerequisite however is restoring sufficient trust between Member States, which involves addressing legacy issues (e.g. non-performing loans) and improving economic convergence within the Union. Enhancing supervisory convergence and consistency in the implementation of financial rules across the EU is also essential, which requires reviewing the powers, operations and governance of the European Supervisory Authorities (ESAs).

Accelerating the resolution of NPL challenges

Contributors

Corso Bavagnoli

Assistant Secretary, Financial Department of the French Treasury, Ministry of Economy and Finance, France

NPL resolution in Europe: the road ahead

Despite the ongoing recovery in Europe, high non-performing loans (NPL) on European banks' balance sheets remain at high levels, despite a clear trend for reduction in a number of countries. While this legacy problem, inherited from the crisis, and from the imbalances that triggered it, is concentrated in a limited number of countries; it is, given its persistence and magnitude, a matter of concern for the EU as a whole, as it could give rise to financial stability risks, possibly spilling-over cross border, and undermine common efforts to achieve sustainable growth.

Yet the issue of high NPLs is multifaceted and its drivers can only be addressed through a variety of initiatives and policy measures. The Council of Ministers has recently endorsed an action plan precisely aimed at developing possible relevant policy options, following several months of technical work.

Though banks are primarily responsible for NPL resolution, the current existing supervision toolbox and practices do not fully provide the right incentives for active NPL portfolio management: notably, the SSM guidance on NPL only targets significant institutions while NPL is an issue in a broader set of banks, and numerous credit institutions lack a proactive NPL management strategy. Therefore the SSM guidance on NPL should be swiftly extended to non-SSM banks while giving consideration to the possibility to set NPL reduction targets on a case by case basis. We also need to make sure that, in every jurisdiction, supervisors have the right instruments to enforce timely recognition and provisioning of NPL. Moreover, the possibility to specifically design macroprudential tools for the purpose of dealing with NPL should be explored.

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

As increased pressure on NPL resolution is likely to generate extra losses and provisioning needs, the ability of high NPL banks to mitigate those losses and absorb them needs to be enhanced. In this respect, it is important to foster the development of secondary markets for distressed debt, which remain underdeveloped in Europe. It will involve, inter alia, initiatives to increase availability, quality and comparability of loan tapes (with possibly state-sponsored "information hubs") and further lifting impediments to transfer, ownership and servicing of NPL across the EU.

As relevant as these initiatives may be, they will not prevent the European banking sector from engaging into extensive restructuring if the NPL problem is to be resolved: in the current challenging environment, a number of banks that face high NPL ratios, with thin capital buffers, will likely never manage to build-up sufficient capital to restore their solvency. They need to restructure with possibly mergers and acquisitions including in a crossborder context where relevant, or exit the market in an orderly fashion when they are not viable. In the overarching context of bank restructuring, public-sponsored distressed Asset Management Companies set at national level may be a useful tool to speed up NPL resolution, as past experiences suggest. It is now for the Commission to clarify the permissible design of such structures pursuant to the Banking Union rules. ●

Giuseppe Siani

Deputy Director General, Directorate General Micro-Prudential Supervision IV, European Central Bank (ECB)

Comprehensive strategy to address the high level of NPLs in the Euro Area protection now

Bank asset quality continues to be a serious challenge for a number of European countries. Large amounts of non-performing loans (NPLs) contribute to low bank profitability and constrain the ability of banks to finance the real economy.

A comprehensive strategy to address NPLs should include at least a combination of actions in three key areas, including i.) supervisory activities, ii.) reforms of legal and judicial frameworks as well as iii.) macroprudential measures.

European banking supervision has therefore paid considerable supervisory attention to the NPL problem since the inception of the SSM in 2014 when the comprehensive assessment was conducted. We set up a dedicated task force on NPLs in July 2015.

In March of this year, following an extensive public consultation process, the ECB has issued its NPL guidance applicable to all significant institutions. The guidance is for instance asking banks with high levels of NPLs to implement an ambitious and realistic strategy for a timely reduction of the NPLs. It is clear that "Wait and see" approaches that we have observed in the past, can no longer be tolerated.

Our supervisory initiative has started to bear fruit across countries. In the past months, we have seen a number of banks starting to address their asset quality issues much more actively. Our efforts addressing this issue will continue. The joint supervisory teams will closely follow and challenge the bank's NPL strategies and the way they are implemented.

Furthermore, we are looking into more prospective solutions to avoid a similar piling of NPLs in the future. One important ingredient to ensure a sustainable reduction of NPLs is sufficient powers for supervisors to enforce that timely prudential provisions are made by banks for NPLs.

However, tackling Europe's NPL problem goes beyond the supervisory domain. Deliberate and determined reduction of NPLs requires concerted action from all stakeholders – including Member States, the Commission and the relevant EU fora.

" « Wait and see » " approaches that we have observed in the past, can no longer be tolerated."

- GIUSEPPE SIANI

Against this background, we published an extended report that analyses national supervisory practices and legal frameworks related to non-performing loans. The Stocktake shows that lengthy legal procedures and insufficient court capacity represent a significant obstacle to banks in their ability to reduce their NPLs. For this reason, proactive and coordinated concrete legislative changes aimed at improving the efficiency of the judicial system as well as developing a framework for timely out-of-court collateral enforcement would contribute to the workout of non-performing loans.

Efforts to foster the development of an NPL servicing industry, to improve data quality and access and to remove tax and legal impediments to debt restructuring will also help develop liquid markets of distressed debt. Experience has shown that banks should use a wide tool-kit to tackle NPL, including, but not limited to, well designed and managed AMCs. Against this background, we welcome that the European authorities led by the Commission will develop an AMC blueprint for EU countries. ●

Paolo Fioretti

Deputy Head of Banking, European Stability Mechanism (ESM)

How the ESM can help solve the problem of high non-performing loans (NPLs)

In the past crisis, five euro area countries obtained financial support from the European Stability Mechanism (ESM). All these countries required support for their banking sectors which, for various reasons, had accumulated large stocks of NPLs. In addition to recapitalising weak banks, the programme conditionality contained coordinated policy measures to address both the stock and inflow of NPLs and to provide a viable means of restructuring NPLs to deleverage corporates and households. These measures included the transfer of NPLs to asset management companies (AMCs) to address real estate bubbles, the introduction of best practices for NPL management, the imposition of NPL restructuring targets on recapitalised banks, the improvement of lending practices, and the introduction >>>

>>> of credit registers and modern insolvency and foreclosure frameworks. Overall, the ESM programmes helped to reduce NPLs, both through policy measures and the financing of balance sheet repair. The experience gained from these programmes has also been informative for the debate on a new comprehensive strategy to deal with the stock of NPLs, which remains high.

The ESM provides financial assistance when a country can no longer refinance itself in the market at sustainable prices, and support is necessary to safeguard the stability of the euro area and its member states. The current package for Greece is the ESM's only active programme. If requested, the ESM could provide support for a country's banking sector through adjustment programme and an assistance package focused on the financial sector, as was done in Spain. The ESM also has a direct bank recapitalisation instrument in its toolkit. However, bail-in requirements and eligibility constraints restrict the use of this instrument to extreme circumstances that are highly unlikely to arise. Given the current legal structure, the ESM cannot directly finance an AMC through equity participation, nor can it provide direct financing or funding guarantees.

The next steps towards a deepening of EMU should aim at the completion of Banking Union, including the creation of a European deposit insurance scheme and a common backstop. It has been suggested that the ESM could become the common backstop of the Single Resolution Fund. In this role, it would further strengthen the institutional architecture of the euro area and ensure that bank balance sheet problems can be addressed. A stronger institutional set-up would also encourage private investors to participate in the NPL markets, and thereby accelerate the reduction of the stocks of NPLs. ●

"Programmes has been informative for the debate on a new comprehensive strategy"

- PAOLO FIORETTI

Michael Dryden

Managing Director, Global Head of SP Finance, Credit Suisse Group

Good progress, but more can be done to boost the NPL market

ESRB estimates point to over €1tr of outstanding NPLs across the EU, including 10 countries with a NPL ratio above 10%. Although good progress has been made to reduce the overall stock and we currently expect less asset quality deterioration over the next 12 months, more has to be done to reduce the economic drag and financial stability risk such loans represent, particularly given the dominance of bank lending in the EU. In this respect, we are fully supportive of the multi-pronged EU institutional focus on this issue.

Credit Suisse's point of view on NPLs is shaped by our lead role in the financing of Southern EU NPL assets, and our market leading position in the US NPL space. We strongly endorse measures to develop an efficient secondary capital markets in NPLs. NPLs may be asset-based or corporate, each requiring different asset management skills with differing restructuring challenges, and so to ensure liquidity of the underlying assets/corporates and greater liquidity in the financing, buyers need transparent information to fully understand their rights during these complex processes.

Secondly, we encourage policymakers to focus on the resolution, modification and other asset management practices in order to reduce the potential volatility of recovery for buyers of NPL assets. Steps to strengthen NPL data infrastructure and more transparency to reduce information asymmetries are important to reduce pricing discounts versus Book, and a simplification and harmonisation of licencing requirements for third party services would be impactful. Given the disparity in the length of insolvency/recovery procedures for NPLs across different Member States, we also encourage the European Commission to carry out a peer review of insolvency regimes to identify and propagate best practice.

"Credit Suisse's point of view on NPLs is shaped by our lead role in the financing of Southern EU NPL assets, and our market leading position in the US NPL space."

- MICHAEL DRYDEN

Although many banks in some parts of Europe tackle their stocks of NPLs with outright sales, although this route can be hampered by price gaps between buyers and sellers. Another useful avenue to consider is securitisation, which increases demand for the senior part of the capital structure through widening the investor base, which over time will reduce the cost of funds, reduce investors' cost of capital for NPL investment, and narrow the bid/offer spread. Securitisation also allows banks to retain some upside if macro-economic conditions continue to recover. Synthetic NPL securitizations can also be efficient from a risk management standpoint, and EU policymakers should consider whether or not, despite the lack of an accounting sale, banks can achieve capital relief benefits for such transactions.

We support a comprehensive and EU level coordinated approach to NPL reduction, however, would >>>

>>> recommend caution on two elements. While supervisory action has been instrumental in the progress made so far, given the illiquidity of the secondary market we note the trade-off between further rapid NPL balance sheet deconsolidation and the impact on banks if significant value is given up. Secondly, although conceptually positive, the idea of an EU AMC seems less likely in the short-term given the heterogeneity of EU markets and the further development necessary on Banking Union.

Focused policy measures to increase secondary market liquidity will be key to tackling NPLs, which in turn is a pre-requisite for the development of a Capital Markets Union and ultimately a more robust financing model for Europe's corporates. ●

Laurent Lascols

Global Head of Public Affairs,
Société Générale

NPL secondary markets: a shared diagnosis

Despite the majority of Member States are not currently affected by excessively high levels of NPLs, their adverse impacts could (i) pose risks of spillovers cross-border effects spreading to the real economy, (ii) threaten EU financial stability, and (iii) alter market perceptions of the whole EU banking sector.

In this context, the development of secondary markets for distressed debt is a key policy area. By end-2016, 107 significant institutions held around €866 bn of gross impaired assets[1], compared with €942 at end-2015. Compared to this, the volume of €80 bn in secondary market transactions[2] in 2016 is very low, with most activity traded in the form of NPL portfolio sales and to a lesser extent as NPL securitizations (only €155m issued in 2016).

"The development of secondary markets for distressed debt is a key policy area."

- LAURENT LASCOLS

Policy makers, central banks as well as the IMF and the EBRD have converged in identifying six impediments to a more active development of secondary markets of distressed debt: (i) "poor" data quality of the assets behind the transaction; (ii) quality of legal and insolvency frameworks, iii) subdued securitization market; iv) lack of licensing and regulatory regimes to enable non banks to own and manage NPLS; v) tax (dis)incentives relating to transfer of NPL portfolios and loan loss deductibility; and vi) lack of economies of scale for small banks, heterogeneity of loans and role of Asset Management Companies (AMCs).

Tackling NPLs has also become a top priority at the EU level. A public consultation is currently collecting views on a possible legislative initiative to strengthen the ability of secured creditors to recover value from secured loans to corporates and entrepreneurs. This would usefully complement the EU Directive on preventive restructuring frameworks and second chance.

The proposed implementation of a European NPL-information platform could enhance transparency while facilitating transactions. Indeed, unavailability of sufficiently detailed, comparable and reliable data on NPLs are a major obstacle to transactions. On the supervisory side, the need for additional supervisory measures to prevent/control new NPLs should be carefully monitored as the ECB issued its final guidance to address the NPLs issue.

All these proposals are in line with the international consensus. They are essential not only for tackling the existing stock but also for avoiding a renewed build-up of NPLs in possible future cyclical downturn. However, the current debate on proportionality does not take into account the NPLs issue, even though most of small institutions probably hold more of them than the biggest one. ●

1. Source : ECB Financial Stability Review, May 2017
2. Source : AFME

Piers Haben

Director, Oversight Department,
European Banking Authority (EBA)

Can asset management companies help deal with Europe's NPL problem?

EBA and supervisory pressure have driven the repair process of European banks, with CET1 capital now some 500bp up from December 2011 to over 14%. Extensive asset quality reviews (AQRs) have been carried out across the EU but, with around one trillion euros of NPLs remaining in the EU banking sector, cleaning balance sheets is still a priority for the single market and requires coordinated EU action.

A series of interlinked actions are needed: supervisors should push banks to proactively tackle NPLs; legal systems changed to make resolving loans easier for debtors and creditors; >>>

>>> market failures in the secondary markets for NPLs addressed; and ongoing restructuring of the EU banking system.

Market failures in the secondary NPL market include information asymmetry, as a result of incomparable and poor data on NPLs, and inter-temporal pricing problems as illiquid markets give rise to a first mover disadvantage. Tackling these would allow supervisors to take a tough stance on banks without risking fire-sales.

"What is key is that the EU AMC blueprint offers clarity, consistency, credibility, and critical mass."

- PIERS HABEN

Historical examples of success in the disposal of non-performing assets demonstrate the key role of the official sector in kick-starting the market, at least for some segments by providing data and liquidity, often via Asset Management Companies (AMC).

Colleagues and I have set out elsewhere[1] how an AMC might address these market failures within state aid rules. We are agnostic on the exact details. What is key is that the EU AMC blueprint offers clarity, consistency, credibility, and critical mass. To do so the EU AMC blueprint must not be an empty set.

The entry criteria must be the same, including the way stress tests are run, the sales threshold, the state aid application, as well as pricing and valuation techniques. Data templates provided at an EU level will provide consistency across the EU for potential investors. The financing and operational governance of the AMC(s) should be to an EU standard, including funding structures and independence of the board. And wind down procedures specified to provide an EU level playing field.

Only such a detailed blueprint covering data, financing, operations, and entry and exit criteria, will provide the clarity and consistency needed to create an EU standard for AMCs. That is the way to foster credibility for potential investors, which in turn will increase both demand and supply into the secondary NPL market, until we reach critical mass and a more efficient clearing price. ●

1. http://www.eba.europa.eu/about-us/organisation/top-management/papers

Post questions and comments
tallinn2017.eurofi.net

Banking Union

Contributors

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The Banking Union glass is half empty

The essence of the banking union is to underpin financial integration in the Eurozone through the centralisation of powers into supranational authorities and the introduction of risk sharing mechanisms among banks in case of crises. Back in 2012, when this major milestone was first outlined, the aim was to put an end to financial fragmentation and break the doom loop between banks and sovereigns.

After three years of life, there is a need to look back and analyse how the banking union is working in practice. The set-up of a whole new institutional architecture has been successfully launched in a record time. This has not been an easy task either for authorities nor the industry, and the balance is quite positive. At this stage, however, I tend to see the banking union glass half empty because of two main reasons. First, as the ECB states in its Financial Integration Report 2017, no further progress in financial integration has been achieved during 2016 in the euro area. Second, the single rulebook has not been truly single among Members as the different solutions for resolution in Spain and Italy illustrate.

In the short run, we need to consolidate the framework we already have. It could be difficult to negotiate further progress if we are not able to meet what we have. The European Commission has to safeguard a harmonised application of the EU law, both in form and spirit while preserving the new paradigm aimed at avoiding taxpayers bearing the burden of banking crises. The priority now should be to fix the existing loopholes in the current legislation, and to learn lessons from recent experiences.

What are the main obstacles for an adequate functioning of the banking union? I will mention a few examples. Overall, we must improve coordination in the communication done by authorities. On the single rule book, we need to align the 2013 Commission's State Aid Communication with the BRRD, and harmonise bank liquidation regimes in the EU. On supervision, we need to phase out national discretionalities. On resolution, we have to develop a single definition of what is public interest. Moreover, we have to revisit the alignment of the bail-in tool and the MREL requirement. We should adopt a common approach to the selling of bail-inable instruments to retail clients and clarify how liquidity works both before and during resolution. We should avoid a better treatment in liquidation than in resolution. Finally, we should reflect on whether the resolution framework can accelerate bank runs. All of that will make the whole framework more credible.

Despite these issues, we should finalise what we started. We should keep working to complete the banking union with a common fiscal backstop for the Single Resolution Fund, and the creation of a European Deposit Insurance Scheme. The Capital Markets Union is even more important after Brexit but also steps towards a Fiscal Union should not be forgotten, both to reinforce fiscal discipline and to start issuing common debt instruments. There is a renewed opportunity to move forward on that front with the lead of Germany and France. Let's pave the way for a better governance for the Eurozone. ●

Esther de Lange

MEP, Committee on Economic and Monetary Affairs, European Parliament

Hand in hand and step by step

Work on the economic and financial architecture of our Union will remain an ongoing process. Not necessarily because our institutions, regulations and directives are not properly designed, but more so because there is divergence on the level of implementation and enforcement and because adaptation and evolvement are simply required in a constantly shifting landscape of economic and financial affairs. The EU's internal and external developments over the past year alone have continued to make this abundantly clear.

Taking stock of our current situation, we can conclude that - unfortunately - government debt is too high, structural reforms remain politically challenging for most Member States and investments are not easy to boost. Still, we have passed several pieces of landmark legislation to strengthen Europe's economic and financial stability and the completion of our Banking Union now comes into sight. The fact, however, that state aid is still being used to rescue banks and (many of) their creditors is complicating matters. At the same time, it is a positive sign that banks described by some as 'zombie banks' are now heavily restructured or leaving the market. And although the distinction and connection between an SRB decision to go into resolution or not and a DG COMP decision to grant state aid or not could use more clarification, there will and should always remain some discretionary powers to our regulators and supervisors.

Summing up, it seems that we are still in a transitional period coming out of turbulent economic times. Patience, however, that was required to resolve crisis legacy issues is wearing thin. There will need to come a time when there is no more or at least very little room for exceptions. The sooner that time comes, the sooner concrete and more substantial steps in the area of risk sharing can be made. The goal, for example, to offer protection to savers irrespective of their location still resonates strongly within the European Parliament. This means that as long as there is progress in the area of risk reduction, including work on national insolvency regimes, work on a European Deposit Insurance Scheme (EDIS) should be a priority.

When it comes to the conditions and short term priorities for the set-up of EDIS, I would argue that concrete and credible protection for savers should have our utmost priority over a fully mutualized European fund, both in terms of timing and in terms of design. This means that a well-functioning system of direct and quickly accessible liquidity support for national deposit guarantee schemes should be set up as a first step, with coverage starting preferably still this mandate. The invaluable benefit of this approach is that we can in the near future provide our citizens with a greatly improved level of protection, even if and when risk sharing remains limited (as this is for many Member States a sensitive issue and will take time).

We owe it to our citizens to provide them with a credible safeguard for their savings. We also need to keep the promise to our citizens to reduce risks in our financial sectors and to stop using taxpayers' money to save banks. We have the unique opportunity to deliver on both those issues, hand in hand and step by step. ●

Danuta Hübner

MEP, Committee on Economic and Monetary Affairs and Chair, Committee on Constitutional Affairs, European Parliament

Banking Union: high time for completion

It has been five years since the roadmap for the creation of the Banking Union was released. Good progress has now been made on the three pillars identified back then, with two being operational and one intensely discussed by the co-legislators.

However, it is clear that the Banking Union needs still lacks a number of elements in order to become a real Union where there is a level playing field for all actors. It also greatly needs to be made more resilient to shocks, crises and threats. One of the benefits to be expected from the Banking Union is to allow banks to operate cross-border more easily, thereby facilitating economies of scale and a more efficient allocation of economic resources. Crucially, this would also allow more private risk-sharing through cross-border investments, improving the resilience of the system. Nevertheless, currently, within the Banking Union, there is still home bias among investors and little cross-border banking consolidation. Deposit protection is not equivalent either.

Today, in order to progress further, the banking union needs confidence and certainty.

Banks need certainty on what rules they should abide by and confidence that those will be the same throughout the Banking Union in order to invest, lend and merge across borders. Savers need confidence that foreign banks respect the same rules as domestic ones in order to feel safe to invest

abroad. We need confidence that regulatory frameworks are equivalent so that financial stability can be preserved without imposing barriers. >>>

>>> And there is no better way of creating confidence and certainty than through harmonisation.

What we are discovering as the banking union is taking shape is precisely how deep this need for harmonisation goes.

A single supervisor has been established for the Banking Union, applying a single rulebook. However, for the SSM to work as effectively as possible, the rulebook has to become even more single, with in particular more harmonisation of the use of national options and discretions.

A single resolution regime has been put in place for large banks. However, insolvency law, likely to apply to small banks, remains national, which leaves the consequences of a failure still partly dependent on the country where the institution is established. Harmonisation of the hierarchy of creditors, and probably of some other key aspects of bank insolvency regimes, is necessary for investors to have certainty on where they stand as creditors and to simplify the work of resolution authorities.

We also now need to deal with the challenge of Brexit, which creates pressures for a regulatory race to the bottom and risks bringing about more fragmentation. The temptation of fragmentation and deregulation should be resisted.

The priority is the finalisation of the crisis management tools, that is, a fiscal backstop for the Single Resolution Fund and a European Deposit insurance scheme. Agreement has to be reached on these two points and would already give more certainty to governments and private actors on how a crisis will be handled and its costs shared.

However, as a longer-term process, we should not lose sight of the more detailed harmonisation work. Carrying it out will be essential to create a genuine Banking Union. ●

Elke König

Chair, Single Resolution Board (SRB)

Takeaways from the first application of the EU's crisis management framework


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Ten years after the outbreak of the financial crisis, the EU and its Member States (MS) today are in a far better position to manage the negative externalities banking can impose on the public. The new framework designed in response to the crisis has been put into practice at a rapid speed. Under this framework, the Single Supervisory Mechanism (SSM) is responsible for minimising the probability of a crisis ex-ante, while the SRB strives to limit the damage to the public should a failure be inevitable in spite of increased prudential measures.

The successful resolution of Banco Popular, the precautionary recapitalisation of Banca Monte dei Paschi di Siena (MPS) and the liquidation of two smaller regional banks in Italy occurred almost exactly five years after the first proposal for the Banking Union in June 2012. The solutions found for these cases varied substantially and this provides the opportunity and necessity to take stock of the crisis framework and to draw lessons to be learned.

The resolution of Banco Popular proved the new system effective, whereas the outcomes for the three Italian banks highlighted the need for further harmonisation, in particular concerning the regulation's objective of breaking the link between public finances and bank losses. In the case of Banco Popular the SRB used the "sale-of-business-tool"and decided upon resolution within the framework of the BRRD and SRM-R. "Precautionary Recapitalisation", the route chosen for MPS, is an option for governments to aid troubled, yet solvent, banks explicitly foreseen in the regulation. It is the exception – under tight constraints – to the rule that state aid will lead to determining a bank "failing or likely to fail". Similarly, the liquidation of the two smaller banks under national insolvency law is the legal consequence of the SRB determining that there was no public interest in resolution. But it also shows that the public can still be exposed to the costs of bank failure at the decision of a MS.

In this context, it has to be considered that the Commission's Banking Communication from 2013 needs to be reviewed against the progress made in the resolution framework. In addition, harmonising national insolvency laws would be needed to achieve a level playing field.

The SRB will focus on making banks resolvable through resolution planning, including setting an adequate level of MREL. This will enhance the chances for private solutions and, in case of failure, minimise taxpayers' exposures.

The resolution of Banco Popular vividly illustrated the importance of funding in resolution. Eventually, the bank's liquidity issue was resolved by selling the entity to a buyer that had the means and willingness to provide the needed funding. To prepare for a return to markets shortly after resolution and in absence of a strong buyer, the work on identifying private and public sources of funding, including the capabilities and limits of the SRF, the Central Banks and MS will be of priority. Other important operational aspects that we were confronted with – from data availability to peculiarities of the national law – will be taken into account in the next resolution planning cycle as well.

The cases highlighted also another critical detail: Although the decisions differed, the four banks shared a common denominator that added to their precarious situations. All banks saw themselves confronted with the same legacy issue. Ten years after the start of the crisis some EU banks still suffer under the weight of NPLs. While the forecasted economic upturn in Europe will certainly contribute to the improvement of balance sheets, authorities must find ways to swiftly address this issue, remembering that seemingly similar exposures may in practice be very different, depending on the underlying and the different legal frameworks in MS that affect recovery values.

We should all be realistic: By definition, losses will emerge in the management of NPLs and portfolios cannot be whitewashed. Increased transparency and the development of a frictionless secondary market would mark steps in the correct direction. There is no time to lose. ●

Accelerating the CMU

Contributors

Steven Maijoor

Chair, European Securities and Markets Authority (ESMA)

Progress towards a Capital Markets Union for the EU

The European Union (EU) needs strong capital markets in order to ensure diversified funding of its real economy. Today, EU financing is still too much bank-bound. Achieving a Capital Markets Union (CMU) with more non-bank funding is essential to strengthen the financial system and to better support the EU economy.

There are various benefits of an improved balance between bank financing and capital markets financing: the latter can provide alternative sources of funding, can improve the level of equity funding, and can increase the overall competitiveness of the financial system.

The fact that the UK has decided to withdraw from the EU reinforces the importance for the EU to progress with the CMU. This would contribute to a more effective single market in financial services and strengthen Europe as a global financial centre. Only an EU with truly open capital markets, reduced fragmentation and strong investor protection is conducive to growth and employment.

The achievement of the CMU needs to be supported by the regulatory and supervisory framework at EU level. The regulatory reform of the past years has not only responded to the risks related to the financial crisis, but has also accelerated the establishment of the single market with the implementation of a range of regulations. Additionally, pieces of legislation were initiated specifically in the context of the CMU, like the ones regarding prospectuses and securitisations.

The evaluation of the ESAs should support the CMU as barriers in EU capital markets partly relate to supervision. The current supervisory model for European financial markets is a mixed one, and provides for both supervision at national level, and in some instances supervisory functions by ESMA, directly at EU level. This system has worked well so far but further improvements are needed, such as the introduction of more effective tools to enhance the harmonisation of supervisory practices by national competent authorities. Supervisory convergence is needed to ensure a European level playing field for market participants. This implies that market participants need to play by the same rules regardless of their location. In turn, all investors will enjoy the same level of protection no matter the point of sale.

A significant part of the post-crisis regulatory framework in the EU introduced both new requirements for market participants as well as strengthened the supervision of, for example, CRAs and trade repositories. These entities have benefitted from a truly European approach built around economies of scale and the pooling of expertise. The review of the ESAs is an opportunity to consider expanding this model to other financial entities and activities, with strong cross-border risk profiles. This would provide for consistency and efficiency of the supervision of EU financial markets.

Key issues relevant for coherent supervision are data collection, the building of databases, and analytical analyses of large data sets. Data lies at the heart of supervision as it allows the monitoring of risks and provides investors with, for example, information about the performance of financial products. That said, the role of data reporting will further increase in the future as will data sharing across borders. Reliable sources of market data are of utmost importance, and the EU legislators did cater for these needs over the last years. Obviously, any overlaps and inconsistencies should be avoided, also to bring down the costs for market participants. Therefore, a comprehensive EU data strategy, taking into account international developments in the area of data harmonisation, should be established and ESMA can play a central role in such a strategy. To support that objective, ESMA would need to have better regulatory tools to ensure further harmonisation in data collection and the definition and maintenance of rules in respect of regulatory reporting requirements. ●

Olivier Guersent

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

CMU at the service of Europe's investment recovery

The EU's economic recovery is gaining momentum, with a fifth consecutive year of growth. But the persistent weakness in investment continues to hold back the momentum of recovery and longer-term growth. To strengthen investment for the long term, the European Union needs stronger capital markets. This is why the Capital Markets Union (CMU) project remains a cornerstone of the Commission's efforts to strengthen the EU economy and stimulate investment to create jobs. But we are confronted with new challenges which called for a review of the CMU agenda. In particular, the future departure of the largest financial centre from the EU made it necessary to re-assess how we could ensure that EU businesses and investors have access to strong, dynamic and more integrated capital markets.

The CMU Mid-term review aims at addressing these challenges through nine new priority measures. The Commission will notably propose a review of the functioning of the European Supervisory Authorities in order to promote effective and consistent supervision across Europe. In targeted areas, we could strengthen ESMA's powers including, where warranted, granting direct supervision. To facilitate equity capital-raising by high-growth companies, the Commission will also explore how targeted amendments to relevant EU sectoral legislation could deliver a more proportionate regulatory environment to support SME listing on public markets. To harness the transformative powers of financial technology, the Commission will also assess the case for an EU licensing and passporting framework for FinTech companies before the end of the year. Finally, to shift private capital towards 'green' investments, the Commission will decide on the concrete follow-up it will give to the recommendations of the High Level Group on Sustainable Finance. A fully-fledged capital market ecosystem cannot be built through a 'top-down' process. It requires a deep partnership between the EU, the Member States and the industry. For example, the Commission will propose a comprehensive strategy on steps that can be taken at EU level to support local and regional capital markets development, notably in Central, Eastern and South-Eastern Europe. The EU aims at creating the enabling conditions for more dynamic capital markets in that region, relying on the Commission's Structural Reform Support Programme. To do this, the strong support of Member States will be still needed.

"A fully-fledged capital market ecosystem requires a deep partnership between the EU, the Member States and the industry."

- OLIVIER GUERSENT

The Commission reports regularly to the European Parliament and the Council on the progress made with the implementation of the CMU commitments. The Commission needs to find effective and simple ways to communicate about the importance and progress of this complex public project. The goals of CMU need to be translated into clear and operational targets and indicators in order to allow Member States, the European Parliament and the stakeholders to understand the impact of each individual CMU measure. This will facilitate sustained political commitment to what constitutes a deep reengineering of our financial system. ●

Marinela Petrova

Deputy Minister of Finance, Republic of Bulgaria and Member of the Economic and Financial Committee (EFC)

Streamlining the CMUs initiatives

The Capital Markets Union encompasses many different initiatives aiming at putting in place the main building blocks for connecting savings to investment and strengthening the EU economy. The CMU planned reforms should be ambitious but achievable.

Achieving such balance could be very difficult, and a good starting point would be to ensure support for the small and medium-sized companies (SMEs) in diversifying their sources of financing. Financial stability and sustainable growth are top priorities and boosting the efficiency and effectiveness of the capital markets is essential to enable savings to be put to productive use as well as drive innovation and ultimately creating jobs.

The recent crisis showed that European SMEs rely heavily on banks for funding and that there was little focus on funding from capital markets. Therefore, the CMU should aim at removing barriers so that more SMEs can reach their full potential including by listing on exchanges. We should also put our efforts to >>>

>>> lighten the supervisory regime for SMEs by removing unnecessary regulatory requirements in a way that does not undermine financial stability. Efforts should be made to remove the information barriers between SMEs and prospective investors, a challenge which is acknowledged in the CMU Mid-Term Review. Strengthening local equity market ecosystems is key in that regard – as far as the size and depth of capital markets are not equal across Europe. In certain market areas Member states already have well-functioning markets and further legislative development at European level should build on existing regulations in order to provide for the national markets to adapt and function well together. A useful tool could be a principle based legislation that can accommodate differences and link markets across EU.

"We should focus on establishing common supervisory practices and enhancing legislation"

- MARINELA PETROVA

Supervisory convergence should also be enhanced. Establishing a common supervisory culture is a very challenging task but is of primary importance in order to remove cross border barriers. There are adequate ESAs instruments already in place for supervisory convergence such as peer reviews, binding mediation, guidelines and recommendations. What should be broadly pursued is to strengthen these ESAs tools in order to use them efficiently for achieving convergence and harmonisation.

After the financial crisis numerous legislative initiatives have been undertaken at European level with the aim of ensuring financial stability and restore investor's trust in financial markets. Now, few years later, after the legislative framework in financial services has widened significantly, we should focus on establishing common supervisory practices and enhancing legislation mainly with the aim to remove some inconsistencies in the pieces of key pan-European legislation and to introduce more proportionality with the aim to decrease unnecessary compliance costs for companies and investors. ●

Alexander Batchvarov

Head of International Structured Finance Research, BofA Merrill Lynch Global Research

An ongoing CMU review is needed to keep up with dynamic capital markets

The CMU mid-term review triggered a re-think of the progress made in developing the CMU in the EU; Brexit brought CMU back into focus of EU policymakers. The action plan for the remainder of the term is commendable and can advance CMU, if adequately, quickly and fully applied.

Capital markets are dynamic: they respond quickly to any news. That raises the question about the adaptability of EU regulations to CMU developments. The current regulatory setup can be unwieldy and burdensome: Level 1 legislation etches in stone enormous amount of details well beyond principles of regulations, prompting for another layer of auxiliary regulations in the form of RTS as Level 2. Both Level 1 and 2 regulations take a long time to change in response to market developments or to misunderstandings during the rule-making process. A regulatory review and subsequent amendments may come after the demise or stunting the development of certain market sectors. Amendments had to be made to Solvency 2 with regards to infrastructure almost immediately after its adoption and took more than one year to finalise. The work on amending CRR to incorporate STS started at the end of 2013 and we are unlikely to see its implementation before mid-2019.

Regulations for a given sector are often developed in silo with limited read-across to other regulations or sectors. They can often reflect political rather than economic and financial priorities. New regulations for a given sector often reflect the priority of the moment, without updating existing regulations for other sectors, thus often putting the former at a disadvantage. The case of regulations for covered bonds, commercial real estate finance, securitisation and others both under CRR and Solvency 2 can serve as examples. Now, expedient Solvency 2 amendments are needed to unlock the potential of these market sectors.

In many respects, the current regulations in their totality favour loan rather than bond and equity financing, favour non-transparent and illiquid forms of financing over liquid and transparent ones. The level of liquidity of EU capital markets continues to decline, as central banks' and markets' studies show. With the implementation of MiFID II, research coverage is likely become more concentrated, which could result in denting market transparency and liquidity further. Market-making is out of fashion. Loans are surging up again over high-yield bond financing, and EU equity markets, especially for early-stage equity financing, remain underdeveloped. All these aspects are long-term negatives for CMU development, if they are not reversed.

We note that the mid-term CMU review identified many of these issues and laid down a detailed action plan. We are confident that the action plan will achieve the desired results when implemented with an adequate coordination of regulatory initiatives, break-down of silos across sectors and regulations in close cooperation between financial industry and policymakers. The complexity of financial markets' regulations requires an adequate and timely guidance. This suggests a need for more power to the ESAs in coordination with the NCAs to provide interpretations to Level 1 and 2 texts beyond Q&A and thus respond to the dynamic developments on the capital markets in a timely manner. ●

Stéphane Boujnah

Group Chief Executive Officer and Chairman of the Managing Board, Euronext

Brexit – Measures to strengthen EU27 capital markets and financial centres

The EU27 Member States must respond to Brexit via further strengthening of EU capital markets and financial centers on the continent. Legislative proposals for significant reform of the European supervisory framework, in respect of both EU and non-EU entities, are of central importance to this goal. This will support deeper integration of financial markets and the development of CMU by ensuring a competitive level playing field and safeguarding financial stability.

In terms of the international dimension, Brexit demands a response from the EU in relation to its approach to equivalence as the current model is clearly no longer fit for purpose. The Commission proposals on supervisory arrangements for EU and third country CCPs, as well as ESMA's work on supervisory convergence in the context of Brexit, are welcome developments in this context. Giving the EU the necessary means to deliver effective supervision of such critical market infrastructure to ensure financial stability - including in certain cases via relocation requirements to the EU should remain a key priority. In addition, the proposals to overhaul the procedures governing the granting of equivalence are also important. We support an expansion of ESMA's role in the initial equivalence determinations, alongside a new remit to monitor compliance by third countries on a regular basis.

"Respond to Brexit via further strengthening of EU capital markets and financial centers"

- STÉPHANE BOUJNAH

In parallel, the EU should also use Brexit as an opportunity to strengthen the application of consistent supervision and enforcement of the financial services single market rule book within the EU. This is key to avoiding economic inefficiencies and ensuring a competitive level playing field. It should be achieved via implementation of the Commission's proposals to strengthen existing ESA tools and powers, particularly in the case of peer reviews, given the role they can play in fostering supervisory convergence among regulators.

Alongside enhanced supervisory arrangements, we support the Commission's approach on CMU in respect of public capital markets, as outlined in the Mid-Term Review. In particular, we welcome the focus on SME listings, beginning with the assessment of the need for targeted amendments to MiFID II and the Market Abuse Regime. On the investment side, we agree with the Commission on the importance of examining the economic drivers behind equity investments on public capital markets by insurance companies and pension funds, with a view to identifying - and addressing - regulatory and other constraints at the EU and national levels. Moreover, we note with interest the Commission's proposed evaluation of the possible use of public funds to support SME listings, notably via the creation of a public-private SME investment fund.

Euronext will contribute to the debates while focusing on its core mandate of powering pan-European capital markets to finance Europe's real economy. The recent creation of Euronext Access, designed to smooth the transition of start-ups and SMEs to markets, and Euronext Growth, replacing Alternext as a market dedicated to mid-caps with adapted listing requirements, underlines this ambition. Beyond the open federal model of Euronext is a fundamental vehicle to enhance the collective ambition to build strong financial centres in continental Europe. ●

Levin Holle

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

Capital Markets Union – focus on contents

The Capital Markets Union (CMU) is a project of shared importance for all Member States, the European Commission and the European Parliament. It is of essence to strengthen the integration of European capital markets' and to foster the financing of companies and investment projects. The recently presented Mid-Term Review of the CMU action plan by the European Commission has been a welcome occasion for the Council to underline its continued strong commitment to the CMU and to acknowledge the good progress made in implementing the initial action plan.

Looking forward, Brexit will make CMU implementation more challenging, but at the same time may serve as cata-lyst for further financial market integration among EU 27. Therefore Germany appreciates the addition of new >>>

>>> prior-ity measures into the roadmap to deepen financial integration and to reflect upcoming challenges, for instance:

- the catch-up of Member States that clearly lag behind in terms of capital market development;
- the integration of sustainable finance and FinTech into the agenda; as well as
- appropriate avenues to develop secondary markets for non-performing loans.

Supervisory convergence and the role played by the European Supervisory Authorities (ESAs) are important in the context of establishing an effective CMU and a sound and efficient EU financial market as a whole. The ESAs so far have broadly done a good job to promote the Single Market supervisory convergence. Moving forward, common understandings and precise criteria for supervisory convergence should be established as a compass for effective and coherent supervision in the future.

In this context the Council of the European Union agreed in its Conclusions of July 11th, 2017 to discuss Commission proposals for amendments of the European Supervisory Authorities framework. Germany will actively take part in the upcoming debates.

"In our future deliberations on the CMU we should focus on the key priorities especially on the content side and avoid getting stuck on institutional changes."

- LEVIN HOLLE

The continued relevance of subsidiarity, proportionality and better regulation as guiding principles for the CMU has been reiterated by the Council more than once. These guidelines translate into the simple message, not to lose out of sight what is sensible. An appropriate balance between harmonization and preserving established and well-functioning markets and structures is the best foundation to make CMU an enduring success, while going forward step by step. In our future deliberations on the CMU we should focus on the key priorities especially on the content side and avoid getting stuck on institutional changes. ●

Neena Gill

MEP, Committee on Economic and Monetary Affairs, European Parliament

CMU mid term review: necessary steps towards an effective Capital Market Union

The recent mid-term review was a welcome opportunity to revitalize the CMU project, one of the core projects of the Juncker Commission. Nonetheless, the dark cloud of Brexit looms over any progress. Despite Vice President Drombovskis' claims that the largest EU capital market leaving the EU makes this work even more urgent, the reality is that CMU without the UK is CMU Light.

To avoid this, the EU27 need to act fast. In September/October, the Commission will publish a legislative review of the European supervisory authorities (ESA) regulation. Provided this reform goes beyond the question of localizing ESAs, this could be an important step towards a fully operative CMU, where investors and savers can invest safely and fully informed across borders.

Several points needs to be tackled. Firstly, we need to rethink their purpose: ESA's need to become less regulatory, and more supervisory. Secondly, ESA's need to become less dependent on national contributions, and instead financed by the industry. Finally, operational reform of the three (may be two in the future after Brexit) ESA's is urgently needed to increase efficiencies.

More effective and consistent supervision is essential to eliminate possibilities for regulatory arbitrage between Member States in the way that they supervise financial entities and activities. Tackling regulatory arbitrage is also a key objective in the cross border distribution of investment funds sector. In this regard I welcome the announcement of the Commission to take action, as it is critical that institutional and retail investors have access to attractive cross border investment propositions on competitive and transparent terms.

"A CMU with a workable third country equivalence regime would be even better"

- NEENA GILL

Finally, it is critical that the Commission has made a mental shift in its mid term review and put more focus on sustainable finance. Obviously, a deep re-engineering of the financial system is necessary for investments to become more sustainable and for the system to promote truly sustainable development from an economic, social and environmental perspective. Sustainability criteria need to become mainstream in every financial initiative, whether it comes from the EC, EIB or the ECB.

A CMU which is truly supervised on an EU level, and focusses on long term sustainable objectives will be able to offer EU 27 citizens the best value for money. A CMU with a workable third country equivalence regime would be even better. ●

Review of the operation of the ESAs

Contributors

Andrea Enria

Chairperson, European Banking Authority (EBA)

Moving to the implementation of the Single Rulebook in the EU

The post-crisis international reform context has provided a unique opportunity to introduce a true Single Rulebook for the banking sector in Europe, to which the EBA has contributed with the publication of a very high number of standards, guidelines and reports. The monumental project is close to completion, although important work remains to be accomplished in relation to the November 2016 'banking package' as well as the review of the Basel framework to limit the unjustified variability of risk-weighted assets. Hopefully all the G20 members will cooperate to reach the finish line. With the completion of the regulatory project in sight, we should not rest on our laurels. A harmonised implementation of the common rules is as important as their design, when it comes to ensuring a true and resilient level-playing field in the Single Market. With the introduction of the Single Supervisory Mechanism, overseeing a very large share of the EU banking system, the need for truly common rules has become even more urgent, as it is extremely difficult for a European authority to shape different administrative processes in order to comply with different rules in Member States participating in the Banking Union.

The EBA is aware that in some key areas of implementation of the Single Rulebook its role as central monitoring body should be enhanced. Two examples stand out that directly relate to institutions' loss-absorbing capacity. Firstly, the monitoring of the quality of own funds instruments issued by institutions across the Union. This is the effective loss absorbing capacity as measured by the numerator of regulatory ratios. Secondly, the monitoring of significant risk transfer transactions in securitisation, and the related relief in institutions' risk-weighted asset amounts. The denominator of regulatory ratios is here at stake.

Own funds have been the first area where the EBA has developed a monitoring function. Experience has been built-up in maintaining lists of eligible instruments, assessing issuances' terms and conditions against the text of the law, publishing monitoring and best practice reports as well as non-binding templates. In the area of CET1 instruments, the EBA recently asked EU co-legislators that its powers be reinforced, to introduce an ex-ante mandatory notification requirement to the EBA on new forms of instruments and the power of the EBA to ultimately determine which instruments are eligible. A harmonised interpretation of the own funds instruments' eligibility conditions is essential if a truly comparable extent of loss absorbing capacity is to be maintained across the EU.

In the area of securitisation, the very recent legislative initiative on simple, transparent and standardised securitisation (STS) recognises an important role of the ESAs as monitoring bodies on key aspects of the reform, for instance in relation to issues arising in the determination of compliance with the STS criteria, or in relation to the calculation of capital requirements under the new methods, on the basis of competent authorities' notifications. Most securitisations are structured to allow the originator to achieve a regulatory capital relief. This relief is today granted only if national competent authorities recognize that significant risk transfer (SRT) to third parties has taken place. The EBA has reviewed the national supervisory practices of SRT assessment and found divergent approaches across Member States. While work is currently being done to strengthen and harmonise the SRT framework, it seems natural to envisage reinforced powers of oversight to the EBA as a central hub for SRT assessments in the EU. >>>

>>> More broadly, the EBA welcomes the discussion on enhancing tools for supervisory convergence launched with the Commission's consultation on the review of the ESAs. To this end, the EBA asked that the peer review process on the implementation of common rules and practices be supplemented with focused reviews of practices at specific competent authorities and the EBA's competence to issue opinions be extended to all its areas of action, so as to ensure that the EBA may more effectively and timely act as the guardian of the Single Rulebook and its implementation in the EU. ●

Steven Maijoor

Chair, European Securities and Markets Authority (ESMA)

Building strong financial supervision for Europe

The European Commission is currently reviewing the operations of the three European Supervisory Authorities (ESAs): EIOPA, EBA and ESMA. The review comes at the right time. The financial crisis in 2007 revealed important shortcomings in financial supervision in Europe, which lead to the establishment of the ESAs in 2011. Since then, ESMA has in my view built a strong track-record in its four main areas of activity.

The review allows to take stock of ESMA's achievements in completing the single rulebook for EU financial markets, direct supervision of specific financial entities, ensuring consistent application of Union law and in assessing risks to investors, markets and financial stability. In addition, the review allows reflecting on the consequences of the UK decision to withdraw from the EU.

In line with the objectives of the Capital Markets Union (CMU), that aims to further the EU internal market for financial services, the review should lead to more efficient tackling of barriers within the EU as well as reduction of risks related to cross-border activities.

Divergent national practices regarding the implementation and enforcement of EU rules can in certain instances work against the uniformity of the single rulebook, act as market barriers and may lead to arbitrage risks. Through its supervisory convergence work, ESMA promotes cooperation, coordination and consistent application of Union law by, for instance, issuing recommendations, Q&As, and guidelines, which further detail and clarify the application of existing rules. In light of the CMU, it is key that this supervisory convergence work continues to ensure a well-functioning internal market for financial services.

ESMA is the single supervisor for Credit Rating Agencies (CRAs) and Trade Repositories (TRs) in the EU. Based on ESMA's experience, more centralised supervision of certain financial entities and activities could lead to the reduction of risks related to market participants with extensive cross-border activities, to the pooling of expertise and creating benefits of scale in supervision.

In relation to third country entities, ESMA welcomes the European Commission's proposal regarding the enhanced requirements for the recognition of third country central counterparties (CCPs), which strengthens the third country CCP regime. ESMA believes that strengthening the implementation and monitoring of the equivalence decisions on third country regimes by providing the ability to the Commission to set specific conditions, and regular monitoring of the relevant third country regulatory and supervisory framework by ESMA, as suggested in the proposal, represents a significant improvement.

Depending on the risks posed by third country entities, it is important to have the possibility of supervision at EU level, to ensure efficient and effective supervision >>>

>>> and meeting the objectives of investor protection and stable EU financial markets. This is especially relevant in the context of the UK's withdrawal from the EU, whereby the biggest EU financial market will move outside the EU.

ESMA has asked the European Commission to consider similar proposals like the one for CCPs for other market infrastructures and key market players. In line with our response to the public consultation on the operations of the ESAs, this should include enhanced third country regimes, including the possibility of direct supervision, for credit rating agencies, trade repositories, benchmarks, and possibly trading venues, and data providers.
Effective convergence work requires having the right tools at hand. The current set of instruments at our disposal have proven to be useful tools in achieving financial stability, orderly markets and investor protection. At the same time, it will be key to enhance the existing toolbox to address continuing and additional future challenges. This is especially relevant regarding the role of peer reviews, access to information on national supervisory practices, the use of the Breach of Union Law procedure, and potential additional convergence instruments regarding the authorisation of certain market participants.

ESMA is committed to support any actions resulting from this consultation with the aim of building a stronger European supervisory architecture. ●

Gabriel Bernardino

Chairman, European Insurance and Occupational Pensions Authority (EIOPA)

Building a European supervisory culture: EIOPA's role

Since its establishment in 2011, the regulation and governance structure have enabled the European Insurance and Occupational Pensions Authority (EIOPA) to fulfill its regulatory mandate, in particular the implementation of Solvency II. Now, however, as EIOPA shifts from regulation to supervision, the aim is to support concrete improvements in the quality and consistency of supervision across the European Union and to support the development of a truly European supervisory culture.
Overall, to ensure sound and effective supervision of the insurance and pensions sectors, EIOPA strongly believes in a holistic and integrated approach towards European prudential and conduct of business supervision.

There is a clear scope for further progress on supervisory convergence to be made and this requires refinements to EIOPA's regulation. The consultation on the operations of the European Supervisory Authorities provides an apt moment to reflect on ways to strengthen supervisory convergence to further enhance consumer protection and stability of the internal market.

The implementation of Solvency II and the growing number of cross-border cases and failures have given a new urgency for the need of achieving supervisory convergence. Therefore, the ability to passport services should imply sound supervision throughout the European Union. Only strong European responses are able to counter negative developments and to provide the consumer with additional safeguards. This means, EIOPA's regulation should be strengthened with a mandate to act more intrusively when it detects risks of cross-border failures. In order to reinforce EIOPA's capacity to deliver fully its mandate, it would also be important to make clear reference in the legislation to supervisory tools that are already in development. This includes for instance the handbook of supervisory practices, the platforms on cross-border business, the >>>

>>> European Union-wide thematic reviews and EIOPA's own assessment of national supervisory practices. In particular, where no colleges of supervisors exist, a framework for risk-based cooperation in on-going supervision is lacking.

Concerning internal models, to improve consistency and to enhance supervisory convergence, EIOPA staff should be able to carry out own initiative work and deliver independent, and non-binding recommendations to the National Competent Authorities (NCAs). This would require EIOPA having access to all relevant information on internal models and a reinforcement of the human resources currently available.

Supervisory independence is another area where EIOPA's role should be strengthened, notably with regard to conflict of interest. These fundamental supervisory principles have gained even more relevance under Solvency II, due to the degree of supervisory judgement necessary in the application of a risk-based regime. It is fundamental that national supervisors are operationally independent, and that they are accountable for the performance of their functions and powers. The operational independence, transparency, and accountability of national supervisors therefore need to be enforced and there should be a clear mandate for EIOPA to assess the compliance with a strong European framework.

Regarding third countries, apart from regulatory reviews, an effective control of the application of equivalence decisions should be considered. This has to be underpinned by technical analysis in the context of a framework for agile monitoring. Going forward, a comprehensive equivalence assessment should include the initial assessment of a third country regulatory and supervisory framework, the follow-up assessment that the frameworks are being implemented as expected, and the monitoring of upcoming changes in the country's regulatory and supervisory framework. To fulfil this role, EIOPA should have full access to relevant information from the third country concerned.

The financial crisis has shown that swift decision by supervisors is of crucial importance. Therefore, through delegation of functions currently assigned to the Board of Supervisors EIOPA should get the required operational capacity to take immediate and effective decisions on threats to European policyholders and the orderly functioning of financial markets.

Since its establishment, EIOPA has fostered more consistent regulation and a higher level of supervision across the European Union. EIOPA remains fully committed to continue building a strong European supervisory culture and by that ensuring better protection of consumers and better supporting the stability of the financial markets. ●

Markus Ferber

MEP, First Vice-Chair of the Economic and Monetary Affairs Committee, European Parliament

Supervisory convergence, proportionality and the single rulebook

The Banking Union and the European System of Financial Supervision strive to avoid regulatory arbitrage and achieve the same regulatory outcomes across the European Union. The very idea of the Single Rulebook is that the same set of rules apply no matter where in the Single Market you chose to set up camp and to do business. >>>

>>> While the very idea of the Single Rulebook sounds attractive and befitting for the Economic and Monetary Union, it has come under scrutiny and debate recently. Many smaller market participants that are only active in their home region keep moaning under the burdens regulatory and supervisory convergence puts upon them.

Rules that have originally been designed to reign in globally systemically important banks are crudely applied to even the smallest of regional institutions. European supervisors are conducting excessive data collection exercises such as AnaCredit ramping up compliance budgets that are already under distress in time of tight regulation and squeezed margins due to an ultra-low-interest environment.

Against this backdrop, the question arises if the Single Rulebook must really apply to each and every single institution across the Single Market and if the goal of avoiding regulatory arbitrage and achieving the highest possible degree of consumer protection cannot be achieved in any other way than copy and pasting the same set of rules for all institutions. Even the European Commission, once a staunch proponent of the virtues of the Single Rulebook and an "one-size-fits-all" supervisory approach, has started to reconsider.

In its proposal for the review of the credit requirements directive and regulation that are at the very heart of EU banking legislation, the Commission proposes a lighter regime for banks below a certain balance sheet thresholds in order to free them from excessive reporting and compliance requirements. This newly developed sense for proportionality is arguably a very welcome change and might even mark a sort of paradigm shift.

However, while certainly a massive improvement in the way of thinking, the focus on size alone is still somewhat flawed. True proportionality means looking into the specifics - even if that might not be the most convenient approach for supervisory authorities who arguably have an easier time if only a single set of rules has to be applied across the board.

After all, it is still very much conceivable to have institutions that are small, internationally connected and conduct very risky business. At the same time - especially in larger Member States - there are institutions with a very simple, regionally focussed large-volume business that results in a substantial balance sheet. Both cases illustrate that a focus on size alone will not do the trick if ones wants to determine the necessary level of regulation and supervision.

In light of those practical difficulties in determining the right set of parameters, what could a sensible and proportionate regime for less significant institutions look like? I believe if one would look at factors such as the degree of regional activity, the level and stability of retail and SME deposits, the degree of foreign exposure and the degree of trading activity one could obtain a very good sense of what level of regulation and supervision is needed for a specific institution.

For those institutions that are eventually deemed to be of less significance in accordance with the above-mentioned criteria it would be entirely appropriate to have national supervisory authorities to do the heavy lifting - as long as a common understanding of the desired outcome of EU banking supervision is reached.

Entities on the other hand that are of significant systemically importance, engage in riskier business models and are engaged in significant amounts of cross-border activities should expect to receive a more intense level of supervision such as provided through the SSM. ●

STRENGTENING THE FINANCING OF THE EU ECONOMY

Content

Issues at stake

Diversifying and enhancing the financing of businesses and infrastructure projects is essential for ensuring the growth and resilience of the EU economy. This is the main objective of the CMU, which is progressively being rolled out. The development of EU securities markets and of longer term investment in sustainable projects and SMEs are indeed some key challenges that are being addressed in the context of the CMU, together with the growth of smaller domestic capital markets and the expansion of fund cross-border distribution.

Prudential measures have also been adopted to improve the resilience of banks and insurance companies but these rules still need fine-tuning in order to ensure that long-term investment and credit attribution to the economy are not hindered and that the level playing field with non-EU players is preserved.

Developing asset management

Contributors

Gerben Everts

Member of the Executive Board,
Dutch Authority for the Financial Markets (AFM)

Increasing cross-border distribution while maintaining investor protection

A strong, robust and future proof CMU can only exist when industry, policy makers and regulators get their act together. A strong EU asset management industry will be the engine for future growth and prosperity in Europe.

Asset management is a key player in mobilising retail and professional capital into the economy. Cross-border distribution of investment funds plays an important role in creating a CMU which strengthens Europe's economy and that of each individual Member State (MS). It allows funds to grow, allocate capital efficiently across the EU, and compete within (inter)national markets to deliver better value and greater innovation. However, the internal market can only become succesful if the interests of investors are sufficiently adressed. This is a shared responsibility of policy makers, regulators and the industry itself.

What could contribute to a more efficient cross-border distribution process without weakening investor protection is on the one hand, to prevent cross-border distribution of funds being unduly hampered due to unnecessary home/host regulation and regulatory fees. Where additional requirements in respect of marketing to retail investors could be appropriate, it seems less fit to impose gold-plating for professional investors. It would be good to explore initiatives that could increase cross-border distribution, e.g. to explore if ESMA could play a central role, for instance by keeping a single record of all cross-border distributions in the EU.

At the same time, it is essential to increase supervisory convergence by national competent authorities (NCAs) as this will ensure EU wide supervision to be sound and effective. Without 'supervising' how NCAs apply and implement the rules, it is uncertain whether all NCAs apply the same standards, a real level-playing field and sustainable EU regulatory approach is secured and whether passporting can be continued in the long run. How can an NCA, subject to sub-optimal peer-pressure and an EU supervisory structure without effective tools to see to it that agreed upon practices are collectively adhered to, resist the temptation of opportunism? Increasing supervisory convergence will prevent regulatory arbitrage or a race to the bottom between MS.

Post-Brexit, the functioning and sustainability of the EU regulatory and supervisory structures will be tested. The application of the EU passporting regime is not necessarily without serious drawbacks and can easily be subjected to public criticism and a full stop. Therefore, we pro-actively need to implement appropriate risk-mitigation against opportunism and regulatory arbitrage before it is too late. In my view, the two years of negotiation with the UK provides excellent timing to follow-up on Lamfalussy's structure and de Larossiere's establishment of the ESA's in order to further strengthen EU's regulatory structure. The current structure leaves too much room for the build up of uncontrolled risks. Only with a strong and sustainable EU regulatory structure, the CMU can really be the engine for growth and prosperity for the EU. ●

Jon Griffin

Managing Director and
Chief Executive Officer,
JPMorgan Asset Management Europe

Don't let Brexit distract from the Capital Markets Union for investment funds

The European Commission has done commendable work over the past two years in the asset management arena. As part of the Capital Markets Union agenda, the Commission has launched a series of consultations that have identified barriers to achieving a true single market for investment funds. We understand that the Commission is now planning further work to help address some of these barriers.

Many of the barriers to selling funds across borders won't be dealt with through EU legislation. As long as rules for marketing investment funds remain largely a national competence, and not in the remit of EU legislation, the single market will remain somewhat constrained in the asset management arena. 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 hope legislators see the benefits of such an approach. Marketing barriers disadvantage not just fund managers who find it difficult and costly to access certain markets, but more importantly, investors lose out on investment options. Marketing barriers set at the national level are also holding back the EU market as a whole. National silos in Europe are hindering the scalability of funds in Europe.

In recent months we have seen a great deal of focus on delegation and outsourcing rules in the context of Brexit. ESMA's work has, quite rightly, focussed on ensuring that EU Member States require that firms have sufficient substance within management companies when it comes to risk management and compliance. If this work were to lead to new restrictions on the ability of investment management companies to delegate certain activities like portfolio management to non-EU jurisdictions, this would be irresponsible.

Delegation, under strict controls and supervisory agreements, allows investors to enjoy both the safety and soundness of a robust set of EU rules (UCITS/ AIFMD) and access to global markets/investments. This in turn also attracts more investment into Europe.

Brexit will be disruptive to markets in a number of ways – Europe needs to keep moving forward with CMU now more than ever. Therefore when it comes to asset management, let's keep our eye on the ball. Let's continue to move forward with tackling barriers to cross-border marketing and distribution and achieve a true single market and the ensuing larger capital pools that benefit both investors across Europe and the competitiveness of the region. Likewise, when it comes to Brexit, let's ensure that as firms adapt their business models, they are not cutting corners.

However, we cannot let Brexit be a threat to the safe and open-model framework that is UCITS, and risk threatening its success as the global gold standard for retail investment funds. ●

Tom Ahern

Corporate Trust EMEA Regional Head,
BNY Mellon

The mid market funding gap evolution

As banks continue to retreat from the European lending market, a significant funding gap continues to provide challenges across the region. A traditional source of finance has essentially dried up for many corporates and is being felt acutely across the region, especially in the mid-market sector (firms with annual revenues ranging from $10m to $75m to EBITDA).

The mid-market is hugely significant from a European economic context, given their associated funding needs. Mid-market firms are responsible for generating 33% of private sector revenue across Germany, France, Italy and the UK, and contribute a combined total of c. €1.1 trillion to the GDP of these four economies.

> *"CMU has a key role in shaping alternative and innovative funding sources for the mid-market."*
>
> - TOM AHERN

Alternative sources of funding continue to emerge, with various options being pursued within Europe. There has been a marked increase in activity in the high yield bond market. Securitisations in the form of Collateralised Loan Obligations continue to gain pace on a year over year basis. However, these products do not necessarily meet the needs of mid-market firms. Equally, the rating requirements, large facility sizes and liquidity constraints associated with securitisations can be prohibitive for the mid-market sector.

Given the bespoke and specific funding needs of the mid-market >>>

>>> sector, the primary source of funding is emerging through the private market in the form of alternative credit. Structures are now being arranged by asset managers and institutional investors. Private placements, the establishment of direct lending funds and tailored managed accounts are providing viable forms of credit to the mid-market.

Private placements accounted for c. €45b in issuance volumes in Europe in 2015, an increase from €33b in 2014. Equally, 2016 numbers are expected to eclipse that significantly. Investor demand is driven by an enhanced yield, and predictable cashflows through a fixed rate coupon. Private placements meet the needs of pension funds and insurance companies with long term liability commitments.

Direct lending has seen significant growth in recent years. The number of direct lending transactions increased from c. 20 per quarter in 2012 to c. 70 per quarter in 2016 demonstrating increased interest as investors search for ways to boost their yield. Another advantage of senior loans investment strategies is the increased recovery protection versus a similar investment in bonds. Transaction sizes are also increasing, with funds raised in Europe accounting for 43% of the global market since 2013. As well as being used to meet refinancing needs, direct lending transactions tend to be used to finance growth capital, meet recapitalisation requirements and to fund M&A activity.

A number of alternative sources of funding are becoming increasingly commonplace across all sectors of the European market, with private debt assets under management increasing from $150b in 2006 to $600b in 2016. The expectation is that this market will continue to grow and evolve, and in doing so, help address the mid-market funding gap in the European Market.

CMU has a key role in shaping alternative and innovative funding sources for the mid-market. We encourage policymakers to use CMU as a pathway to support the funding needs of the mid-market sector. ●

Alfred Lejsek

Deputy Director General
for Financial Markets,
Federal Ministry of Finance, Austria

How can the industry contribute to investor protection?

The current market developments clearly show that retail investors and institutions, dedicated to manage small asset portfolios, are increasingly outsourcing their asset management. In addition, public investors are obliged to improve their risk management and therefore subcontract asset management to professionals. At the same time, banks are compelled to change their traditional core business model of granting loans and taking deposits, mostly driven by higher capital requirements, lower profitability or due to consumer pressure asking for new and innovative products. "Search for yield" and "misselling" are keywords directly connected with inherited risks. In such an environment the goal of the Capital Market Union is to complement the traditional banking business model and to provide new types of financial instruments, thereby boosting the financial capacity for the real economy. This will lead to a broader spectrum of financial opportunities which are connected to asset management in various ways. Asset management in that sense comprises a broad range of different instruments including covered bonds, UCITS, AIF, ETF, Private Equity as well as portfolio management for life insurance and pension funds.

New product segments, which should be offered across the border, will make new forms of an "indirect" investor protection necessary. Generally investors should act in a responsible way having knowledge about the product and the risks inherited. Investors should be aware that higher yields usually come along with higher risks. Therefore, the general product information available is not the only crucial factor for a good investor relationship. Financial knowledge as well as the ability to perceive whether the financial product satisfies the investors' needs are important criteria. In addition, it must be ensured that the investment fulfils the desired investment strategy.

"It should be the industry´s task to invest increasingly in financial literacy."

- ALFRED LEJSEK

Financial Literacy is the key. Generally it is a subject of public interest and also many central banks have identified it as one of their key goals. But public sector´s resources are limited. At this point the industry has to step in: It should be the industry´s task to invest increasingly in financial literacy. This could be achieved by co-operating with universities and schools, but also, as an example, by organizing informative meetings with potential investors. This task should not be limited to distributive channels but has to be addressed by product designers and asset managers as well. Offering a broad spectrum of profound financial education and having a good information policy will help investors to become well informed and to be more responsible for their investment decisions.

Therefore, investment in financial literacy and education undertakes the function of an indirect investor protection. It will help to prevent future losses for investors and, to be relevant for the industry, reduce the risk of legal proceedings. By avoiding large scale misselling financial stability risks will also diminish so that financial literacy can be seen as an investment in stability and – last but not least – in growth. ●

Joe V. Bannister

Chairman, Malta Financial Services Authority (MFSA)

Marianne Scicluna

Director General, Malta Financial Services Authority (MFSA)

Asset management contribution to the Capital Markets Union

The European Union's [EU] economic agenda is to achieve sustainable growth and boosting the economies of Member States [MS]. The Investment Plan for Europe focuses on boosting investments to create jobs and growth by making smarter use of new and existing financial resources, removing obstacles to investment and providing visibility and technical assistance to investment projects.

"An ELTIF and the AIFM managing the ELTIF must both be established in a Member State."

- JOE V. BANNISTER & MARIANNE SCICLUNA

Diversifying corporate financing and decreasing dependency on bank loans lies at the centre of the EU's Capital Markets Union [CMU] project. The projects are seen as a boost to the asset management industry as bank lending particularly to SME's has decreased significantly in recent years.

Sustainable growth is the key driver behind the European long-term investment fund (ELTIF). Asset managers can play a key role in promoting ELTIFs. The aim of the ELTIF is to increase the pool of capital available for long-term investment in particular for infrastructure projects, small and medium sized enterprises, research and development and education. The Regulations prescribe that an ELTIF must invest at least 70% of its assets in "eligible investment assets" and up to 30% in assets similar to UCITS fund to preserve liquidity.

The Regulations define a real asset as any asset that has value due to its substance and properties and may provide returns, including infrastructure and other assets that give rise to economic or social benefits. Real assets should yield a predictable cash flow, and the recitals to the Regulations include examples such as energy, transport and communication infrastructure, as well as education, health, welfare support and industrial facilities.

An ELTIF is an AIF and therefore must be managed by an authorised AIFM (each as defined under the Alternative Investment Fund Managers Directive (Directive 2011/61/EU)) that is authorised to manage AIFs that follow investment strategies of the type covered by the ELTIF regime. An ELTIF and the AIFM managing the ELTIF must both be established in a Member State. In contrast to the rules under AIFMD, a third-country AIFM may not manage an ELTIF. An ELTIF can be internally managed, but a self-managed ELTIF must also be authorised as an AIFM.

An ELTIF must be closed-ended and must specify the date on which its term will come to an end. The term may be temporarily extended. While no fixed minimum is prescribed, the term of the ELTIF must be long enough to cover the life cycle of each of its assets and be consistent with the long-term nature of the ELTIF.

"Sustainable growth is the key driver behind the European long-term investment fund (ELTIF)."

- JOE V. BANNISTER & MARIANNE SCICLUNA

An ELTIF can marketed both to professional investors and retail investors under the marketing passport available to EU AIFs under AIFMD. An ELTIF may be appealing for investors aiming to achieve a steady flow of income and long-term returns within a well-regulated fund product such as pension funds and insurers who will benefit from better capital treatment than other fund products, as type I equities under Solvency II.

However, unlike AIFMD, when an ELTIF is marketed to retail investors it must comply with additional requirements. Primarily the AIFM must establish facilities in each Member State where the ELTIF proposes to market for making subscriptions, making payments to investors and repurchasing or redeeming units/shares. The AIFM must be authorised to provide investment advice to retail clients in accordance with MiFID. The AIFM must provide the retail investor with "appropriate investment advice" when marketing the ELTIF.

The cross-border activities of ELTIFs is important for the success of the CMU. However, the about considerations create a limitation for their success as the costs to the AFIMD will be high. The European Commission is required to review the implementation of the ELTIF regime no later than June 2019. ●

Natasha Cazenave

Deputy Head of the Policy and International Affairs Directorate, Autorité des Marchés Financiers (AMF)

Investment fund cross-border distribution: what's needed is a solid framework to foster investor confidence

The Capital Market Union launched by the European Commission aims at developing a more diversified financial system to finance the economy. The asset management industry has a key role to play to meet that goal and contribute to a genuine single capital market.

The European directives already provide for passports allowing managers to develop their activities throughout the Union via a simple notification procedure, which is a remarkable success. While the existing framework is robust, the AMF has identified targeted areas where it could be further improved.

The adoption of a harmonized definition of what constitutes marketing for both UCITS and AIFs for instance, would facilitate their cross border distribution by clarifying to market participants the activities that trigger the application of marketing requirements.

The promotion of European principles for the review of marketing materials would foster more convergence among national authorities and hence also facilitate cross border distribution. Managers need to adapt marketing materials to target investors for commercial purposes. It is vitally important to subject these materials to the supervision of the host authorities, which are best placed for that review considering their knowledge of local cultural norms and distribution networks. Common principles could encompass ensuring risks and advantages are presented in a balanced way as well as a setting a maximum timeframe for authorities to review such materials.

"Harmonized definition of what constitutes marketing"

- NATASHA CAZENAVE

While certain limits to cross-border investment remain as a result of the architecture of national distribution networks, cultural savings habits and fiscal rules, online distribution can help change behaviors and allow a wider diffusion of investment funds. Developing a single set of rules for the various actors offering innovative solutions could be a first step.

Cross border distribution will only be a success if there is sufficient investor confidence in the level of protection of the EU financial system to invest in foreign products. Powers of national authorities to intervene promptly and effectively in response to actions which cause damage to the local investors could be strengthened.

We believe these practical proposals can help meet the Commission's aim to promote a dynamic cross border distribution framework and contribute to the development of the EU asset management sector. ●

Dennis Gepp

Senior Vice President, Managing Director and Chief Investment Officer, Cash, Federated Investors LLP

Investors matter: EU focus must be to protect EU investors

I can imagine it can be quite difficult even for experienced politicians and law-makers to take a step back from their work and objectively assess what has truly been the impact on European markets, investors, and citizens of the regulations they have passed and compromises they have reached. Doing just that formed the cornerstone of the Capital Markets Union originally proposed by Commissioner Hill and now carried forward by Commissioner Dombrovskis. However, for the exercise to have any real meaning, the focus needs to be on investors. Unfortunately up to now I fear the requirements of investors have been far too often set-aside whilst politicians claim Pyric victories or certain Member States settle for arbitrariness instead of sound reason and principle.

"Preserving a sound and robust future for European Investors and the European Investment Industry should not to be too hard."

- DENNIS GEPP

Is there room for scaling back on implemented reform? Without question, yes. Will it happen? Who knows? This once dominant project in the EU has, and must, take a back seat to the negotiations on Brexit. My personal views as a UK citizens aside, the fact of the matter is that the UK has Brexited, and unless there is a recanting, attention must be focused on EU investors (which today, let us remember, includes all UK investors). Exit bills and terms of political surrender may be debated, but it will be the strongest politicians who are able to set ego aside and remember that the deals cut will matter greatly to all EU investors. >>>

>>> Will all citizens have access to the best portfolio managers? Will those managers be able to manage their portfolios in the most efficient manner? Will arbitrary rules lead to further increased costs in distribution and management which will ultimately end up being passed on to investors? Will the only dominant global investment product, UCITS, lose its favoured status in third countries due to the inability to compromise on the simplest of principles?

Preserving a sound and robust future for European Investors and the European Investment Industry should not to be too hard. Financial services should not be a pawn in the larger Brexit game; not when real investors are the ones at risk. I know that large corporations can shuffle the board as needed with employees, or find replacements where necessary. And large member states can look to pick-up the crumbs of the UK financial industry being forced out of the UK. But at what cost?

The focus needs to be on further developing and enhancing the investment universe in Europe, greater transparency, better and simpler disclosure, greater scrutiny on proper distribution and continued efforts for clear and concise regulation which does not make portfolio management impossible.

Let us help all EU investors plan for the future and manage their savings, pensions and futures reasonably and properly. ●

Eric Derobert

Group Head of Communications & Public Affairs, CACEIS

Cross-border distribution's new challenges

Thanks to 20 years of regulation, cross-border distribution of European funds is easier than ever. Nevertheless, hurdles remain that regulators can help reduce. The fund industry is also facing massive change due to MiFID II, which will impact fund distribution's economic model of incentivising financial intermediary sales. Investment managers must therefore find new distribution models, such as selling products directly to the end-investor.

"Asset servicers have the commitment to and capacity for innovation"

- ERIC DEROBERT

Fund promoters and investment managers face the following three challenges:

1. **Establishing a direct relationship with the end-investor.**
   Ideally, the investor should be able to open an account online and rapidly start making transactions. Just a few clicks and no incurred costs - all in full compliance with regulatory restrictions. Cheaper computing power, Fintechs, and technologies such as BlockChain, facilitate such alternative distribution models. Asset servicing companies, like CACEIS, already have 2.0 solutions, and are investing heavily in the innovative solutions of the future.

2. **Anti-money laundering and anti-tax evasion measures now require full transparency on end-investor identity and asset origins, and information on investments must also be declared.**
   At present, promoters and investment managers have few tools to respond to these measures in a simple and cost-effective manner. However, a standardised investor registry which asset managers, transfer agents and other providers could use to register, or verify the registration of, each investor prior to any investment in a European fund would increase efficiency. Such a registry would also facilitate FATCA and AEOI tax reporting.

3. **Funds are required to publish investor information documents covering investment policy, charges and risk exposure etc.**
   The UCITS KIID and PRIIPs KID type documents, are an administrative burden, and their production, updating and dissemination costs can impact fund performance. Here too, the entire industry would benefit from standardised information requirements and common registry.

Today, barriers to efficient cross-border distribution remain despite the progress regulation so far has enabled. Technology can enable the necessary efficiency in the right regulatory environment, by facilitating international investor on-boarding, and allowing standardisation of, and a central repository for, investor and fund information.

Asset servicing companies have the commitment to and capacity for innovation to develop solutions to these three challenges. And by combining our Big Data analysis capabilities and vast data lakes, we will remain a key partner for the investment industry going forward. ●

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Sustainable finance challenges

Contributors

Daniel Calleja Crespo

Director General for Environment, European Commission

SDGs and Paris Agreement: financial sector implications and EU priorities

The EU is fully committed to implementing both the UN 2030 Agenda and the Paris Agreement, and both agreements make it clear that finance has a key role to play in delivering on their objectives. There is increasing recognition in the EU of the need for a deep re-engineering of the financial system in order to move the economy onto a truly sustainable path[1].

A few figures help to understand why: the worldwide investment needs to achieve the Sustainable Development Goals (SDGs) and COP21 targets have been estimated to some US$ 90 trillion during the period 2015-2030, equivalent to US$ 6 trillion per year[2]. While public finance plays an important role in transitioning towards sustainability, it will not be sufficient. Mobilising and orienting private capital towards sustainable investments is crucial for responding to these needs – this is the first imperative of sustainable finance.

The SDGs and the Paris Agreement both constitute frameworks for shifting financial flows. These global commitments send a strong signal that sustainable investments will be further encouraged by policy-makers worldwide, while the regulatory pressures and obstacles already faced by unsustainable investments are likely to increase substantially in the near future.

The second imperative of sustainable finance is therefore to integrate sustainability considerations into mainstream decision-making in the financial sector. This is necessary not only for delivering on the SDGs, but also for mitigating systemic risk and ensuring the stability of the financial system itself.

Given the scale and the systemic nature of environmental and other sustainability challenges, the European Commission has established a High-Level Expert Group (HLEG) to give recommendations on a comprehensive and overarching EU strategy on sustainable finance. The early recommendations of the HLEG were issued in July[3], and the European Commission is already moving forward on issues such as the integration of sustainability considerations in disclosure requirements, fiduciary duty and corporate governance, but also in rating methodologies, benchmarks and supervisory processes. Going forward, the European Commission has committed to follow-up in early 2018 on the final recommendations of the HLEG on an EU sustainable finance strategy (due in December 2017).

While the Paris Agreement and the SDGs differ in scope, there are some overlaps[4] as well as clear synergies between climate goals and other SDGs[5]. The core deliverable of the Paris agreement is the energy transition, which clearly points to investments in specific sectors, such as renewables, energy efficiency and transport. The financial sector can therefore develop a common understanding around the Paris agreement, in order to contribute to its implementation.

The SDGs are far broader and articulating their implications in terms of investments may seem more challenging. Nevertheless, policy makers are starting to propose solutions that encourage investors to shift support to sustainable projects and companies. >>>

>>> At EU level, the 2015 Circular Economy Package is a crucial contribution to achieving the SDGs, shaping investment opportunities across all the phases of the economic activity from the extraction to eco-design, production, consumption, repair, remanufacturing and recycling. More specifically EU regulation in the water and wastewater sectors have contributed to sustainable investments and green jobs, while air pollution policy has encouraged technological improvements with measurable benefits to human health. Such sector-specific measures are also important drivers in mobilising and shifting private capital towards sustainability objectives. ●

1. Capital Markets Union Mid-Term Review, p. 9
2. http://newclimateeconomy.report/2016/wp-content/uploads/sites/4/2014/08/NCE_2016Report.pdf
3. http://ec.europa.eu/info/publications/170713-sustainable-finance-report_en
4. Cf. SDG 13 on climate action and 7 on affordable and clean energy.
5. This is particular true for goals 14 and 15 (on life below water and on land) but is also valid for SDGs 11 (sustainable cities and communities), 12 (responsible consumption and production), and 6 (on access to clean water). More broadly, climate change threatens healthy ecosystems, which are crucial for supporting societies and economies and delivering on all SDGs.

Alain Godard

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Lakshmi Shyam-Sunder

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GEMs – helping to mobilize private sector investment in emerging markets

The UN 2030 Sustainable Development Goals and the Paris Agreement on climate change represent global challenges to which Multilateral Development Banks (MDBs) and Development Finance Institutions (DFIs) are expected to respond in a substantial way over the coming years. A successful outcome will require a significant enhancement in existing development financial flows and the full mobilization of all development partners, from public authorities to the private sector.

Similarly, recent G20 initiatives like the Action Plan for MDB Balance Sheet Optimisation or the Infrastructure Action Plan have highlighted the need for MDBs to partner, find new ways of leveraging the strength of their balance sheets, and act as a primary catalytic force in emerging markets, working alongside private sector resources in new ways.

It has become evident that the financing resources needed to meet global development goals will require the >>>

>>> mobilisation of private sector capital to complement and leverage the MDBs and DFIs contribution. MDB's capacity to crowd-in private investors, provide technical assistance, share country knowledge and relationship with local Governments will be crucial.

However, private sector investment in emerging markets and the developing world is typically hampered by uncertainty and misperceptions of the associated risks. The availability and quality of relevant data can be problematic and impact private sector actors' capacity to infer risks and determine their investment strategies. MDBs can help to address these concerns and provide support that could stimulate greater private sector investment in those economies. The Global Emerging Markets Database (GEMs) could be an important instrument in this regard.

GEMs combines the credit risk experiences of a consortium of 15 MDBs and DFIs, covering almost 30 years of their own investments in a comprehensive sample of emerging markets and developing countries. It was established by the EIB and the IFC in 2009. The database collects, on an anonymized basis, risk data (default and recovery rates) on loans to sovereigns, public entities and the private sector. By pooling the data in a consistent manner, the database derives risk parameters that can be used by members when taking investment decisions in emerging markets and developing countries.

Whilst the primary objective of the Consortium is to pool data and to derive the risk parameters used in supporting investment and pricing decisions, and estimating capital requirements, GEMs has been used as a platform for cooperation and a discussion forum for different topics that impact both MDBs and DFIs.

At a time when MDBs are increasingly asked to partner and contribute more to world economic growth and the fight against poverty, GEMs represents a concrete example of how institutions can work together to achieve collectively more than they can alone. The credit experience of a single MDB in an emerging market is probably not enough on its own to support the future investment decisions of new investors in that market. But taken together, the credit experiences of several development institutions present in a given market represent a solid basis for investors to make better informed investment decisions in emerging markets.

The GEMs consortium is currently considering making its information available to the wider investment community, including private sector and standard setting bodies, recognizing that the engagement of all players in these markets is critical to achieving real progress. The list of recommendations to the G20 from the B20 initiative (representing the entire G20 business community) includes the point that MDBs should share their comprehensive pooled data on credit performance, currently only available through GEMs. ●

Frédéric Samama

Deputy Global Head
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Fighting against climate change – the ongoing mobilization of the financial sector

With increasingly visible effects on the planet, climate change is on the way of becoming one of largest challenges to humanity in the upcoming years. In a collaborative, bottom-up effort, governments from countries around the world gathered in Paris in December 2015 to sign the Paris Agreement, thereby pledging to try to maintain global warming "well below 2°C" above pre-industrial levels.

But ambitious objectives entail substantial financing needs: US$90 trillion of investments are required over the next 15 years to achieve the sustainable development and climate objectives[1].

Fueling the real economy, financial actors have a key role to play in financing the energy transition, and while governments have been active, asset owners have been too. The unprecedented mobilization of policymakers at the COP21 was accompanied by the emerging of a new, transversal, global force: that of asset owners (pension funds, SWFs, insurance companies, etc.). As asset owners already interested in climate change represent $100tn of AUM[2], a 0.1% shift from being interested towards taking concrete actions would mean a $100bn reallocation of capital or debt towards a low carbon economy.

Why has the topic suddenly become of interest to asset owners? First, there is a growing consensus that long-term investors are facing market failure regarding climate change as climate change-related risks aren't priced in short-term markets. Second, the rise of climate financial innovations have facilitated access to climate finance and favored early adoption of responsible behaviors (e.g. low-carbon indices, green bonds, etc.). Third, there has been a move towards enhanced knowledge sharing and standard setting through the establishment of market initiatives and key coalitions (e.g. the Portfolio Decarbonization Coalition which gathers 29 investors representing over $600bn in decarbonization commitments[3]). Fourth, governments are increasingly realizing the role that the financial sector can play in the energy transition, and have been implemented a number of key innovative initiatives such as the Article 173 in France to foster both disclosure of and contributions to low-carbon and energy transition-related investments.

With the Article 173, France is an interesting example of how policy makers are now playing with market forces to achieve goals that were until recently only at the Governments levels. Replicating the French initiative on climate change-related risks disclosure at the asset owners level would certainly accelerate the transition and help make green finance mainstream.

In conclusion, the mobilization of the financial community might be one of the essential keys to the fight against climate change. ●

1. See "The Sustainable Infrastructure Imperative: Financing for Better Growth and Development," The New Climate Economy, United Nations, 2016. Available at: http://www.un.org/pga/71/wp-content/uploads/sites/40/2017/02/New-Climate-Economy-Report-2016-Executive-Summary.pdf and http://www.unep.org/newscentre/g20-financial-leaders-commit-exploring-green-finance-options-0
2. See 827 investors representing $100tn backing CDP https://www.cdp.net/en/info/about-us
3. See http://unepfi.org/pdc/ as of July 19, 2017.

Artur Runge-Metzger

Director, Climate strategy, Governance and Emissions from Non-trading Sectors, DG Climate Action, European Commission

The Paris climate deal: is the EU up to the challenge?

The EU ratified the Paris Agreement in 2016, less than a year after the deal was done, making it possible for this UN agreement to enter into force in record time. As yet, 153 countries have committed to implement. Notably, nineteen of the world's major G20 economies have recently signed up to a G-19 Action Plan. In addition, globally numerous sub-national governments, municipalities, and also business have come forward with ambitious commitments to reduce greenhouse gas emissions and to adapt to the adverse effects of climate change.

The EU is leading in the implementation of the Paris Agreement. Already in the run-up to Paris, the first proposal was tabled in order to strengthen the EU's emissions trading system (ETS). Further legislative packages were tabled in June 2016 on the non-ETS sectors, in November 2016 on promoting clean energy for all, and in May 2017 on low emission mobility.

These regulatory packages are underpinned with considerable financial support and new initiatives under the Capital Markets Union creating an enabling environment for business, communities and citizens to actually make the necessary transformative investments. In the EU's energy sector alone, investment needs are estimated to amount to at least €150 bn annually over the 2020-2030 period.

Within the framework of the European Structural and Investment Funds (ESIF) Member States have pledged €38 bn in climate action related project including €17 bn in energy efficiency. Under Horizon 2020, 35% out of €70 bn are earmarked for research, development and demonstration of innovative technologies for clean energy and industrial processes, as well as low emission mobility.

From the revenues of auctioning ETS allowances, €2 bn have been committed for first-of-a-kind large scale demonstration of renewable energy technologies and carbon capture and storage. As a successor, the Innovation and Modernisation Fund will be set up, and will also assist in reducing the carbon footprint of energy-intensive industries.

However, the majority of these funds are planned to be spent in grant support thereby achieving low leverage. In contrast, the European Fund for Strategic Investments (EFSI) mobilizes private financing for energy efficiency and small scale renewables at a greater scale. As of mid-June, approved EFSI projects are expected to raise €43.9 bn for energy out of a total investment of €209.1 bn. The smart financing for smart buildings initiative will support the development of investment platforms and facilitate the deployment of new financing products and reinforced technical assistance.

"With its new and comprehensive financial and regulatory framework the EU and its Member States will deliver on its ambitious 2030 climate and energy targets under the Paris Agreement."

- ARTUR RUNGE-METZGER

At the same time, the EU is scaling up climate finance to help the most vulnerable countries mitigate and adapt to climate change. The European Fund for Sustainable Development with an EU contribution of €4.1 bn is supposed to leverage investments worth €44 bn by 2020. The EU will contribute its fair share to making available $100 bn per year by 2020 to these countries. The EIF was successful in attracting finance from the UN Green Climate Fund for one of its flagships Global Energy Efficiency and Renewable Energy Fund. ●

Stewart James

Managing Director and Deputy Head, Group Public Affairs, HSBC

Sustainable finance, the key to unlocking Europe's low-carbon future

Almost two years after the Paris Agreement, Europe is making progress towards a more sustainable and lower-carbon future. In July, the interim Report of the High Level Group on Sustainable Finance was published, setting out an agenda for Europe to follow. While there is much to support, there is much more still to do to turn recommendations into action. At HSBC, we are focused on the following priorities:

- how to mobilise private finance at scale and speed to drive the transition;
- how to ensure that the financial system can support the low-carbon energy, transport and industrial sectors of the future; and
- how to embed sustainability in the core of financial and non-financial businesses by improving environmental, social and governance performance.

The process of transition is a risk and an opportunity for Europe. On the risk side, the danger is of assets becoming "stranded" - by changing regulation, innovation or consumer choices. On the upside, the transition needed to deliver on Paris provides a huge opportunity both for the financial sector and for the wider economy – to boost efficiency >>>

>>> and competitiveness through new infrastructure, supporting innovation and technology for sustainable growth. Decarbonising private transport is an example of this dynamic in which the switch to hybrid and fully electric vehicles is set to accelerate through a combination of pollution concerns, innovation in the automotive sector, and the provision of a new charging infrastructure to support changing customer behaviour.

While the destination at least is becoming clearer, Europe has choices about the best routes to follow. The report of the High Level Expert Group provides a roadmap, including:

- better classification of green assets, including green bonds – to help investors to allocate capital;
- recognition of the role of sustainability in regulation, including how asset managers discharge their obligations to clients; and
- how to boost Europe's capacity for infrastructure projects as set out the Juncker Plan and in Energy Union – to improve efficiency and resilience.

To get to a sub-two degree pathway as pledged by the Paris Agreement now requires a concerted effort by public and private sectors working together across developed and emerging economies.

We will need:

- better information and transparency – taking on board the recommendations of the FSB Taskforce on Climate-related Financial Disclosure to help the market to price risks more accurately;
- blended finance in which public resources are deployed to share risks for maximum impact – leverage not lending – to crowd in private investors; and
- perhaps most important, the right incentives to drive change.

On the latter, there is now a real discussion on whether and how financial regulation should be used to achieve policy objectives.

At HSBC, we welcome the opportunity to debate how best to remove any barriers in the regulatory framework: to ensure that it is fit for purpose and sustainable. There is also scope for new models of finance. By seizing the opportunity, Europe can improve access to sources of funding to help bridge gaps in the risk capital available to smaller companies and projects, and new, clean technologies, building on proven best practice. We are on a journey and climate change doesn't respect borders! To deliver our shared objectives, Europe must continue to show the vision and the political will to become a world-leader in sustainable finance. ●

Christian Thimann

Head of Regulation, Sustainability and Insurance Foresight, AXA Group and Chairman of the EU High-Level Expert Group on Sustainable Finance

Sustainable finance: what it is and what it means for banks and insurers

Sustainable finance is about two imperatives: the first imperative is to improve the contribution of finance to sustainable and inclusive growth, funding in particular society's long-term needs for innovation and infrastructure, and accelerating the shift to a resource-efficient and low-carbon economy. The second imperative is to strengthen financial stability and asset pricing, notably by improving the assessment and management of long-term material risks and intangible drivers of value creation – including those related to environmental, social and governance (ESG) factors.

In short, sustainable finance means 'better development' and 'better finance' – growth that is sustainable in each of its economic, social and environmental dimensions; and a financial system that is focused on the longer term as well as material ESG factors.

Progress on sustainable finance starts not with finance itself; the first step is to describe the desired economic model of sustainability. The European Union has developed this vision: a low-carbon, resource-efficient and increasingly circular economy characterised by high employment, technological innovation and sustainable growth. The second step is to see how finance needs to change to move the economy towards the vision. This implies adjustments in policy and financial regulation, as well as changes in financial market practices, norms and behaviour. To guide this second step, the European Commission has launched the High-Level Expert Group on Sustainable Finance.

The Group's Interim Report that was published just before the summer outlines key areas where European policy-makers could promote better alignment of financial practices with sustainable policy objectives.

It begins with a vision for a sustainable financial system, key barriers that will need to be addressed to achieve that objective and the critical factors for success.

The Report then provides detailed analysis of ways of integrating sustainability into the EU's regulatory and financial policy framework, covering issues such as disclosure, accounting, fiduciary duty, corporate reporting and benchmarks.

It examines the roles in the financial system of market participants (banks, insurance companies, pension funds and asset managers) and market facilitators (including credit rating agencies and stock exchanges). And it explores measures that can mobilise more capital flows towards sustainability, in terms of both public and private finance. It also addresses the issue of sustainability taxonomies, standards and labels.

The Report highlights a few key areas of adjustment in the regulation of banks, insurance companies, and even accounting rules. For example, while there is broad support for the new prudential rules in banking, the question arises whether in some aspects of long-term lending, project lending and specialised lending, the framework would benefit from adjustments. In insurance, there is broad support for Solvency II, but the question arises whether the framework has an adverse impact on long-term investments and products, and whether pro-cyclicality can be attenuated. In accounting, the question arises whether the focus on current market prices and the volatility that this creates unduly restricts long-term and equity investment of long-term investors.

All these are issues put forward in the Interim Report for stakeholder consultation, through a questionnaire on the European Commission website that can be found through a web search on "questionnaire sustainable finance". Banks, insurers, other financial institutions and market participants, as well as all other interested parties are invited to share their insights and feedback. ●

Alexandra Richers

Managing Director,
DekaBank Deutsche Girozentrale

Paris agreement targets on sustainability – Deka goes ahead!

"DekaBank has in implemented 2014 a sustainability filter for all new investments across all proprietary investments."

- ALEXANDRA RICHERS

As a result of the decisions of the Paris Conference on Climate Change in December 2015 and the agreement on limiting the global temperature increase to a maximum of two degrees Celsius, we attribute particular importance to the issue of climate change in the current business strategy.

Taking sustainability criteria into account in capital investment and in the lending business is not only an expression of our corporate citizenship. Moreover, independent analyses show that the inclusion of criteria related to social and environmental issues and good corporate governance mean that risks are better assessed and thus reduced in investment and financing decisions. In addition to our corporate citizenship, a fiduciary responsibility toward our customers also comes into this. We satisfy this through the use of the exclusion criteria for investment and financing, the comprehensive assessment of the social and environmental quality of issuers, borrowers and real estate as well as the active use of our influence in the companies whose shares or bonds we hold.

As a pioneer among system-relevant banks in Europe and Germany, DekaBank has implemented in 2014 a sustainability filter for all new investments across all proprietary investments. At the core of the filter is a catalogue of exclusion criteria in the fields of environment, armour, human and labour rights as well as corruption. Issuers of securities who violate one or more of these exclusion criteria are excluded from investment. As at 31 Dec 2016, approximately 18.2 billion euros of proprietary investments in securities were managed under application of the proprietary investment filter.

Sustainability criteria are also used in the management of public funds. This is why funds managed by Deka Investment GmbH, as a matter of principle, do not invest in companies which produce anti-personnel landmines and cluster munitions. In addition to the funds, DekaBank offers institutional investors individual investment solutions, in which the respective sustainability-related requirements and criteria are fully taken into account.

The volume of sustainable investments managed by Deka has again significantly increased 2016. Up to around 28.4 billion euros with consideration of social and environmental criteria and criteria aimed at encouraging good corporate governance. This corresponds to a share of over 20 per cent in the total of sustainably managed money in Germany. ●

EUROFI MEMBERS

Green finance and FSB disclosure

Contributors

Jonathan Taylor

Vice President, European Investment Bank (EIB)

A bond for a green planet

Climate change is perhaps the greatest issue facing our species today. If our world is to be saved, it is climate finance that will do so. I am optimistic that we are on the way towards getting the job done.

But climate action isn't cheap. We need massive investment to build the innovative technologies that generate clean power and protect the environment. That makes the green bond market more important than ever. It is already a leading source of capital in the climate finance sphere. Now the market is moving into a new stage that shows a greater maturity and the involvement of powerful new partners.

With the issuance of our first Climate Awareness Bond in July 2007, the European Investment Bank pioneered the green bond market and established its defining feature - namely the ring-fencing of the proceeds, earmarking them for renewable energy and energy efficiency projects.

Since that first bond 10 years ago, the EIB alone has issued more than EUR 19 billion in 11 currencies. The Bank is the largest issuer of green bonds. It's a key part of our massive role in climate finance. The Bank has committed to provide USD 100 billion in new climate lending in the five year period to 2020. The EIB also promised to increase climate action lending to 35% of its operations in developing countries by 2020.

But a big challenge for the green bond market has been the measurement and reporting of impact. Different green bond issuers may calculate and report impact for the same project using different approaches. In some cases they don't report on impact at all. Investors have until recently been short of information about the emissions they have saved through their investment.

The EIB is instrumental in building market transparency to attract issuers and investors. By chairing the Steering Committee of the Green Bond Principles (GBP), a global forum for issuers, banks, and investors with over 100 subscribed parties, we help provide the market with recommendations and guidelines that promote transparency and accountability across the green bond market.

The progress is clear. In the eight years it took to raise the first USD 100 billion in green bonds, the EIB and its multilateral development bank peers provided the bulk of issuance. But it took only a little over a year to raise the second USD 100 billion. Now, with Asian and sovereign issuers entering the market, we expect this growth to continue. We believe cooperation among issuers and investors and harmonisation of definitions and reporting guidelines will further benefit the market. With this in mind we recently launched a cooperative project with Chinese authorities to map out standards in China with those endorsed by the GBP. This is likely to boost investment in Chinese green bonds and to facilitate Chinese investment in green bonds issued elsewhere in the world – a win/win situation.

>>>

>>> That structural shift in the market is evidence of the enormous potential for green bonds to mobilise private capital for climate finance. It also demonstrates the efficacy of policies pursued by governments over the past few years, notably Germany, Britain and China, by putting green finance on the G20 agenda.

We are, however, beginning a long journey. To have built a EUR 200 billion green bonds market is a great achievement. Yet the total fixed-income market is over USD 90 trillion dollars. We must move green bonds from the billions to the trillions.

This requires progress on areas still lacking general consensus, such as reporting metrics, definitions of green projects - what market participants refer to as taxonomies—as well as verifiable standards. We need global guidelines to encourage more reliable allocation and reporting as well as greater consistency and comparability in reported information. We must do this while preserving the market's flexibility. That is how to attract new issuers and to address different market participants' interests and needs. Ultimately it is how we will build a market that can truly save the planet. ●

Michael Leinwand

Chief Investment Officer,
Zurich Group Germany

Disclosure: the necessary but not sufficient step to catalyze green finance

The green bond market has just turned ten years old. Initiated by the EIB's first Climate Awareness Bond issued in July 2007, it has grown into an international success story. With around 2bn USD invested from Australia to Chile, including every EU balance sheet, Zurich is a very experienced player in this market. The green bond markets' success in the next decade will depend on a few factors and serves as a good proxy for sustainable finance:

"Only fixing misleading price signals can unleash the full power of green finance."

- MICHAEL LEINWAND

Green Bond markets – Displaying challenges ahead

Owed to their success so far, demand for green bonds currently outpaces supply. Especially the non-financial corporate sector remains underrepresented in relation to its potential. While growing in transaction volume and diversity of underlying projects, the green bond market will have to maintain its quality – both in financial terms, but especially in regard to the projects' "shades of green", positive environmental impact and, ultimately, reputation. Tools to assess the former and measure the latter are being developed and tested. Pricing remains an area of vivid discourse: Investors expect pricing indifference between green and conventional bonds from the same issuer due to equal credit risks. Issuers cite the lack of pricing benefits as a major deterrent for the additional workload the transparency required for use-of-proceed instruments poses. However, exactly that unprecedented transparency on funded projects and their environmental impact are the green bonds' largest side-benefit: the environmental education for issuers, intermediaries and investors is the foundation that will catalyze future >>>

>>> funding of sustainable projects through a variety of instruments.

Efficient regulatory support

The EU Non-Financial Reporting Directive, the FSB recommendations on disclosure of climate-related risks and the interim recommendations presented by the EC HLEG on sustainable finance are all steps in the right direction. Disclosure of ESG (including climate) risks and opportunities, a common understanding of green taxonomies and measurement tools for both positive and negative impact are fundamental prerequisites for investors and issuers alike. On the supply side, what is required are incentives to bring projects online: targeted and affordable reporting requirements; stable, predictable – and most importantly – fully integrated energy, industry, climate and environmental policies on EU level; tax incentives or technical assistance for firms; targeted public spending; etc.

Looping in the SDGs and Paris Agreement

Most SDG supporting projects can find a home within the use-of-proceeds logic of the green/social/ sustainability bond markets – or adequate instruments in other asset classes. While all points discussed above will be as viable for them as for the green bond market, meeting the targets published under the Paris Agreement (addressing SDG #13) will require action beyond disclosure standards: the number one contribution of policy makers would be to create a level playing field by pricing environmental externalities in an economically viable way. This means setting a carbon price, fixing the ETS, clear transition plans etc. ●

Daniel Calleja Crespo

Director General for Environment, European Commission

The role of green bonds and disclosures in delivering sustainability

A deep rethinking of the financial system is necessary for transitioning to a truly sustainable economy: an innovative, inclusive, circular and low-carbon economy where natural resources are managed sustainably and biodiversity is protected.

The UN 2030 Agenda for Sustainable Development, the Paris agreement and the 2015 Circular Economy package are major milestones for this transition, which will make Europe more competitive and resilient, and create new jobs. They all require financial markets to play a role alongside public finance.

Green bonds are one of the most promising tools for mobilising financial flows. They are aimed at financing investments with an environmental benefit, and differ from conventional bonds in that the proceeds are usually exclusively allocated to the foreseen "green activity".

In recent years, green bond issuance has grown exponentially, reaching US$ 81 billion in 2016, with projections for 2017 in the range of US$ 120-200 billion[1]. Despite these encouraging developments, green bonds still represent less than 1% of total bonds[2], and the focus on climate mitigation could usefully be broadened to other environmental issues.

The European Commission is assessing the need to help further development in this emerging market, as already mentioned in the Capital Markets Union Action Plan. In late 2016, it published an independent "Study on the potential of green bond finance for resource efficient investments"[3], which identifies key bottlenecks and potential measures to overcome them, and assesses the feasibility and expected impacts of setting standards on the size of the market.

The EU High Level Expert Group on Sustainable Finance has also issued early recommendations on standards for green bonds and other asset classes[4]. In order to review and classify existing definitions and taxonomies of green finance across asset classes, but also to assess the potential to include environmental projects beyond climate, the European Commission has launched a study on "Green Finance: Definitions and implications for investments", with results expected in October 2017.

> *"All require financial markets to play a role alongside public finance."*
>
> - DANIEL CALLEJA CRESPO

Another major tool are disclosure requirements which help to integrate sustainability considerations into mainstream financial decision-making. EU law[5] requires large companies to disclose information on the way they operate and manage social and environmental challenges. In June, the Commission adopted guidelines on non-financial reporting[6], with the aim of helping companies disclose high quality, relevant and more comparable ESG (environmental, social and governance-related) information. Investors can now use this information to identify risks and opportunities related to sustainability.

All of these initiatives will play a key role in mobilising the financing needs to the low carbon circular economy of the future. ●

1. Climate Bonds Initiative, "Green Bonds Highlights 2016", https://www.climatebonds.net/green-bonds-highlights-2016
2. http://unepinquiry.org/wp-content/uploads/2016/09/Synthesis_Report_Full_EN.pdf
3. http://ec.europa.eu/environment/enveco/pdf/potential-green-bond.pdf
4. http://ec.europa.eu/info/publications/170713-sustainable-finance-report_en
5. EU Directive 2014/95/EU on disclosure of non-financial and diversity information by large undertakings and groups
6. https://ec.europa.eu/info/publications/170626-non-financial-reporting-guidelines_en

Michel Madelain

Vice Chairman, Moody's Investors Service

Climate-related credit risks: Priority should be given to disclosures

Market participants and policy makers are focusing more on the potential for environmental, social and governance (ESG) factors to affect economic growth and stability. This is particularly true of environmental issues with regards to climate change. This last topic poses unique challenges for analysis due to the long time horizon, as well as the large tail risks from both climate change itself and the associated policies that have the power to shape industries. The investor is faced with multiple physical, political, strategic and technological scenarios that could occur, resulting in very different financial outcomes.

In addition to these challenges, company disclosures on environmental issues are not consistent, transparent and comparable like they are for financial reporting, making it much more difficult to assess meaningfully the associated risks and financial implications involved. In this context, policy makers can achieve the most significant contribution to better informed economic decisions by focusing their efforts on improved disclosures.

This is why Moody's supports and has contributed to the Financial Stability Board's (FSB) efforts to develop voluntary, consistent climate-related financial risk disclosures. While the recommendations of the Taskforce did not receive full endorsement at the recent G20 Summit, more than 100 companies and CEOs, with a combined market cap of about $3.5 trillion, have committed to supporting them. The disclosures are voluntary and constitute positive steps toward accurate identification of climate-related risks. The next step could be for policy makers to promote their further development and adoption, replicating what has already been achieved with international financial reporting standards.

Credit ratings are forward-looking opinions of the relative credit risks of issuers or debt obligations. Moody's seeks to consider ESG factors as part of our holistic analysis of credit risk. It is important to note that our ratings do not assess how environmentally friendly an issuer is; they assess how material environmental factors are to its credit risk. We attempt to incorporate these risks with the most forward-looking view that visibility permits, and with the understanding that we cannot always calibrate the future repercussions of very long-term risks.

"In this context, policy makers can achieve the most significant contribution to better informed economic decisions by focusing their efforts on improved disclosures."

- MICHEL MADELAIN

Recognising the need to articulate better how we think about environmental risk factors, Moody's has, along with a number of other market participants, taken a much more structured and systematic approach since 2015. Our research on carbon transition risk, our environmental risk heat map, and updates to our oil and gas rating methodologies are evidence of this. We are working to increase transparency on the impact ESG issues have on individual issuer ratings – through analytical tools and entity-level research – as it is important to understand how environmental factors could affect a specific asset, brand, manufacturing process or the resilience of cash flow.

While recognizing these initiatives are work in progress, all stakeholders will benefit from better disclosure, creating greater efficiency and accountability in the functioning of financial markets. Policy makers in the EU should therefore focus their efforts on the adoption of transparency standards, disclosure and comparability of information as they did with success in the last two decades for financial reporting. ●

Christian Thimann

Head of Regulation, Sustainability and Insurance Foresight, AXA Group and Vice-Chairman, FSB Taskforce on Climate-Related Financial Disclosures (TCFD)

The FSB Task Force on Climate-related Financial Disclosures: life after Trump

Disclosure about long-term economic, social and environmental risks and opportunities is an essential instrument in steering towards a sustainable economy. A significant challenge with sustainability-related information and metrics is their breadth. They often encompass both economic and ESG criteria, which can be difficult to delineate and measure. The question of whether a given indicator is relevant for economic and investment decisions depends on the type of activities considered. It can vary across sectors, locations and other contexts. Compared with financial information, sustainability metrics may also be harder to summarise in a single indicator.

Another challenge is the time dimension. As sustainability is intrinsically linked to longer-term developments, relevant metrics should be >>>

>>> forward-looking and take account of long-term horizons. Forward-looking information, whether relating to financial or sustainability dimensions, is exposed to the criticism of being insufficiently objective. New types of disclosure may be needed to give sustainability-relevant information, including on long-term risks and opportunities, robustness, comprehensiveness, coherence and comparability. Scenario analysis, laying out a series of alternative business projections along some broadly established trajectories of variables, may be valuable for some themes and sectors (for example, climate change-related disclosures in the energy or extractive sectors).

Many EU firms are global leaders on sustainability-relevant transparency in their respective sectors. Building on this, but also recognising the need for further improvement, in 2014, the EU adopted the Non-Financial Reporting Directive. This directive requires certain large firms (approximately 6,000) to disclose as of 2018 relevant information on environmental and social aspects. In June 2017, the Commission adopted guidelines on non-financial reporting to help firms disclose environmental and social information.

"Many EU firms are global leaders on sustainability-relevant transparency in their respective sectors."

- CHRISTIAN THIMANN

The work of the Task force on Climate-related Financial Disclosures (TCFD), established by the Financial Stability Board (FSB), is a major international development. The TCFD has developed a framework for voluntary disclosures of climate-related financial information, including risks and opportunities, in the annual reports of firms and financial institutions. This climate-specific framework, published in June 2017, recommends disclosures on governance, strategy, risk management and metrics. One of the innovations in the TCFD framework is to propose scenario analysis to provide forward-looking disclosures that are particularly relevant to guide investments, seem both from within firms and by outside investors.

The European Commission's guidelines on non-financial information already reflect the TCFD recommendations and the solutions proposed by other relevant national, EU-based and international frameworks. The political signal by the EU and the "G19" to stick to the Paris Agreement despite the withdrawal of the United States announced by President Trump is very welcome. In the implementation of the TCFD recommendation, the EU will consider that – including vis-à-vis US firms – European firms are not disadvantaged in terms of reporting burden and commercial risks. Moreover, care should be taken to avoid undermining the level playing field.

Financial institutions should also disclose more systematically how they factor sustainability risks and opportunities into their investment and lending strategies. Impact-oriented metrics and other targets will show how also financial institutions contribute to sustainable development. ●

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EU infrastructure and mid-sized enterprise financing prospects

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Unlocking investment

What are the current financing challenges faced by infrastructure projects and SMEs in the different EU Member States?

Economic stability and the implementation of reforms have contributed to the recovery in investment, which has exceeded pre-crisis levels in some Member States. However, further efforts are needed to compensate for the investment gap accumulated since the outbreak of the crisis.

Member States need to step up their efforts to implement the necessary reforms aimed at removing obstacles to investment that were identified in the context of the European Semester. Despite action taken by some Member States, in particular by euro area countries heavily hit by the crisis, progress to address barriers to investment has been overall uneven and more needs to be done. This concerns areas such as insolvency, public procurement, the efficiency and transparency of public administration or sector-specific regulations, as well as the functioning of labour and product markets. In particular, efficient and transparent public administration and effective justice systems are necessary to support economic growth and deliver high quality services for firms and citizens. In some Member States, barriers to investment may also include a high level of taxation and overly complex taxation systems, corruption, weak research and innovation frameworks, as well as difficulties in access to finance, particularly for SMEs.

What is the impact of the existing economic divergence among EU Member States and of the fragilities of the banking sector observed in certain EU countries on the level of investment in both infrastructures and SMEs?

The financial crisis reinforced divergence and fragmentation among Member States, compounded by the unwinding of pre-crisis economic imbalances. The sudden stop in capital flows exposed sustainability and competitiveness gaps that had accumulated over time. In this economic environment, investment contracted sharply, especially in the countries most affected by the crisis.

Despite recent improvements, investment is only gradually recovering in many Member States, and remains below long-term trends. Given the positive role of investment for productivity and growth, continuous low investment levels could inflict long-term damage in terms of perpetuating differences in Member States' economic potential.

In a number of Member States, investment is still held back by legacies inherited from the crisis, as well as by structural weaknesses. Notably, the high level of non-performing loans remains a serious challenge in a number of Member States. High stocks of non-performing loans and operational inefficiencies in combination with a low interest and low growth environment, weigh on banks' profitability, which in turn, weighs on banks' ability to generate or raise new capital in support of new lending. The financing >>>

>>> conditions of firms very much depend on their geographical location. Lending to SMEs was hit hardest in the countries most affected by the crisis, both with tightened lending terms and falling lending volumes. Member States thus need to timely address remaining vulnerabilities in the banking sector to foster investment and facilitate the financing of the European economy.

What is the ambition of the European Investment Plan in this context? How is the situation improving?

The Investment Plan for Europe was presented in November 2014 as an initiative to fight economic weakness lingering from the 2008 financial crisis with the aim to relaunch investment and restore EU competitiveness, thus increasing growth and creating jobs.

It has proven a useful tool for delivering concrete results and encouraging a sustainable increase in investment in Member States: as at 15 June 2017, the European Fund for Strategic Investments (EFSI) has mobilised EUR 209 billion across the 28 Member States, i.e. 66% of the overall objective of EUR 315 billion by mid-2018. This is expected to benefit close to 427,000 SMEs and mid-caps.

Building on EFSI's success, the Commission proposed to extend the duration of the EFSI until end-2020, with an increased target of at least EUR 500 billion of investments. The proposal also addresses the three main shortcomings identified over EFSI's first year of implementation: additionality, geographical concentration and transparency. It should be adopted in the autumn. ●

Carmine Di Noia

Commissioner, Commissione Nazionale per le Società e la Borsa (CONSOB)

The challenges of SME finance: a regulatory perspective

SMEs are a key driver of economic development. However, evidence shows that the creation and the growth of smaller firms in the EU suffer from under-investment. Banks have traditionally nurtured start-ups and other SMEs, but the financial crisis has seriously hampered credit institutions' ability to perform this function, especially in EU peripheral countries.

At the same time, other possible sources of funding have not yet been able to replace banks and to mend the consequences of credit crunches. Among these alternative sources, trading venues dedicated to SMEs play an important role. However, their ability to provide a platform for the initial provision and the subsequent transfer of debt and equity capital for a large number of firms does not seem to have expressed its full potential to date.

While investor protection naturally enhances market efficiency by fostering liquidity and reducing adverse selection, excessive regulatory burdens may at the same time squeeze smaller firms out of the market. The EU regulatory framework does not seem to deliver a satisfactory equilibrium between investor protection and SMEs' needs. The risk is that SME markets might become a safe place for investors just because they are empty.

The EU legislator is meritoriously striving to facilitate SMEs' access to finance, for instance by introducing simplifications for SME Growth Markets. >>>

>>> However, these simplifications are limited. Furthermore, their underlying policy seems to rely on the idea that administrative action can create markets from scratch. An SME-friendly regulatory environment should look different in both respects: the law should add further simplifications, and market participants should have the opportunity to rely on a broader set of optional rules.

By way of example, consideration should be paid to the following simplifications:

- Takeover law should grant listed SMEs the option to opt out of the mandatory bid rule (totally or partially), so as to simplify control change for certain start-ups. Anti-takeover devices should be freely available to SMEs.
- The disclosure threshold for major shareholding should be raised for SMEs. Transparency requirements should not include derivative contracts.
- Corporate governance statements for SMEs should be simplified by eliminating the repetition of information already available to the public. More ambitiously, the publication of governance reports should be optional for SMEs.

"SME markets might become a safe place for investors just because they are empty."

- CARMINE DI NOIA

- The ongoing disclosure duties currently set forth in the market abuse regulation (MAR) should be confined to regulated markets alone and should not apply to MTFs, unless these decide to opt into them. For SMEs whose securities are traded on a regulated market, the default regime should avoid mandatory disclosure of events that are simply likely to occur.
- Prospectuses concerning securities issued by SMEs should be replaced with lighter documents reporting a limited set of key information items. SMEs' legal seat should not be the only connecting factor for determining the national competent authority for prospectus approval. ●

NB: this note is based on M. Bianchi, C. Di Noia and M. Gargantini, The EU Securities Law Framework for SMEs: Can Firms and Investors Meet? in C. Mayer et al. (eds.), Finance and Investment: The European Case, Oxford University Press, forthcoming 2018

James Chew

Global Head, Regulatory Policy,
HSBC Holdings plc

Economies need risk capital to grow – who will provide it?

For any economy to reach its full potential, it needs a consistent supply of finance, of all types, at each stage of business development. Some can be debt in a variety of forms – term loans, overdrafts, leasing, receivables financing or even credit cards. But there is a limit on how much money can come from banks and other credit providers. They need good sources of repayment from cashflows (often unreliable), assets pledged as collateral (increasingly scarce in more service-based economies) or guarantees from business owners (often their own home). So in many scenarios, lending capacity is limited for growing business and equity is needed.

In the early stages, friends and family, start-up or venture funds can help and, ultimately, public markets and private equity will pick-up these firms. The challenge is for companies in the middle; which have outgrown their initial shareholders but which are not yet attractive to larger investors. Equity finance for these firms is often expensive, controlling and difficult to find. This has been a consistent problem – in the UK, it was first documented in the MacMillan Report, written after the 1929 crash, in part by J M Keynes– and it is almost universal in emerging and developed economies. Addressing it needs bold thinking. It is about filling a gap in the financial system; creating a new piece of financial infrastructure to operating alongside the mainstream banks and financial markets.

In the UK, we tackled this through the creation of the Business Growth Fund (BGF), a Multi-Bank Investment Company, with £2.5bn from major UK banks to invest as equity in growing businesses in small tranches, typically £2m – £10m. BGF operates at arms-length from its shareholders with nine separate offices across the UK and its own management and decision-making process. Individual investments are small but the scale of the Fund and volume of transactions means that it is an efficient investor.

"It is about filling a gap in the financial system"

- JAMES CHEW

Crucially for the long term, BGF also offers good returns. With a current portfolio of over £1bn in around 200 firms across the UK, the impact from the single failure are markedly reduced. And with multiple banks as shareholders, the financial risks to each individual bank are smaller still, particularly since the invested capital represents only a small portion of each bank's capital base. As a result, under both Basel Committee and EU rules, these investments are treated as risk-weighted assets for the banks, rather than a capital deduction. So modest returns from the portfolio of companies are a decent return on risk-weighted assets and equity, incentivising banks to invest.

It is delivering in the UK – companies in which the BGF invests employ 35,000 people - and the idea has been taken up by the banks in Canada. Other countries have similar interventions. Can this model offer much-needed capacity across Europe to deliver sustained economic growth? ●

Xavier Larnaudie-Eiffel

Deputy General Manager, CNP Assurances

Bolder action needed: insurers' view of the Juncker Plan

When EC President Juncker launched his ambitious Investment Plan for Europe three years ago, he rightly recognised the important role of insurers. The insurance industry is the largest European institutional investor, with assets under management equivalent to more than 60% of the GDP of the EU.

All three areas on which the Juncker Plan focusses are of the utmost importance to insurers. The aim to increase private investment in infrastructure echoed insurers' own calls for the creation of more, suitable long-term investment opportunities. And the industry welcomed public support, where needed, through the European Fund for Strategic Investments.

Last but by no means least, insurers were optimistic that the Capital Markets Union project — aimed at removing regulatory barriers to investment — would address the unnecessarily punitive treatment of long-term assets under the EU's Solvency II insurance regulation.

While progress has undoubtedly been made in all three areas, bolder action is needed to allow insurers to maintain and grow their long-term assets.

Firstly, there has only been work on a very limited range of assets (infrastructure, securitisations, unlisted equity and unrated debt), which probably account for under 5% of insurers' investment portfolios. And infrastructure — the only area in which progress has so far been made — accounts for less than 2%. The other 95% should not be ignored.

A second concern is that the Commission's proposed fixes do not seek to address the fundamental problem: the erroneous assumption in Solvency II that insurers act like traders. In reality, insurers are long-term investors who match their assets with their long-term liabilities. They can and do invest long-term and, unlike traders, they are rarely — if ever — forced to sell their entire portfolio at a bad time.

The current Solvency II approach leads to an exaggeration of liabilities, to excessive capital charges and artificial volatility for long-term guarantees and investments, which in turn can make the insurance products they back unnecessarily expensive or even unviable. Solvency II can become appropriate for insurers' investments only when it measures the actual risks to which insurers are exposed. This is currently not always the case.

> *"Bolder action is needed to allow insurers to maintain and grow their long-term assets"*
>
> - XAVIER LARNAUDIE-EIFFEL

Meanwhile the availability of suitable infrastructure projects, while improved, remains low across the EU. European policy actions currently lag behind the ability and willingness of insurers to invest. Several large insurers have publicly committed to increasing their infrastructure investments, and a 2% to 5% increase in the average allocation would create €200–500bn of new investment. The significance of this is clear when you consider that the Investment Plan's objective is to mobilise €315bn of new investment.

The European (re)insurance industry continues to strongly support the aims of the Juncker Plan. Swift, bold policy action on appropriate prudential regulation and project/asset supply could help make a real difference to the European economy. ●

Nathalie Berger

Head of Unit Insurance and Pensions, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Prudentially sound risk calibrations for infrastructure

What are infrastructure projects and infrastructure corporates?

Investment in infrastructure is extremely important for the functioning of businesses and public services and for economic growth in the European Union. Infrastructure investments can be broadly classified into two categories: "infrastructure projects" and "infrastructure corporates". The former category typically involves the construction of new infrastructure facilities. Infrastructure corporates on the other hand are infrastructure businesses that are already operational.

What is so special about infrastructure investments?

Infrastructure investments are typically long-term in nature. Loan requirements for 10 to 15 years or even much longer are quite common among infrastructure borrowers. Insurance companies, particularly long-term insurance companies, are well-placed to make >>>

>>> infrastructure investments and hold them for a long period thus providing stable sources of funding.

"The introduction of the infrastructure corporates asset category is one of several measures under the CMU Action Plan and the overall Investment Plan for Europe."

- NATHALIE BERGER

Infrastructure investments carry specific risks that require specialist knowledge and due diligence by investors. Infrastructure investments are generally illiquid and investors need to be prepared to hold them for a long period until maturity.

What are the main changes introduced by the Commission?

The Commission has reduced the risk calibrations for qualifying debt investments in infrastructure corporates by 25% on average, and for equity investments in infrastructure corporates by up to 27%. Insurance companies will therefore hold less capital against qualifying infrastructure investments, which are considered less risky based on historical evidence. Unrated infrastructure debt will be given the same treatment as BBB rated debt, subject to prudent qualifying criteria.

Is the reduction in risk calibrations prudentially sound?

Research studies have shown that, especially over a longer period, investments in infrastructure can be much less risky than in some non-infrastructure alternatives. The reduction in the risk calibration for debt, as adopted by the Commission, ensures that the capital held against such investment is proportionate to the investment risk in a diversified portfolio.

If the risk calibrations for infrastructure corporates debt are kept at the same level as for non-infrastructure corporate debt, that could encourage insurance companies to make higher risk investments. Such a situation would be counterproductive to the prudential objective of Solvency II and will be avoided as soon as the revised calibrations enter into force.

Of course, not every infrastructure investment has lower risk and therefore investors need to do their homework. The qualifying criteria such as the predictability of revenues and sound financials therefore play an important role in the selection of investment opportunities by insurers.

What overall impact will this have for the European Union?

The introduction of the infrastructure corporates asset category (in addition to the infrastructure projects asset category) is one of several measures under the Capital Markets Union Action Plan and the overall Investment Plan for Europe. The current level of insurers' investment in infrastructure has been estimated at 0.5% of their total investments. Over a 5-10 year period, assuming there will be good quality investment opportunities, the Commission anticipates that insurance companies can at least double their investment in infrastructure. ●

Laurent Zylberberg

Senior Executive Vice President, Public Affairs and International Relations, Caisse des Dépôts et Consignations & President, European Association of Long-Term Investors (ELTI)

Addressing the funding challenge in European infrastructure projects

Stimulating a steady and sustainable growth in European Union relies significantly on a voluntary infrastructure's investment policy. According to the assessments of the European commission, a global amount of 1,500 Billion € is required until 2020 in the infrastructure field, ranging from the economic ones (transports, energy) to social infrastructure (health, education, social housing).

From this point of view, the first phase of the Investment Plan for Europe ("IPE") launched in 2015 provides an encouraging response.

As "enablers" of the deployment of the IPE, the National Promotional Banks and Institutions ("NPBIs"), have helped to identify and structure projects in the different Member States and have co-financed a large number (more than one third of all EFSI operations). This proves the incomparable capacity of NPBIs to mobilize private and public stakeholders, including for the funding of small and medium-sized infrastructure projects.

In terms of technical assistance and consulting services, most NPBIs have signed a cooperation agreement with the European investment bank to develop the European Investment Advisory Hub (EIAH), the NPBIs and their national networks being natural points of entry for project developers requesting assistance.

The announcement made by the European Commission to extend the IPE through to 2020 was warmly received by NPBIs, particularly as the initiative underlines the importance of investment platforms their capacity to gather small projects in order to make them eligible for Juncker Plan funding.

NPBIs expertise and networks (national and European through the European association of long term investors) are key for understanding local environment. This skill has proved to be extremely valuable in making the Investment Plan for Europe a complete success.

Regarding social infrastructure, the ELTI association has launched on

early 2017 a High Level Task Force chaired by Romano Prodi and vice-chaired by Christian Sautter gathering 20 experts in order to publish recommendations by the end of the year to promote the financing of social infrastructure (health, education, social housing...).

Caisse des dépôts and the other financial institutions members of the European association of Long Term investors (ELTI) are fully mobilized on this major issue to reach this goal of common interest. ●

Michael Wilkins

Managing Director,
Global Infrastructure Ratings,
S&P Global

Incentivising institutional infrastructure investment

The Juncker Plan has been designed to mobilise €315 billion of investment in Europe's real economy over 2015-2017. Key to the Plan is the European Fund for Strategic Investments (EFSI), which was launched to encourage the crowding-in of investment by bolstering the financial environment. The EFSI seems largely on track: by the start of 2017, EFSI financing of projects approved by the European Investment Bank (EIB) was set to trigger €168.8 billion of investment – 54% of the target. Yet more must be done to incentivise private investment.

Not there yet

Long-term, large-scale investment depends on institutional investors with long-term liabilities, such as insurance companies and pension funds which, lacking confidence in Europe's economic recovery, have been reluctant to invest in the real economy. This means projects exposed to market risk – those in construction, or relying on user-generated revenues – have been less well supported.

The risk of regulatory change is also a barrier to investment. In southern Europe, for example, after retroactive subsidy cuts, investors remain wary about financing renewable energy. Institutional appetite for infrastructure project debt has therefore mostly focused on social infrastructure and other projects where market, regulatory and political risks are limited.

Another major concern for banks and insurance companies is the cost of capital – so much so that the total volume of investment in project finance-funded infrastructure represents only a quarter of that channelled to infrastructure corporates.

Possible solutions

Greater regulatory stability aside, project bundling – combining separate smaller ventures into one larger infrastructure entity – could help boost investment. The EFSI, for instance, has established over 20 financing platforms that pool together smaller projects in order to attract larger-scale institutional investors. The EIB is also considering financing higher-risk tranches to incentivise investors looking for higher-yielding assets.

"Long-term, large-scale investment depends on institutional investors"

- MICHAEL WILKINS

Last year, capital requirements for insurers investing in the infrastructure project asset class were reduced. In June this year, the European Commission went further and proposed lowering credit risk capital requirements for infrastructure corporate debt by 25%.

The time is now

The EFSI programme is, positively in our view, expanding: "EFSI 2.0" will run until 2020 and add €200 billion to the original €315 billion. While additional investment is crucial, it is in our view needed soon, before the rise in global interest rates divert investors' attention away from the Juncker Plan. ●

Jean-Jacques Bonnaud

Director and Treasurer, Eurofi
and Vice-President of
a Cluster in Toulon

We need to attract more savings to invest in the future SMEs

Increasing the number of SMEs in the context of a European balanced economy is a condition for developing jobs, exports and for regional progress. This has to be achieved factoring in that, today and even more in the future, innovation is driving the move, since this reality changes dramatically the nature of the risks and the critical size of the firms.

Indeed, international competition imposes a growing level of expenses devoted to research, trade-marks, access to adequate distribution networks, etc. before being able to initiating any production. For example, in service industries be they in the area of health, telecoms, energy - the investment cost related to infrastructures outweighs by large operating cost.

Eventually, the size the investments required to launch new firms and successfully grow smaller ones, is increasing fast to the point that >>>

>>> it is frequently underestimated by managers and entrepreneurs.

Finally, the subsequent change in the nature and level of risk, discourages classical forms of financing, which are generally provided by the retail banks, especially when these banks are involved in the current cycle of bank consolidation.

"A support of European Member States is therefore required to secure a significant increase of the size and scope of the EU investment Plan and related efforts of the EIB in terms of capital as well as loans."

- JEAN-JACQUES BONNAUD

Limited and slowly growing prospects of European capital markets are giving for a while a crucial role to specific mechanisms intended to channel existing savings in Europe towards the SMEs. In addition, non-listed financings, which are those needed by most of the still fragile SMEs – will demand strong public support – the type provided by the Juncker Plan – due to the higher level of their risks.

A support of European Member States is therefore required to secure a significant increase of the size and scope of the EU investment Plan and related efforts of the EIB in terms of capital as well as loans.

In this perspective, EU individual savers notably, should be incentivised to underwrite « preferred bonds of long term development » dedicated to finance such an investment effort. An exclusion, for a specific period of time from income tax or capital tax bases, of a defined proportion of the amounts that individuals have invested in such preferred bonds of long-term development (say up to 10.000€ annually), could be agreed upon by EU Member States, in order to provide an incentive, which is proportionate to the higher level of the risk incurred by saver. Only the Member States involved in such tax incentive, would benefit from the proceeds of those bonds.

Such a support from the Member States would also give a renewed sense of EU citizenship that Europe badly needs and that the presently changing international environment may help to create. ●

Attracting retail investors

Contributors

Verena Ross

Executive Director, European Securities and Markets Authority (ESMA)

Towards a more active participation of retail investors in EU capital markets

The participation and involvement of the retail public in the EU capital markets has been on the forefront of the European agenda since the European Commission's 2015 Green Paper on building a Capital Markets Union (CMU).

Retail investors will only be attracted to invest in capital markets if they trust them as well as their operators, and believe they can safely secure a better return on their savings. Indeed, restoring confidence and trust is a big challenge and key responsibility for public authorities post the financial crisis. In today's ever increasing complexity of financial markets and products, enabling consumers to understand, compare and choose financial products more effectively and easily is an important goal for regulators.

The problem of a lack of retail investor involvement is further exacerbated in a cross-border environment, thus creating a challenge for the realization of the CMU. Investors may exhibit a home bias due to a lack of understanding of products, language difficulties or simply a lack of trust in the products or brands they are not familiar with.

There are various supply-side and demand-side initiatives that can encourage greater public involvement. It is a question of striking the right balance between incentivising an improved product offering, promoting an open-architecture which gives investors more choice while at the same time ensuring the highest level of investor protection.

Strong regulation and supervision can contribute to building investor confidence. European legislation, with a significant contribution by the ESAs, has made significant progress in improving disclosure requirements across all sectors. For example, in PRIIPs the new KIID improves comparability of products across sectors. However, full transparency at product level is not sufficient. Latest initiatives such as MiFID II seek to strengthen investor protection through a robust framework for the provision of services to retail clients. For example, in MiFID II, more substantive requirements have been developed to ensure a more effective protection of investors through the introduction of enhanced product governance requirements; the tightening of regulation around distribution (including making the access for retail investors to execution-only sales more restrictive); and the regulation of independent advice. Furthermore, as a last resort, new product intervention powers for ESMA and national regulators have been developed in order to allow regulators to restrict products or practices in certain circumstances.

To ensure that investors can truly rely on the same level of protection across the Union, supervisory practices also need to converge further. ESMA has carried out and will continue to conduct considerable work to ensure that the legislative acts are applied fully and consistently to the benefit of all EU investors. We have therefore developed guidance (e.g. formal guidelines and Q&As) addressed to market participants and supervisors on many important topics, but also enhanced cooperation through joint working of national supervisors under the leadership of ESMA on specific cases.

It is important to support the legislative and regulatory framework with appropriate powers and tools to achieve genuine supervisory convergence. ESMA is fully committed to using its existing convergence powers but has also argued that some strengthening in certain areas (e.g. improvements to the legislative framework to deal with Breaches of Union law) is required to further investor protection and trust in an increasingly border-less CMU. ●

Dr. Birgit Puck

LLM, Managing Director Securities Supervision, Austrian Financial Market Authority (FMA)

CMU, MiFID II and PRIIPs – Bringing retail investors to EU markets?

Key features to enhance retail investment are attractive, transparent products and confidence in capital markets. It is also crucial to enlarge the possibilities for consumers to invest.

Therefore the Capital Markets Union (CMU) has set several measures to overcome the EU economy's reliance on bank lending by providing a more diversified system in which non-bank finance efficiently complements the traditional banking channels. They are intended to increase the amounts available to finance the EU economy.

"CMU, MiFID II and PRIIPs offer incentives for strengthening retail investments"

- DR. BIRGIT PUCK

Particularly the Consumer Financial Services Action Plan - COM (2017) 139 seeks to enhance consumer trust, to empower consumers when buying services at home or from other Member States and to reduce legal and regulatory obstacles affecting businesses when providing financial services abroad.

Also MiFID II and PRIIPs contain several rules for enhancing investors' trust: The provisions of MiFID II introduce independent advice whereby monetary inducements are absolutely prohibited. Furthermore, strict rules for product governance oblige producers and distributors to define appropriate target markets for their products; this enables investors to check their personal risk profile against their return expectations. PRIIPs introduces a key information document (KID) that will provide investors with information on financial instruments as well as life insurance products and structured deposits. The KID will present the key features of an investment product in a simple and short manner on standardized three pages. It will enable investors to compare products effectively on a cross-sectoral basis.

These regulations are important steps towards enhancing transparency of products and increasing investors' confidence in EU capital markets. Therefore these provisions are a substantial contribution to raising retail investment. However, it is also necessary to focus on some challenges evolving from these new rules.

The Directive 2016/97/EU on Insurance Distribution (IDD) includes new rules regarding inducements. These rules are not harmonized with the inducements provisions in MiFID II. As a consequence, in a substantial area such as inducements there is no level playing field. Time will show how these disparities impact on investment behavior.

Current discussions with market participants show that it is rather challenging to calculate parameters for the PRIIPs information document (e.g. calculation of market and credit risks). The goal to compare products on a cross-sectoral basis can only be achieved if the PRIIPs rules are applied in the same way across sectors. This will be a main focus for the FMA as integrated supervisor in 2018.

In conclusion, CMU, MiFID II and PRIIPs offer incentives for strengthening retail investments in EU capital markets. Only if the new rules are applied in a way that ensures a level playing field across sectors the goal to raise retail investment can be achieved. Integrated supervisors are best equipped to ensure this level playing field. ●

Niels Lemmers

Managing Director, European Investors' Association

New measures to foster retail investor participation

When discussing participation of individual investors in capital markets, a distinction needs to be made between two types of investment: indirect participation, primarily through investment funds and ETFs, and direct participation, mainly through equity (individual shares).

When being asked about cross-border investment and the main barriers to it, individual investors approach both types of investment differently. This is evidenced by a short survey held by the European Investors' Association among its members in July 2017.

Investment funds

The most notable outcome of the survey is that individual investors have a fairly significant home bias in regard to their choice for investment funds.

More than 40% of respondents say they do not invest in funds abroad because the range of products offered by domestic fund managers is sufficient or simply because they have little confidence in foreign fund managers.

Further, over one fifth of respondents indicate the lack of information about funds offered >>>

>>> by foreign managers as a reason for the absence of foreign funds in their portfolios.

Equity

For direct equity investment, the home bias is less significant. Still, respondents perceive many barriers to cross-border investment.

One third of respondents mention difficulties with procedures for withholding tax refunds as being one of the main barriers to cross-border investment in equity. Annually, investors lose out 6.03 billion euro (by not claiming their refunds). Fortunately, the European Commission (EC) is now working with Member States on a Code of Conduct, focusing on refunds.

14% of investors that participated in the survey, refer to legal reasons for not investing cross-border (more). Investors do not benefit from, at least that is the perception, the same levels of legal protection when investing abroad and they are afraid that no proper (collective) redress mechanism is available when matters take an unfortunate turn. Also, they see less opportunities truly to engage with foreign listed companies.

"Relief at source from withholding tax and binding EU collective redress rules"

- NIELS LEMMERS

Finally, 20% of the respondents say their reluctance to invest cross-border in equity is due to a limited availability of information about foreign listed companies and securities.

Ways forward

Based on the outcome of this survey, we believe that, in relation to funds, focus should be on raising awareness about foreign funds and making sure information is made available to investors.

MiFID II and PRIIPs will enter into force soon. We would encourage the EC to monitor closely whether these legislative measures deliver on their objectives, taking as a starting point the outcomes of its current study into the distribution of retail investment products.

Fostering cross-border equity investment requires other measures: relief at source from withholding tax and binding EU collective redress rules. Also, more online tools for shareholder engagement (e.g. allowing for real time participation and voting at annual general meetings from a remote location).

These measures will increase the willingness and confidence of individual investors to step into foreign equity investment, supporting economic growth and the emergence a genuine CMU. ●

Jean-Paul Servais

Vice Chairman, IOSCO; Chairman, IFRS Foundation Monitoring Board; Chair of ESMA's Financial Innovation Standing Committee and Chairman, Financial Services and Market Authority, Belgium (FSMA)

Retail investment development in the EU in the context of the CMU

The CMU pursues larger, more integrated and more competitive capital markets, thereby increasing access for European companies and investors. Retail investor engagement is traditionally rather low. Retail investors tend to invest in the short term and do not often pass national borders. One of the aims of the CMU is to increase retail investor participation in long term investments, including on a cross-border basis. This will require a competitive offer to retail investors and confidence by those retail investors in financial markets. Key for the CMU is the right balance between market efficiency and investor protection.

A central element of the CMU is the modernisation of the EU prospectus regime, that increases the prospectus exemption thresholds. This may effectively facilitate access for SME's to capital markets. However, retail investor participation, built on confidence and protection, is also a prerequisite for succesful markets. In the absence of a prospectus, advertising material could become more important. The clear allocation of competence for advertising supervision to the host supervisor is important in that perspective.

This allocation of competence is consistent with the allocation of product intervention powers under MiFID II and PRIIPs. This harmonized framework for product intervention is a major progress of the MiFID II reform and the PRIIPs intitiative. Product intervention should however always be the final link in the entire value chain of a product. MiFID II and IDD appropriately emphasize the product governance process, thereby putting the interest of the client at the forefront, starting from the development phase of a product to its maturity. MiFID II furthermore strenghtens the quality of advice through the concept of investment advice on an independent basis and through additional suitability requirements. These evolutions can all contribute to increase investor confidence and participation in financial markets.

"Key for the CMU is the right balance between market efficiency and investor protection."

- JEAN-PAUL SERVAIS

The CMU also focuses on increased transparency and comparability of costs and performance of retail investment and pension products. Stronger cost transparency requirements in MiFID II and IDD - costs have to be visualized as the yearly impact on return - pursue the same objective. These requirements also converge with the new PRIIPs obligations. Developing a short and investor-friendly document for all packaged investment products, whatever the legal format, including harmonized rules for the risk, performance, and cost measures, is an important step forward from the perspective of horizontal product transparency and should enhance understanding and comparison of products by retail investors. ●

Antonio J. Zoido

Executive Chairman of the Holding - Bolsas y Mercados Españoles (BME)

Retail investors participation in financial markets

Close to 18% of household savings in Europe (UK excepted) is held in financial assets (around €23 trillion against €7.7 trillion held in bank deposits and cash).

The value of household financial assets out of the total financial assets of the economy of the Eurozone has shifted from between 3.75% and 4% from the year 2000 to 2007, to a current 2%, after hitting 0.8% in 2013 (the most critical point of the economic crisis). There is no doubt that the environment and the perception of risk and valuations have an impact on the relevance of participation of households in the financial markets.

In the light of the above, there are some questions we could pose: Is it important that retail investors participate in financial markets? Is it convenient or desirable? Particularly in stock markets?

The above-mentioned figures of the involvement of retail investors in European markets and outside of Europe, does it represent a meaningful participation? Is it minor or insignificant? What is the reason behind the different developments of this involvement in different markets? Is it related to the development of each market? Is it more closely related to each country's income level? Is this involvement in retail markets directly or indirectly related to the economic growth of each country? How do retail investors interpret the risk aspects of their investments? What impact do individual issuers' and the system's financial crises have on retail investors? Which historic data explain some of these impacts? Are retail investors confident or concerned about globalization? Is globalization good or bad for them? Supervisors' main role is, usually, investors' protection. In such a broad, global and complex financial world where this role is focused on retail investors, can this protection be effective? Or is it a utopia or a paternalistic approach? What about the role of the different financial intermediaries? ...

"There is no doubt that the environment and the perception of risk and valuations have an impact on the relevance of participation of households in the financial markets."

- ANTONIO J. ZOIDO

I believe there is enough historical evidence to have an opinion on these -and many other questions not mentioned here- to find, all of us together, the right path for these matters in pursuit of the development of European capital markets. ●

Urban Funered

Director of Public Policy, Fidelity International

Building a Capital Markets Union for retail investors

The Capital Markets Union (CMU) initiative, recently subject to a mid-term review, is one of the most important projects of the EU. Properly implemented, it will contribute to creating jobs and growth in Europe. As good progress has been made e.g. to make it easier for companies to raise capital and to make investments in SMEs, the time is now ripe to build a truly pan-European retail financial services market.

Some of the initiatives and developments highlighted in the mid-term review will be key to this project. Efforts are being made to facilitate cross border investments and distribution of UCITS and AIFs. Financial Technology will bring forward more efficient solutions e.g. in the area of robo-advice. Increased focus is placed on sustainable investments, in line with the increasing interests on the side of institutional as well as retail investors. More emphasis is also placed on extending the geographical reach of capital markets.

An important building block in the CMU is the proposal for a Pan-European Pension Product (PEPP). PEPP will be positioned to take advantage of progress made in all of the aforementioned areas. It will already from the outset be a product for the new era, following in the footsteps of UCITS when it was first presented in 1985. PEPP will be positioned to reap the benefits of ongoing work to bring down existing barriers to cross-border distribution and investments. Important is thereby that key steps in the process are preceded by consultations and consumer testing.

As the PEPP will be a product for the digital age, it is appropriate that the first discussions take place under the aegis of a truly digital Estonian EU Presidency. It comes at a cross-roads in history, when ESG and climate change is at the top of the agenda. New investment >>>

>>> opportunities will open up, which is of crucial importance as old investment patterns, with focus on bank accounts and real estate, may not suffice to bridge a growing pensions gap in Europe.

PEPP will, with its pan-European client base, national compartments and our numerous national tax incentive regimes, already from the outset be a complex undertaking. In order for asset managers and other PEPP providers to be able to present the safe, transparent and cost-efficient PEPPs that future savers deserve, it is important that we continue the ongoing constructive dialogue between all stakeholders, making sure to consult stakeholders and conduct proper consumer tests along the way.

While the Commission estimates that up to €700 billion may come to be invested in PEPPs by 2030, the actual amount will in the end depend on the structure and text of the final regulatory framework, as well as on the attractiveness of the products that will in the future be offered by PEPP providers.

The PEPP project may not be a completely easy task, and it is more important to do this right than to haste, but when we succeed we will have contributed to making the CMU a reality for European retail investors. Not only for the more than 11 million Europeans that today live in another Member State than their home Member State, but also for all future generations of Europeans. ●

Florence Lustman

Chief Financial Officer,
La Banque Postale

Banks can enhance retail investment while maintaining long-term consumer trust

Developing EU Capital Markets is a promising way of channeling savings towards investment in a manner that may eliminate some of the shortcomings of financial intermediation and benefit everyone.

Textbook economics aside, some challenges remain. First of all, as banks are the usual channel of financial intermediation, such an evolution would structurally shift their business model

"Maintaining a long-term trust of consumers in the financial system."

- FLORENCE LUSTMAN

from collecting, investing and managing liquidity to advising and charging fees. While this change is already happening, and might be welcome in a low interest rate environment, providing advice is, in many ways, more difficult than offering deposits paying a defined rate: retail investors are often not financial professionals, and might not be well informed on risk reward arbitrages or even willing to take risk at all.

Besides fostering financial education, legislation first has to further clarify the notion of investment advice, in order to limit legal and judicial uncertainty. Banks then have to guarantee that their advisors are well-trained, with high standards in terms of compliance when offering investment advice.

This high quality of advice is key for maintaining a long-term trust of consumers in the financial system.

In this context, robo advice will be the solution for the future: automated optimal use of customer information (through customer database or live questioning of the client) to determine his risk profile, market knowledge and tax situation, and instant access to market information and performance figures will allow to give precise and customized advice while minimizing human error and lack of knowledge of regulatory requirements. Banks can do it by themselves; they also can cooperate with agile Fintechs (eg crowdfunders and crowdlenders) that understand well new digital customs, by providing their know-how: financial analysis, risk scoring, wholesale access to market infrastructure, AML-ATF, etc.

Another pre-requisite in order to attract retail investors to EU capital markets is to enlarge the range of securities and counterparties accessible to direct investment, allowing clients to gain autonomy in portfolio selection, including ethical or "values driven" choices (SME, socially responsible firms, public infrastructure investment).

While EU has to facilitate access of SMEs to capital markets (equity or bonds), banks can do their part by expanding customers access to bond issuances, besides their own. The continuous decrease of retail investment in equity shows that customers would certainly like access to credit risk.

Finally, retail clients have to be sure that fees are adequate, competitively set and without incentives for advisors to drive them towards highly risky products. While PRIIPS and MIFID2 will make a step in this direction, regulation must not become too burdensome, or it will induce too many costs for end customer. ●

Bank prudential rules impacts

Contributors

Mario Nava

Director, Financial System Surveillance and Crisis Management, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Better regulation at the EU framework for financial services: evaluations and the "Call for Evidence"

Evaluations are a key component of the Commission's Better Regulation agenda and the Regulatory Fitness and Performance (REFIT) programme, which ensures that EU legislation delivers results for citizens and businesses effectively, efficiently and at minimum cost. An evaluation is intended to assess the actual performance of interventions compared to initial expectations. Evaluations also provide key opportunities to engage stakeholders and the general public, encouraging feedback on how interventions are perceived. In this respect, is important to ensure that a commitment to evaluate is not interpreted by signal as a signal of deregulation.

Some of the factors that contribute to a successful evaluation include:

- The evaluation needs to be comprehensive, by assessing the effectiveness (how successful the action has been in achieving or progressing towards its objectives), efficiency (the relationship between the resources used by an intervention and the changes generated by the intervention), relevance (the relationship between the needs and problems in society and the objectives of the intervention), coherence (how well different actions work together) and added value (which observed changes can reasonably be attributed to the intervention).
- The evaluation needs to be proportionate, which means that the scope and analysis conducted must be tailored to the particular intervention, its maturity and the data available.
- Robust and reliable results can be delivered only by independent and objective evaluations. An evaluation can be considered as independent when evaluators: (i) carry out their tasks without influence or pressure from the organisation; (ii) are given full access to all relevant information required; and (iii) have full autonomy in conducting and reporting their findings.
- Evaluations are based on the best available evidence, which should be drawn from a diverse and appropriate range of methods and sources. Not all sources of evidence are equally robust and consideration must be given as to when and how the evidence was collected and whether there is any bias or uncertainty in it. Where possible, sensitivity and/or scenario analysis should be conducted to help test robustness of the analysis. Any limitations to the evidence used and the methodology applied, particularly in terms of their ability to support the conclusions, must be clearly explained.

In 2015, the Commission launched a comprehensive review of the EU regulatory framework for financial services referred to as the "Call for Evidence". The financial crisis triggered the adoption of more than 40 new pieces of EU legislation to restore financial stability and market confidence. It was deemed important to monitor the continuing development, early implementation and functioning of the new rules to check that they were delivering as intended. The call for evidence included an assessment of the interaction between the individual rules, and their combined economic impact. It ensured that unintended consequences, inconsistencies and gaps in the current regulatory framework were addressed.

Based on a thorough review and analysis of over 300 responses, the Commission concluded that overall the financial services framework in the EU is working well. However, the Commission took targeted follow-up action in the following four areas:

- reducing unnecessary regulatory constraints on financing the economy (e.g. the Commission proposed key adjustments in the CRR2 package to safeguard banks' capacity to finance the economy and it extended the capital benefit for loans to SMEs).
- enhancing the proportionality of rules without compromising prudential objectives (e.g. the Commission proposed easing reporting requirements for smaller and

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>>> less complex banks, and it proposed to remove unnecessary complexity in the treatment of trading book market risk and counterparty credit risk).

- reducing undue regulatory burdens (e.g. the Commission launched a comprehensive review of reporting requirements in the financial sector) .
- making rules more consistent and forward-looking (e.g. in order safeguard banks' ability to provide client clearing services under EMIR, in the Commission proposed adjusting the leverage ratio to allow banks to offset the potential future exposure of the relevant derivative transactions with initial margin).

Ryozo Himino

Vice Minister for International Affairs,
Financial Services Agency, Japan (JFSA)

Towards smarter globalization of financial regulation

We live in the age of the globalization paradox, in which globalization reinforces anti-globalization.

More and more goods, services, people, information and money flow across borders. The benefit of globalization continues to grow exponentially, but the side effects of globalization swell as well. I believe the net benefit is enormous, but anti-globalization sentiments grow together with the increase in the gross size of the side effects.

The latter half of the 19th century and early 20th century were another period of rapid globalization. But it ended with the Second World War.

How can we minimize the side effects while keeping the benefit of globalization?

The tools we have are the regulatory power which is scattered across nation states, regional unions and global standard setters. The coordination of the use of these tools is indeed a painful process. One regulatory response tends to create another cross-border inconsistency and further side effects. If it is painful for regulators, it should be all the more so for the industry, which needs to abide by conflicting requirements without knowing when the reconciliation will happen, and, more importantly, the pain might also be felt by customers in the form of limited availability of services or increased cost. One could argue that the implementation of OTC derivatives market reforms may have been made unnecessarily painful due to less than optimal coordination among major jurisdictions.

We, however, need to be patient; there is no easier way other than to solve problems one by one. We also need to be effective; if we are caught up in bureaucratic inefficiencies or political gaming, then the risk of repeating the history of the last globalization cycle may become a reality. G20 leaders have encouraged jurisdictions to defer to each other as much as possible. We need to facilitate deference by better communication and mutual trust.

The public opinion, however, seems to be getting more and more impatient about being governed by a process which is beyond direct national democratic control, and backrush from the pursuit of a wholesale harmonization may result in an all-out fragmentation. Now that the post-crisis reconstruction of the financial regulatory framework is coming to its end, it may be time to start developing a strategy for smarter globalization, tailoring and differentiating the division of labor and accountability between global standard setters and national regulators according to the nature of the issue.

A review of good and bad reasons for setting standards globally and also for tailoring regulations nationally may help us design a smarter globalization of financial regulation. >>>

>>> Good reasons for global standard setting include promoting good practices and preventing a race to the bottom, preventing negative spill-overs, pooling scarce expert resources, reaping the benefits of common metrics and languages, reducing arbitrage opportunities, avoiding impositions of conflicting requirements, reducing compliance costs, and leveling playing fields.

The most typical bad reason for resorting to global standard setting is to short cut the painful process to persuade domestic stakeholders.

The most important reason for tailoring regulations nationally is to reflect differences in developmental stages, market structures and policy priorities.

The most typical bad reason for national discretion is to conceal the vulnerabilities unique to the country. This kind of special treatment may work as a short-term painkiller but often results in bigger calamities afterwards.

Benefits and costs of harmonization differ across regulatory areas. We may want to make more granular harmonization where conflicting requirements can hinder cross-border activities. On the other hand, we also may want to increase roles for national regulators in areas with limited spill-overs. Differentiated reallocation of responsibility between national authorities and global standard setters will help us defend the globalized financial markets from the risk of fragmentation. ●

Frédéric Visnovsky

Deputy Secretary General, Autorité de Contrôle Prudentiel et de Résolution (ACPR)

Setting the right calibration for the new banking rules

Several recent policy initiatives have confirmed (again) the importance of fully taking into account the expected impact of future rules on banks, but also more broadly on the economy and financial markets during any policy-making process, and also to monitor their consequences afterwards.

The development of the latest components of the Basel 3 reforms (review of the credit risk and operational risk approaches, potential introduction of an output floor) has been driven by the objective of reducing the unwarranted variability of risk-weighted assets. This objective, important for prudential reasons, had to be balanced by other considerations, notably the need to preserve risk-sensitivity (an essential component to ensure that the framework will create sound incentives), but also, the need to have "no significant overall capital impact" according to mandate given by the G20. To ensure that this mandate is satisfied, which is essential to avoid any negative consequences of the reform on the financing of the economy and also considering the extent to which capital requirements have already been raised since 2009, detailed assessments and impact studies are essential. The Basel Committee and its members have devoted significant resources to that to allow a well-informed decision-making process. However, these exercises are complex and difficult, and they often require some assumptions and judgements. It will be important, notably in Europe, to check after the adoption of the rules that the estimates were accurate.

The importance to monitor a reform once agreed and to react if necessary is well illustrated by the Fundamental Review of the Trading Book (FRTB). Data and evidences collected since the adoption of the new rules have shown that the impact was higher than expected due to some extent to an excessive calibration in some part of the framework or to some criteria judged as unsuitable >>>

>>> to the operational reality, as in the P&L attribution test. This is clearly an area that needs to be addressed by the Basel Committee.

Beyond the issue of the overall impact of the rules, it is also important to consider their more granular aspects, to avoid penalizing some businesses or some markets. Doubts and questions regarding the impact on some products or markets, when no fully dealt with during the policy-making phase, will have to be addressed, if needed with review clause (see for example the current work of the Basel Committee on the treatment of derivatives in the NSFR) or when implementing the rules (like the EU Commission proposal to adjust the treatment of repos in the NSFR), These safeguards are essential, as part of a sound policy-making process.

These questions about the impact and consequences also need to take into account, for the internationally active banks, the issue of the level playing field. Europe, with its risk reduction package under discussion, has again demonstrated its commitments to implement international standards like the NSFR or the FRTB. It will be important to monitor if these standards are really implemented by third countries and to adjust EU regulatory initiatives underway if necessary. ●

Damian Harland

Managing Director, Group Treasury, Barclays Bank

Resilience: How much is too much?

Is the current reform agenda securing excessive safety at the cost of vibrant capital markets?

As Mark Carney highlighted recently, for the largest banks, capital requirements are already ten times higher than before the crisis. He also stated that reform implementation must be dynamically adjusted to avoid unintended consequences. However, proceeding to 'finish the job' when not enough is known about the cumulative impact of post-crisis reforms risks stifling the very growth in markets that we are all so keen to see benefit the EU economy.

The debate in the Basel Committee is not over (at time of writing) and despite the GHoS mandate not to significantly increase capital requirements, over-riding risk-based approaches will lead to increased capital levels for many European banks given the tendency for banks to retain low-risk assets on their balance sheets.

At the same time, Europe is pressing ahead with the implementation of major new prudential standards such as the FRTB (tackling market risk capital already dramatically increased under Basel 2.5) and the NSFR (with its penal treatment of wholesale activities), which are significantly over-calibrated and in need of further development. Not enough is known about what their impact might be or their likely interaction with other standards, let alone whether other jurisdictions will follow Europe's lead in implementation. There is a real risk that these poorly-designed reforms will stifle banks' ability to originate securities issues and ensure deep and liquid secondary markets (including in associated securities financing markets such as repos). This may help create the conditions for the next crisis, such as thinly traded, fragile markets in sovereign and corporate bonds, prone to volatility and disappearing liquidity when it is most needed.

Global rules making banks more resolvable are vital, but higher TLAC/MREL requirements driven by European supervisors' setting of Pillar 2 will increase the burden on European banks. When overlaid by national tendencies towards hoarding resources via local subsidiarisation requirements and internal TLAC, the result may be bank structures that are more brittle and less well-placed to absorb risks.

The Global Financial Crisis had an enormous cost. But the marginal benefits – which may be close to zero – of increasing the current levels of resilience need to be set against the marginal cost. The global standard setting bodies have undertaken some quantitative impact studies of individual reforms, but no assessment has been made of the cumulative impact of post-crisis reforms. Not enough detailed work has been done to understand the impact on specific products or segments separately. The FSB has only now finalized its framework for post-implementation evaluation of the reforms, although their approach to assessment appears to envisage piecemeal analyses rather than anything more ambitious at present. Quantitative impact studies need to be undertaken prior to implementation, looking at procyclicality and interaction between reforms (such as between IFRS 9 and 'Basel IV'). Without a proper understanding of impact, the increased costs may well result in a permanent loss of capacity and skills in particular products or markets. These impacts may be difficult or impossible to reverse.

The problem is especially acute for the EU, which is engaged in the Capital Markets Union (CMU) project to promote capital markets financing and reduce excessive reliance on bank lending. Level playing field issues are an important consideration for EU banks assisting this project. If, for example, the EU proceeds with FRTB and NSFR implementation, at a time when the US may be putting introduction on hold, and with the prospect of Brexit disrupting the EU's principal capital market, the EU economy will struggle to compete with the US economy; EU banks will struggle to compete with US banks; and capital markets financing by EU businesses may well migrate to New York (with EU SMEs potentially unable to access adequate market-based finance).

Now is the time to ask "How much is too much!" ●

Christelle Lefebvre

Global Markets, Head of Regulatory Affairs and Strategic Projects, BNP Paribas

For a balanced EU approach on upcoming regulations impacting Capital Markets activities

Capital and liquidity requirements linked to capital markets activities have increased massively over the last decade. This is especially true for capital markets activities.

Quantitative impact studies conducted recently on some >>>

>>> upcoming regulations, especially the Fundamental Review of the Trading Book (FRTB) and the Net Stable Funding Ratio (NSFR), but also the so-called Basel IV framework under final discussion at BCBS level, produced some rather alarming results for European banks.

According to BCBS figures[1], the sole FRTB is leading to an increase of 67.2% and 75.9% in current market risk capital charge for internationally active banks and G-SIBs respectively. This impact is significantly higher for European players than for their US competitors, which already have more than 50% market share in Europe.

It is therefore critical to better factor in the specificities of the EU institutions and economy.

European banks have significantly fewer assets outplaced than their US competitors. Most EU banks stick to a traditional buy and hold model where their US peers largely rely on well-established distribution channels of assets, which feed an active financial market. This results in European banks having less agility in their balance sheet management and being hit harder by some upcoming rules.

This was so far mitigated by large European institutions developing robust sophisticated internal models - whose reliability is currently being reviewed in the ECB TRIM[2] exercise- to support their franchise. The challenge of such models by the FRTB (especially in case of failure to the P&L attribution test, with the use of the standard approach as a fallback) has a massive impact. The introduction of an output floor on global capital requirements based on standard methods as currently contemplated in the Basel IV package raises a similar concern to a much larger extent.

This is combined with the fact that European Capital Markets activities, covering local markets of the various member states, are structurally more fragmented and less liquid. Consequently, the current provisions on FRTB Non Modellable Risk Factors (NMRF) will penalize significantly the European model.

Deviations to the Basel framework contemplated by the European Commission in the revision of the CRR as well as the BCBS decision to reopen the discussions on some FRTB and NSFR aspects are recognition of the major flaws in the regulations, but with an uncertain outcome.

With the US announcing recently[3] that they postpone NSFR and FRTB until further consideration, the European legislators should adopt the same stance. The development of the European capital markets, which is critical to ensure the necessary diversification in the financing of the European economy, as well as the actual emergence of the Capital Market Union are at stake. ●

1. BCBS QIS based on end of June 2016 data. Increase computed before P&L attribution test, i.e. assuming that internal models will continue to apply.
2. Targeted Review of Internal Models (TRIM)
3. Targeted Review of Internal Models (TRIM)

Gerry Cross

Director of Policy & Risk,
Central Bank of Ireland

The impact of banking sector reforms on Europe's capital markets?

Reforms introduced since the global financial crisis have strengthened the banking system. They have made banks more resilient and improved their resolvability should they fail or become likely to fail. Importantly these reforms have helped address the mispricing of risk that was central to the crisis. This should be expected to result in improved capital allocation in the economy over time.

These reforms, including the current introduction of the NSFR and FRTB, can be expected to affect both the functioning and structure of financial markets structures. This is particularly the case in respect of fixed income instruments.

On the positive side, we have seen strong growth in the assets under management of investment funds since the crisis. This has no doubt been driven at least partly by reforms in the banking system and the repricing of bank risk. This is a welcome development as it is likely to represent a more efficient distribution of savings. It should result in more diversified funding of the economy; a safer financial system as a whole; and an economy better able to recover from shocks. These benefits are often overlooked.

On the other hand, there is much debate about whether banking reform is having a negative impact on the functioning of fixed markets and in particular. A good example of this is the excellent report by the Committee on the Global Financial System on repo market functioning. The report found that repo markets are in a state of transition and experience since the crisis differs between jurisdictions. Outstanding volumes have declined significantly from pre-crisis peaks in many jurisdictions, though this is driven by multiple factors and no single cause.

What this points to, in my view, is that it remains too early to say with certainty what impact some banking reforms may be having on fixed income and capital markets. More importantly, as the picture in this regard becomes clearer, the question will remain as to what, if any, the regulatory response should be. It must be avoided to surrender potential long term improvements in fixed income market efficiency for short term liquidity. Diminished levels of liquidity could of course be cause for regulatory concern. However, so too must be the resilience of those markets to future shocks. The focus cannot just be on steady-state liquidity levels. Markets are usually adept at adapting business models to fit prevailing norms; hence, for regulators an important focus is those contexts where markets may not function as they should – for example in stressed situations. ●

CRD IV / CRR II pending issues

Contributors

Kadri Martin

Counsellor for Financial Services, Economic and Banking Affairs, Permanent Representation of Estonia to the EU

Ensuring financial stability through regulation without excessive cost

Financial stability, as well as market confidence, are the long run goals, which we need to build carefully and consciously. The question of how to strike the right balance between regulations enforced on banks, without imposing an excessive burden, is of course a tricky one to answer. On the one hand, increased financial stability through regulation will help to reduce costs and increase efficiency in the end, but on the other hand, it may increase costs or decrease efficiency in the short term.

In the current economic situation, with lower levels of cost, revenue and profit efficiency compared to pre-crisis conditions, banks have tried to boost their performance via laxer standards and/or decreased monitoring of credit. This should of course be avoided as it increases future risks.

The 2008 banking crisis showed us that steps have to be taken to prevent future crises, as these can be very costly for the taxpayers: EU-28 deficit increased cumulatively by over €200 billion between 2008 and 2016 due to interventions related to the financial crisis[1], and the legacy of the crisis continues to affect public finances and economies at large. The proposed way to prevent such crisis from re-emerging is through ensuring financial stability by limiting banking risks. This is to be realised by increasing banks' capital and liquidity requirements while limiting the amount of leverage that financial firms can take on.

The increased regulation is meant to bolster the banking system in the long run, but it comes at a short term cost – higher requirements in terms of capital and liquidity will likely lead to an increase in lenders' operating costs, affecting bank customers, employees, and investors. Banks will have to reallocate resources to fulfil regulation requirements, which may decrease their efficiency.

It is clear that financial stability will not come for free. The goal of these new regulations is not to decrease efficiency by burdening Member States with new regulations to follow; the point is to reform the system to combat difficult areas, to enable banks, systems and Member States to act more efficiently hereafter. The aim of the Estonian Presidency of the EU Council is to find a balance between the short term and long term impact of capital and liquidity requirements. The proposed changes in CRD/CRR will help to make EU rules more proportionate, making it easier for banks to lend to SMEs and fund infrastructure projects. This will support investment and ease the burden on SMEs without compromising their stability.

The ability of banks to finance the economy should be enhanced without impinging on financial stability or market confidence. The objectives of the capital regulations should be achieved with the lowest cost possible for the banks, and through that influencing negatively the end-users (bank clients) and market as little as possible.

Lowering the cost for compliance and the administrative burden could be achieved by offering the European central level services, like central databases for different purposes etc. Market confidence could be given, while also lowering cost, by providing more legal certainty and fair solutions for different stakeholders in case of failure.

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>>> What currently inhibits new lending is the legacy of the past crisis, especially due to the high degree of non-performing loans. To ensure financial stability, steps need to be taken to clean the balance sheets and more generally improve policies to deal with the aftermath of the crisis, as well as making the market toolbox more transparent. Decreasing banking risks should bolster the banking system and enable financial stability and economic growth.

Stability comes at a cost, but one that will eventually pay off. By strengthening market confidence and resolving current issues in the European economy, we will expect less frequent and less costly financial crises. While the proposed requirements may be somewhat costly and burdensome in the short term, the long term stability and bolstering of the European economy they will provide should outweigh the costs of the reforms in the short run. ●

1. http://ec.europa.eu/eurostat/web/government-finance-statistics/excessive-deficit/supplemtary-tables-financial-crisis

Diederik van Wassenaer

Global Head Regulatory & International Affairs, ING Group N.V.

Progressing on the journey towards Banking Union

Europe is progressing on the journey towards a full Banking Union. Yet as the three pillars of Banking Union (Single Supervision, Single Resolution and a shared DGS) are being built up, some of the remains of the past national approach to bank regulation should be phased out. In today's transitional state, there are still important remaining impediments to the unencumbered transfer of assets across borders. Some of the regulatory requirements are complicated and challenging to meet.

We believe the freeing up of intragroup flows of capital, liquidity and loss-absorption capacity is a crucial factor in the further integration of the Eurozone. Cross-border intra-group flows not only increase efficiency of funds allocation, but also benefit financial stability and risk management. And not least, they are instrumental in fostering competition.

Persistent restrictions on free intragroup flows should therefore be addressed by smart regulation respecting both prudential and efficiency considerations. The current CRR review provides the right vehicle to address most of these issues.

"Freeing up of intragroup flows of capital, liquidity and loss-absorption capacity is a crucial factor in the further integration of the Eurozone."

- DIEDERIK VAN WASSENAER

When discussing free flow of funds, it is important to distinguish liquidity, capital and loss absorption. With respect to each of these elements we consider the following: For liquidity current regulation offers the possibility to create as so-called cross-border Single Liquidity Subgroup (C-SLS). The C-SLS concept allows for a more efficient management of liquidity buffers within the group whereas at the same time not resulting in an unlimited amount of unsecured exposures between the parent and subsidiaries of the same banking group. The C-SLS concept does not waive local requirements but >>>

>>> makes them more proportionate subject to certain conditions. We believe this concept is an appropriate one that should be promoted and made more use off.

For capital, the EC in its CRR review proposes that solo capital requirements can be waived subject to certain conditions; an important one being that at least half of the solo requirement shall be met with collateralised guarantees. We believe for capital this is a reasonable and prudent approach, however the collateral requirement should be capped at 50% to prevent Member States impose disproportionate requirements. In any event solo requirements should always be proportionate compared the requirements at consolidated level.

On TLAC/MREL (bail-inable debt instruments) under the EC proposal resolution authorities could allow local MREL pre-positioning requirements to be met through the right balance of collateralised and uncollateralised guarantees, in particular within the Banking Union. ●

Per Callesen

Governor, Danmarks Nationalbank

CRR/CRD reform should improve the risk sensitivity of capital requirements

Risk reduction measures currently subject to negotiations in Brussels implies changes to the capital requirement regulation and directive (CRR/CRD) and will introduce in EU legislation the Basel standards on leverage, liquidity, large exposure limits and coverage of market risk. This will add to the creation of uniform framework conditions for financial actors in the Single Market and at the global level.

In the EU, we should use the opportunity to strengthen and not weaken the risk sensitivity of our capital requirement frame-work. Huge efforts have been invested in developing and improving internal models (IRB) for a more sophisticated and pre-cise calculation of risk weights (RWs) in the largest banks. RWs which more precisely reflect the actual underlying risk creates healthy incentives for the development of banks' business models. And more accurate RWs lead to higher transparency as the resulting risk weighted assets better reflect the true risk exposure of the bank.

IRB-RWs will – like weights based on the standardized approach (SA) - never be fully accurate, but as long as regulators, su-pervisors and banks make sure that inaccuracies are not systematically biased in between segments of exposures, we can best compensate by adding horizontal buffer requirements, as we already do in CRD IV. If we think the buffers are too small, we can raise them, reducing uncertainty while preserving sound incentives.

Careful calibration is needed if we – as a result of the current Basel negotiations – at a later stage will have to introduce a floor for the risk weighted assets resulting from IRB models. Were such a floor to become binding, and thus enforce the SA on IRB-banks, we would introduce a bias and effectively allow for some components of extra risk to be added with no extra capital requirement at the margin. The RWs used would be less accurate, in particular due to the non-granular treatment of broad categories of exposures in the SA. As an example, actual risk varies substantially for mortgages in between very different liability and insolvency regimes.

Specific (favorable) treatment of certain asset classes in the current RW-rules should be reconsidered, to avoid challenging the credibility of the risk sensitive framework. One example is the so-called SME support factor, which is a reduction of RW's not based on risk factors. Another example is the absence of accounting for concentration and credit risk of exposure to sover-eigns, although this is mitigated somewhat by the leverage ratio. ●

Nicolas Duhamel

Head of Public Affairs, Groupe BPCE

CRD V / CRR II: 3 suggestions to promote simplification, innovation and proper risk assessment

The European Commission published 1 year ago its proposal for the revision of the European prudential regulation. The package is overwhelming in size, technically complex and colludes with the long lasting debates on the relative roles of European authorities. We suggest to take the time to check the fundamentals.

Before everything, we shall mention 2 themes so important that they are treated separately in their own ad-hoc panels. First, the timeline of transposition for FRTB and SACCR, in the context of on-going calibration work and level playing field with other jurisdiction. Second, the calibration of resolution requirements, and linked issues like internal MREL, introduction of IHC or breach of MDA.

For this panel, I will therefore focus on the 3 following items: domestic waivers, software investments and pillar 2. >>>

- Regarding the waivers: I understand very well the intensity of the debates on cross border activity. But first of all our experience as a cooperative group is that we have multiple sub-consolidation levels within the same jurisdiction. Since supervision process has not evolved with our structure, we now produce, only for our activity in France no less that 44 sets of solvency reporting for the SSM. You can imagine that the concept of proportionality resonate with our operational teams.
- Secondly, the treatment of software investment has become very sensitive: Unlike non-banking or non-European competitors, banks shall deduct those assets from their prudential capital. This might have a link with the lack of modernity of the information systems of many banks. Anyhow for cybersecurity reason and also for commercial reasons, such situation is not acceptable any more. Therefore we cannot maintain any longer such primitive treatment of those assets for capital management purposes.
- Lastly, the pillar 2 revision seems very controversial. It was initially introduced to promote better risk governance and assessment, as opposed and complementary to the normative measure of pillar 1. It notably reflects internal measures like stress tests and interest rate risk of the banking book. By definition it is a bank-specific supervisory tool, which has grown to become a major management indicator.

Separately, new questions are being raised: comparability of economic measures, convergence and control of supervisory practices, treatment of macro-prudential risks in particular systemic risk... The latter are currently under review of the Commission and might require specific legislative decisions. Yet they shall not pollute the debate over the RRM package and pillar 2 shall reflect banks specificities and not be standardised.

Although additions to the already thick proposal from the Commission, we expect that the 2 first items will be regarded as necessary technical corrections. In addition, we urge the legislator not to denature the pillar 2 measure that still separate banks from becoming utilities and allow them to choose their business model with their own risk appetite and strategies. ●

Dr. Karl-Peter Schackmann-Fallis

Executive Member of the Board, Deutscher Sparkassen- und Giroverband (DSGV)

European banking regulation: From "too big to fail" to "too small to survive"?

In the framework of the risk reduction package the European Commission tabled specific proposals for more proportionality in the Capital Requirements Regulation 2 and the Capital Requirements Directive 5. Indeed, the Commission proposed less burdensome requirements in the fields of reporting and disclosure for credit institutions with a balance sheet total of up to € 1.5 bn. Unfortunately, this approach is far too moderate and does not live up to the expectations of the Commission's own announcements. Instead of a clear commitment to a proportionate regulation, the proposals contain selective alleviations which are tied to an extremely low and purely quantitative total asset threshold.

European banking regulation still largely follows a 'one-sized-fits-all' approach. Rules that were originally intended solely for big, internationally active banks are being applied to all smaller players. A real-life example shows that one German Savings Banks with a balance sheet total of € 7bn has 65 full-time employees working on regulatory matters. If we were to apply the same ratio to a large bank with a balance sheet of € 1.5 tn, that bank would need about 14,000 specialists - a rather large compliance department.

"It is high time to be daring and to introduce "real" proportionality."

- DR. KARL-PETER SCHACKMANN-FALLIS

Europe's banking landscape is rich and diverse. If we want to preserve this diversity of banking business models, which is crucial to a resilient financial system, it is high time to be daring and to introduce "real" proportionality. Europe needs regulation that does not overburden regionally active credit institutions. Big, internationally active institutions, which can endanger general financial stability when in distress, should be subject to different regulation than smaller institutions with a low risk business model. DSGV has developed a Small and Simple Banking Box to be introduced that would ensure small and medium-sized European retail banks receive a scaled-down, adapted, tailor-made regulatory regime in accordance with their specific business model.

DSGV also supports the German Finance Ministry's proposal for classifying credit institutions into three categories which was put forward in summer 2017. According to this approach, large institutions with a certain systemic relevance would have to implement all regulatory measures. Medium-sized institutions would be selectively exonerated, e. g. via downsized reporting and less burdensome remuneration rules. Small and non-complex institutions would be institutions with a balance sheet total of less than € 3 bn. These institutions would be exempted from certain requirements concerning disclosure, remuneration and recovery and resolution planning and would only have to comply with a significantly reduced set of core data points in reporting. Thus the "quantitative" threshold suggested could potentially be combined with a relative element.

Whichever approach to proportionality might be chosen in the end, it is crucial to finally introduce significant relief for small/non-complex as well as for medium-sized credit institutions. Otherwise, Europe will go from 'too big to fail' to 'too small to survive', a situation that cannot be desirable from the perspective of financial stability. ●

Dan Sørensen

Member of the Executive Board, Nykredit Bank

Pillar 2 guidance – need for harmonizing stress testing models

The CRD5/CRR2 and BRRD2 proposals cover a wide range of very important issues that will affect European banks significantly. The Commission had a daunting task in drawing up the proposals but seems to have struck the right balance on a number of key issues.

As the largest covered bond issuer in Europe Nykredit is especially concerned about the treatment of covered bonds in the market risk framework (FRTB) and in the Net Stable Funding Ratio (NSFR). In line with the CMU project and the push to further strengthen covered bonds financing of the real economy an appropriate treatment of covered bonds in the prudential rules is key. The Commission proposal made significant improvements on the FRTB and NSFR compared to the international standards. However, further fine-tuning is needed in the European legislative process.

Another issue, which seems to be a bit overlooked, is the significance of the new pillar II guidance requirement. Pillar II guidance is to be set based on the result of a supervisory stress test. Thus, the link between stress testing and legal capital requirements will become stronger and more explicit.

However, stress testing is not an exact science and our experience is that banks use very different stress test models when participating in domestic and European wide stress test exercises. This may result in different capital impact and thus different pillar II guidance requirements. Of course, differences are valid based on differing business models, risk profiles etc. but differences due to differing models may undermine the level playing field domestically and across borders. Thus, the increased reliance on stress testing when setting future capital requirements warrants a more harmonized approach to stress testing domestically and across the EU so as to ensure a level playing field.

As stress testing models are often based on banks internal models for capital purposes the real key is a further harmonization of the internal models – a work already very much ongoing at the EBA and in the Basel Committee. This work should be strongly supported as it is also the best alternative to the simplistic approach of introducing a capital output floor in order to address differences in risk weights as is currently discussed in the Basel Committee. ●

Corso Bavagnoli

Assistant Secretary, Financial Department of the French Treasury, Ministry of Economy and Finance, France

A unique opportunity to deepen the EU single banking market

A number of recent initiatives (the single rulebook, the banking union) have effectively contributed to a safer European banking sector. However, the related achievements towards a more integrated banking sector have been uneven. As discussions on a new banking regulation package are ongoing, there is a unique opportunity to reap the economic benefits of this effort by enhancing cross-border banking integration, which will in turn foster better capital allocation and resilience of the Eurozone and more broadly of the EU.

Enhancing supervision at the highest level of consolidation is necessary. The recent Commission's proposal goes someway in this direction by proposing to enhance cross-border waivers on liquidity and capital requirements but the conditions under which these waivers would be used need to be improved and operationalized.

Another key aspect to foster integration is the preservation and the strengthening of the single rulebook. Avoiding full exemptions from prudential rules (especially since supervision authorities are already able to adapt requirements to the specifics of each institution e.g. through Pillar 2) and consistently applying of the single rulebook sector wide is necessary. Alleviating the administrative cost of regulation for small and non-complex institutions can be legitimate, but the application of the proportionality principle should not result in diverging prudential frameworks and eventually to the replacement of the single rulebook by different set of rules that would endanger the level playing field and jeopardize financial stability.

A single resolution framework within the European Union is key to improve the resilience and limit the impact on the financial stability of banks' failure. As a result, more confidence of the Member States on the European ability to face crisis would limit appetite for ring-fencing measures at national level and allow for the development of cross border activities. In this regard, the creditor hierarchy and the BRRD2/SRMR2 proposals are welcome.

In the realm of the Banking Union, the natural consequence of the progress achieved so far should be to consider the Banking Union as a single jurisdiction. It could be first achieved in the case of the computation of the G-SIB score: this score currently applies the same treatment to cross-border activity within the Banking Union and between a participating Member State and a third country, whereas most of the obstacles that justify this treatment at international level are not relevant in the Banking Union context. ●

Mario Nava

Director, Financial System Surveillance and Crisis Management, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

What level of capital requirements for a right balance between financial stability and economic performance?

The global financial crisis illustrated that many European banks had deficient capital and liquidity buffers, were poorly governed, inadequately regulated and insufficiently supervised. In line with global efforts, the EU has overhauled regulation and supervision to restore financial stability and market confidence. A key aspect of this work was the creation of the Banking Union, with a single supervisor, resolution board and resolution fund. These reforms have made the financial system more stable and resilient.

The transition of euro area banks towards higher capital ratios coincided with lower lending volumes and higher interest rates for households and corporations in some EU Member States. While demand for funding has overall declined during the crisis, there was a notable shift of corporate funding from banks towards market sources, partly attributable to banks' lending constraints. The traditional overreliance on banks by European corporations has led the European Commission to support the development of the Capital Markets Union, which is intended to lead to a more balanced financing mix for corporations. However, bank financing remains vital in Europe, particularly for households and SMEs which cannot access market financing. The Commission has therefore proposed an extension of the scope of the so-called "SME supporting factor".

Bank regulation and in particular capital requirement should ensure both financial stability and an efficient monetary policy transmission, which is essential for the good functioning of the European economy. Since the crisis, capital levels increased most for European banks compared to peers in other regions resulting in a change in the very nature of the risk in Europe. Rather than vulnerable to systemic risks, European banks are nowadays exposed to idiosyncratic risks, particularly those with high levels of NPLs and low profitability. This change in the nature of risk is an essential achievement and did not entail structurally higher funding costs for European banks along the intuition of the Modigliani–Miller capital structure irrelevance principle. While the cost of equity has remained high and the share of it increased, other funding sources such as bonds were getting cheaper as investors perceive the lesser risk induced by the higher levels of capital ratios.

"Bank regulation and in particular capital requirement should ensure both financial stability and an efficient monetary policy transmission, which is essential for the good functioning of the European economy."

- MARIO NAVA

The interplay between the banking sector and the real economy should also be considered when calibrating capital requirements. While insufficient capital buffers were associated with excessive leverage and credit growth, which eventually put the financial system at risk, too high capital requirements could become counterproductive. Negative feedback loops between ever higher capital requirements, banks' capacity to lend and market confidence in banks' ability to generate profits should be avoided, in particular as structural weaknesses such as banks' business models and still high levels of NPLs weigh on bank profitability and make it more difficult for banks to sustain the rebuilt capital and liquidity buffers.

Recent developments in economic conditions and bank lending growth are rather reassuring as they show a pick-up in the economic cycle accompanied by a recovery in bank lending across the euro area and signs of a reversal of the trend decline in banks' profitability. This suggests banking reforms have been overall balanced and allow the economic recovery to take place in parallel with enhanced financial stability. ●

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Review of Solvency II

Contributors

Nathalie Berger

Head of Unit Insurance and Pensions, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Solvency II and the Capital Markets Union

The primary purpose of insurance regulation is to protect policyholders against losses. A strong supervisory framework is also a necessary element of well-functioning and integrated capital markets. Solvency II delivers these objectives by measuring insurers' risk exposure in a forward-looking manner and thus functions as an early warning system for firms and supervisors, providing for different layers of intervention to ensure that insurers remain financially sound. The market-consistent valuation principles underlying Solvency II are important tools by which this is achieved. In the Commission's 2014 'long-term guarantees package', which ensured an appropriate treatment of insurance products that include long term guarantees, great care was taken to adapt the market consistency embedded in Solvency II to the insurance sector, which is characterised by long-dated liabilities and low leverage.

These characteristics make insurers also natural investors with a long time horizon, and therefore a focus for the Capital Markets Union. European insurers hold almost 10 trillion euros worth of assets, and therefore play an important role in financing the European economy. The European Commission is committed to ensure that no regulatory barriers exist to insurers playing a key role as long-term investors; it also seeks to create incentives for insurers to channel funds towards investments that benefit growth and jobs in Europe. This process has started even before Solvency II went into full application. The Solvency II Delegated Regulation adopted in 2014 featured lower capital requirements for long-term debt instruments, a specific risk class for strategic equity as well as for social entrepreneurship funds, venture capital funds and alternative investment funds. In 2015, reduced risk charges for EU long-term investment funds and infrastructure projects were introduced. In June 2017, new risk calibrations for infrastructure corporates were adopted. The Commission will keep the momentum by developing lower capital charges for simple, transparent and standardised securitisations held by insurers, and assessing whether safer investments in both private equity and privately placed debt can be recognised.

In these initiatives, we never lose sight of policyholder protection. Accordingly, the prudential framework will be calibrated in a risk-adequate manner, and that appropriate risk-management requirements apply to new asset classes.

To sum up, the Commission will continue to facilitate the insurance sector channelling funds into the real economy, but without jeopardising the overall prudency level embedded in Solvency II. This approach is driven by the understanding that while prudential regulation of insurers can lend a helping hand to economic growth, the overall amount insurers can allocate for investment in different asset classes is driven by the business they write. ●

Gérald Harlin

Group Chief Financial Officer, AXA Group

Solvency II – keynotes after one year of application and upcoming framework review

To date, Solvency II can be considered as the most comprehensive and sophisticated regulatory framework developed by supervisors on such a large scale among the insurance industry. As for any sophisticated framework, a significant number of parameters and assumptions had to be made and agreed upon, after lengthy discussion and necessary arbitrage, to properly capture and retrieve relevant measures, deemed to stay efficient even in erratic environment and striking the right balance between prudence and economic realm. Obviously, some of the assumptions taken few years ago might need to be reviewed in particular considering economic conditions such as the persistent low interest rates environment.

The decision of having built-in 2 major review dates in the Directive to go through essential components of the framework (i.e. standard formula calibrations in 2018 and Long Term Guarantee "LTG" package by 2021) necessarily implies that the shared commitment from EU law makers (Council, Commission, Parliament) along with the technical support of EIOPA and in consultation with the Industry continues to thrive, to ensure no one is losing sight of the very global purpose of the Solvency II framework.

On the opposite, should the regulator rush into a reform without due consideration given to the potential economic consequences of such reform, there is a significant risk that it could defeat its very purpose in the long run. A recent illustration of this being review of the Ultimate Forward Rate "UFR", proposed by the European supervisor, which led to the adoption of a new methodology for deriving the UFR. Based on this methodology, UFR will be lowered progressively from the current 4.2% to 3.65% for the euro. Providing the very long term horizon considered (over 20 up until 100 years), it could have arguably been more sensible to review it altogether with the LTG package, for which UFR is a key component. For now, the decision taken creates further disincentive for very long term business underwriters pending the review and outcome of other scheduled parameters.

Likewise, while some of the industry players running internal model are less impacted by the upcoming review because they are mainly focusing on standard formula calibrations, there are shared concerns among the industry around possible adjustments to parameters such as risk margin, eligibility of capital instruments or loss absorbing capacity of deferred taxes. It is fundamental that any adjustment that might be proposed preserves the fragile equilibrium of the framework and copes with the economic approach underpinning Solvency II, rather than being seized as an opportunity to take an overly prudent stance which could prove harmful in the long run for the entire system. ●

Burkhard Balz

MEP, EPP Coordinator in the Economic and Monetary Affairs Committee, European Parliament

Solvency 2: gaining experience in the application, whilst preparing for refinements

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. It is obvious that any substantial change in regulation has to be preceded by a comprehensive impact assessment evaluating both quantitative and qualitative aspects of the existing rules as well as of potential adaptations. Any impact assessment that properly involves industry, supervisory authorities and consumers needs a thorough preparation. First steps leading to a substantial recheck of the Solvency 2 long term measures may have their proper timing after the next European Parliament and the next European Commission have been constituted. To complete the picture, such a timing may also enable legislators to integrate the progress made in the global regulatory agenda once the work on the international capital standards, the G-SII designation methodology and the high loss absorbency standard advanced further. Until then, however, time should not pass unused.

The co-legislators and the Commission should do their best to make use of the insurers' capabilities to support the financing of the EU economy and 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 will rightly bring 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 the framework, to reduce pro-cyclicality, and to avoid a distortion in asset allocations. The European Parliament agrees with envisaging the 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.

"It is crucial that the positive efforts currently pursed are not offset by regulatory constraints"

- BURKHARD BALZ

At the same time, it is crucial that the positive efforts currently pursed are not offset by regulatory constraints, which are counterproductive to the aim of supporting the financing of the EU economy and the continuous build-up of the CMU. A substantial concern is the early review of the risk free interest rate term structure as proposed by EIOPA. EIOPA is already constantly involved in the overall assessment process on the long-term guarantee package. A stand-alone approach on the UFR without the co-legislators' agreement surely has to be rethought by Commission, Council and Parliament. The impact of a change of the UFR cannot be properly evaluated if detached from the long-term guarantee package as such. The European 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. ●

Dr. Frank Grund

Chief Executive Director, Insurance and Pension Funds Supervision, Federal Financial Supervisory Authority (BaFin)

SRC review is under way – keep it as simple as possible

EIOPA's SCR review project is currently working on numerous very relevant topics intending to revise the delegated acts of Solvency II until 2018 mainly in the context of the standard formula. BaFin is supporting and accompanying that project acknowledging the importance of the issues under consideration. Whereas the main objectives of the European commission are to simplify the standard formula, to remove technical inconsistencies and constraints to financing, BaFin particularly focusses on the first of those.

The reduction of complexity is our first priority. The current design of the standard formula is overly complex, particularly for small and medium-sized undertakings. Simplifications are necessary and desirable – some of which are currently under discussion such as the introduction of an additional simplification for the (non)-life lapse risk, a reduction of complexity of the counterparty default or CAT risk module or a simplification of the look-through approach.

Apart from these complexity issues, a number of adjustments are discussed which could induce a material impact on the solvency position of both life and non-life undertakings. Among these, I particularly want to mention the treatment of the loss absorbing capacity of deferred taxes (LAC DT) as well as the size of the cost of capital (CoC) rate as a driver for the size of the risk margin.

A survey across the European supervisory authorities has already depicted that dealing with LAC DT is a complex and sensible exercise. Certainly, additional guidance for supervisors how to apply the requirements would be an obvious solution. However, we are yet not convinced that this is will be sufficient – a limitation of LAC DT is a sensible alternative option to consider.

With respect to the CoC rate, BaFin appreciates any efforts made by EIOPA to develop its methodology of deriving the CoC rate further. However, I find it important to make changes only where there is sufficient evidence.

Last and by no means least, EIOPA considers a potential change of the interest rate risk module, which could particularly imply a significant impact on the solvency position of life insurance undertakings. Issues related to the current approach are discussed in the context of very low or even negative interest rates. However, care needs to be taken to arrive at a method that works in different interest rate environments, ensuring that it does not result in a significant overestimation of capital requirements.

"The reduction of complexity is our first priority."

- DR. FRANK GRUND

Finally, I would also like to mention the second EIOPA project currently ongoing, which analyzes potential adjustments of Solvency II – the LTG review project. The timeframe of this project is longer – a final report of EIOPA to the European Commission is intended by the end of 2021. However, the issues under consideration are not less relevant. Even though these projects are de-coupled, arriving at a general survey is essential. ●

Giulio Terzariol

Head of Group Planning & Controlling, Allianz SE

Solvency II reviews – safeguarding consistency while supporting financial stability and growth

While the European insurance industry has just completed its first year operating under Solvency II, legislators and supervisors are already gearing up for the first review of the framework. The directive sets out the scope and timing for regular reviews. This allows Solvency II to evolve alongside supervisory and industry experience while maintaining consistency and the defined safety level for policyholders.

In line with the guidance set by the directive, the EU Commission chose to focus on the standard formula review in 2018, saving core elements of the framework like the Long-Term Guarantee (LTG) Package for 2020. However, EIOPA has advised the Commission to explore further topics like a new calibration of the interest rate risk module and also proposed a new methodology for setting the ultimate forward rate (a key element of the political compromise). Unfortunately, these developments seem to be incompatible with the idea of a consistent evolution of Solvency II and are challenging the political consensus on which the framework has been built.

Furthermore, from an economic point of view, such a piecemeal approach is likely to result in imbalances and an unwarranted tightening of the regulation. Solvency II is the most risk-sensitive regulatory framework in the world and already includes buffers beyond the 1-in-200 year safety level prescribed by the regulation. Therefore, a further tightening of the framework is unnecessary and should only be considered as part of a wider review in which relevant counteracting measures are included as well.

As such, we believe that it would be more constructive to either expand the 2018 review to include EIOPA's positions alongside the other elements of the LTG Package - or to focus only on the Standard Formula as originally foreseen and to consider other elements in 2020.

If policymakers chose to expand the 2018 review, we believe that especially the Volatility Adjustment should be thoroughly re-examined. The current approach is too complex, ineffective and even provides adverse incentives. An undertaking-specific approach for the Volatility Adjustment would better reflect the long-term business model of insurers and the actual underlying risks while reducing unwarranted solvency volatility. This would support insurers' natural role as stable investors in long-term assets thereby also contributing to economic growth and financial stability.

"In conclusion, policymakers should avoid lopsided changes in 2018 which could throw the framework out of balance."

- GIULIO TERZARIOL

Other important topics for a comprehensive review include tackling volatility in the risk margin and developing an adequate approach for calculating the loss absorbing capacity of deferred taxes. Last but not least, given massive digitalization efforts in the industry, it would be meaningful to recognize digital investments as assets, as in other industries.

In conclusion, policymakers should avoid lopsided changes in 2018 which could throw the framework out of balance. Whatever approach is finally chosen by policymakers – a meaningful expansion of the 2018 review or tackling the fundamental topics in 2020 as originally foreseen – we are looking forward to constructively work with all relevant stakeholders towards the further improvement of Solvency II. ●

Alberto Corinti

Member of the Board of Directors, Italian Insurance Supervisory Authority (IVASS)

Addressing shortcomings without departing from Solvency II principles

In principle, the review of the Solvency II SCR standard formula is neither supposed to produce substantial amendments to the current design of the formula, nor to strengthen or relax the current capital requirements.

The declared main objectives of the review are to: i) reduce unnecessary complexity; ii) correct identified technical inconsistencies; iii) remove unjustified regulatory barriers to investments in certain financial instruments. For example, the focus now is on simplifying the calculation of capital requirements for counterparty risk and catastrophe risk, as well as the application of the look through approach. Also, the treatment of non-rated bonds and unlisted equities as well as the concept of strategic equity are under review to evaluate potential undue impediments to their spreading. >>>

>>> Improving a consistent application of Solvency II is a priority as well, focusing on specific elements where practical experience has highlighted different interpretations, such as the calculation of the Loss Absorbency Capacity of Deferred Taxes.

Solvency II is a solid and effective supervisory framework. However, as expected, it has shown certain shortcomings, which in my view mainly insist on three aspects: its complexity, the high sensitivity to the market volatility of its indicators, which could inflate procyclicality, and, finally, possible inconsistencies in the calibrating factors, which could determine undesired effects, especially in investment behavior.

Most of these aspects could be seen as natural downsides of the agreeable principles of Solvency II. In the ongoing review, therefore, the challenge will be to improve these aspects without departing from those principles: reducing excessive complexity without watering down its risk sensitivity; softening the effects of short-term, artificial volatility without reducing the capability of the system to produce early warnings; avoiding undesired behavioral consequences without departing from the agreed capital calibration criteria.

"The challenge will be to improve these aspects without departing from those principles"

- ALBERTO CORINTI

Also the objective of reducing excessive discretion should be pursued without transforming Solvency II into a rule-based regime, but rather by relying on EIOPA powers to enhance convergent supervisory practices.

Even though it is not formally part of the SCR review, it will be particularly critical in my view to improve the tools which influence the Solvency II balance sheet sensitivity to short-term volatility. In this context, EIOPA is also in the process of drawing up annual reports on the use of Long Term Guarantee measures, to be used as a technical basis for the review of the measures in 2021. Together and consistently with the SCR review, this will be key for the European insurance market. ●

Fausto Parente

Executive Director, European Insurance and Occupational Pensions Authority (EIOPA)

Solvency II - Proportionate and evidence based

Solvency II, now in place for almost two years, is a modern, robust, risk-based, proportionate and market consistent supervisory regime. It is applicable for (re)insurance companies across the European Union.

It is too early to fully assess the impact of the regulatory regime. However, EIOPA already started the important review process set out in the Solvency II Delegated regulation. In concrete terms:

- The review of the Solvency Capital Requirement standard formula (SCR) by 2018
- The overall review of the regime, including the treatment of long-term guarantees (LTG) by 2021

The main objectives of the review are to ensure a proportionate and technically consistent supervisory regime for (re)insurance undertakings, to look for possible simplifications in the SCR standard formula, to guarantee the appropriate application of the requirements and to remove technical inconsistencies based on the collection and thorough analysis of robust Solvency II reporting data and stakeholder feedback.

In July, EIOPA published a consultation paper on its first set of advice to the European Commission on the SCR standard formula. This consultation covers the following aspects: simplified calculations, reduction in reliance on external credit ratings, treatment of guarantees, exposure guaranteed by a third party and exposures to regional governments and local authorities, risk-mitigation techniques, undertaking specific parameters, look-through approach on investment related vehicles and information on loss-absorbing capacity of deferred taxes.

"More simplicity and proportionality whilst reflecting risk-sensitivity of the system and avoiding pro-cyclicality"

- FAUSTO PARENTE

In parallel, EIOPA is working on a second set of advice and will launch the respective consultation by the end of the year. This consultation will address: risk margin, own funds, policy options on loss-absorbing capacity of deferred taxes, catastrophe risks, premium and reserve risks, mortality and longevity risks, counterparty default risk, currency risk at group level, interest rate risk, simplifying look-through, unrated debt, unlisted equity, and strategic participations.

EIOPA believes in an evidence-based policymaking approach. Therefore, in the conduct of this review appropriate gathering and detailed assessment of information is key. In addition, EIOPA will make use of the data collected through the Solvency II reporting for further analyses and impact assessment.To indeed achieve more simplicity and proportionality whilst reflecting risk-sensitivity of the system and avoiding pro-cyclicality, EIOPA is interested in concrete proposals from stakeholders through-out the review process in order to take informed policy decisions. But in general EIOPA is not expecting major changes linked with Solvency II capital needs. ●

Thomas Groh

Deputy Assistant Secretary for Insurance, Directorate General of the Treasury, Ministry of Economy and Finance, France

The revision of Solvency 2 and the long-term financing of the economy: time for action

The revision of the delegated acts of Solvency II, scheduled for 2018, and the revision of the long-term guarantee package in 2021 are two important milestones in order to introduce significant improvements to this prudential framework, notably as far as long-term investments are concerned.

"Ensure that that insurers are allowed to fully play their role as long term investors, supporting growth and job creation in the European Union."

- THOMAS GROH

Towards this end, the decision of the European Commission to launch next year a study on the possible unintended effects of Solvency II on the financing of the European economy is welcome. The possible impact of prudential regulation on insurers' asset mix, and in particular equity investments (which have tended to stay flat or indeed diminish over the last years, despite rising stock indexes and a search-for-yield environment) should indeed be further documented, so as to ensure that that insurers are allowed to fully play their role as long term investors, supporting growth and job creation in the European Union. Regulators must ensure that prudential requirements are well adapted, and do not create wrong disincentives to invest in certain asset classes, in turn hindering the financing of the economy.

However, it is important that the current prudential regime continues to be improved, without waiting for this study to be completed.

Some welcome progress was already achieved for investments in infrastructures, for which a better risk-profile and cash flow predictability were recently rewarded through a more adapted calibration.

Other improvements are already on track, in particular as regards the risk sensitivity of investments in unlisted equity, for which a lower risk factor could be extended to certain portfolios. In the same vein, unrated bonds and loans could receive a more adapted treatment – which would also help reducing the mechanistic reliance on external credit assessment institutions.

Beyond, the criteria for "strategic investments" shall also be simplified, as the conditions currently attached to this bucket make it very difficult for insurers -and supervisors alike- to implement in practice.

Last but not least, long term equity investment strategies led by insurers – in line with their long-term liabilities - shall be better recognized, whereas the current Solvency 2 capital requirements are currently defined, with the very limited exception of some pension products, so as to ensure that the assets market value remain sufficient even after a severe shock over the following year. ●

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Developing Baltic and CEE capital markets

Contributors

Vitas Vasiliauskas

Chairman of the Board, Bank of Lithuania

Capital markets: national, regional, european

Recent CMU developments

Development of the Capital Markets Union (CMU) has been relatively slow. This is quite worrying given that a well-functioning CMU is a prerequisite for completing the Economic and Monetary Union (EMU).

Nonetheless, it is widely known that sufficiently deep and liquid capital markets could ensure better financing conditions for firms (especially SMEs) as it would supplement bank lending. Developed capital markets also imply a smaller burden for national budgets when confronted with shocks, this way loosening the toxic sovereign-bank nexus. On a broader note, increased risk redistribution via the private sector may lessen the need for a single fiscal policy in the EMU.

Understanding these benefits and seeing the insufficient pace of implementation of EU-level initiatives, more progress is needed on the national scale. Domestically, authorities face the necessity to deal with legislative barriers, as well as diverse depths and "cultures" of domestic capital markets – factors impeding cross-border capital flows.

Impetus for harmonisation (e.g. of company law) from domestic institutions is crucial. Without a strong national push, the CMU is unlikely to become fully operative. Moreover, due to complexity of the issue, effective and sustained cooperation among domestic institutions is vital.

Towards a fully-fledged domestic capital market

CMU developments are especially relevant to Lithuania and the Baltics – when it comes to bank lending, our economies are even more dependent than the EU as a whole. The recent crisis experience has unveiled the risks associated with such excessive linkages.

Lithuania has taken action to address this situation, establishing a legislative framework to facilitate the functioning of the domestic capital market. The Bank of Lithuania, together with other authorities, has put forward a number of initiatives, which have already been approved and are being implemented.

Setting up enabling regulation for crowdfunding platforms has been the cornerstone of our domestic strategy. The regulatory framework provides limited liability companies with the possibility to issue bonds publicly, lowers capital requirements for public companies and lifts restrictions on the maximum number of shareholders for private companies.

As a result, we are already observing activity in the crowdfunding market, with new platforms commencing operation. The market for small-scale bond emissions is also becoming increasingly more vibrant.

>>>

>>> Other important elements of this strategy include ensuring that adequate mechanisms are in place to protect bondholders' interests, defining private placement and allowing firms to grant equity to employees. In addition, we are constantly working on further improving domestic capital market regulation. Main initiatives currently "in the pipeline" concentrate on enhancing the regulatory environment for collective investment vehicles.

The Baltic capital market

Even under a fully developed legislative framework, the Lithuanian domestic capital market is small by European standards. Due to a shared currency and a high degree of economic openness, investors already tend to view the Baltic States as a single region. Bearing this in mind, regional cooperation may seem like a plausible option.

Nevertheless, by building capital markets on the regional level, we would risk creating several competing blocks with incompatible regulatory frameworks within the EU. In reality, this would hamper, rather than facilitate, the development of a common pan-European capital market.

We should instead gather best practices in domestic capital market regulation, combine them and construct a CMU framework acceptable and beneficial to all parties involved. Hopefully, this process will receive new impetus from the Estonian Presidency of the Council of the EU. ●

Kilvar Kessler

Chairman of the Management Board,
Estonian Financial Supervision
and Resolution Authority
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Andre Nõmm

Member of the Management Board,
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Developing the local capital market is a challenge for smaller jurisdictions

Estonia is a European country with 1.3 million inhabitants, a figure which sets limits on the local capital market. There are 16 shares and 3 bonds traded on the Nasdaq Tallinn, and the market capitalisation is about 2560 million EUR. The typical local retail investor invests their savings primarily through passive UCITS-type pension funds, where the underlying assets are predominantly managed by global asset managers, while the >>>

>>> use of other investment services is very low. The economy is mostly financed by groups of foreign credit institutions. For the sake of competition and risk management, Estonia is interested in developing livelier domestic capital markets and in gaining easier access to trading places in other member states.

In recent years, we have faced a tsunami of regulations concerning investor protection, market infrastructure, transparency and prudential requirements. The cost of compliance has increased significantly, and this has been followed by an increase in the cost of supervision.

It is undoubtedly a challenge for a small country to maintain the local capital market ecosystem together with the necessary infrastructure and market participants. Regulation creates costs which may affect certain segments more than others, making it even more difficult for capital markets to compete with bank financing or institutional investors for example. We have seen a trend of smaller players quitting the business as compliance costs are too high given the size of the client base. To counter this, proportionality should be carefully followed when European Union regulations are drafted. Even more than this, we welcome the recent trend for harmonised capital markets rules to set de minimis rules leaving room for a local approach for smaller offerings and institutions. A good pathway to effectively functioning markets and free competition should consider not only consumer protection, but also diversity among businesses.

Estonia is a very open country which is notable for its strong ecosystem for the realisation of new ideas by start-up companies, including services that are designed for cross-border business. The opportunities here are undoubtedly greater for a smaller country in areas or industries where there is less regulation. We are also seeing a tendency in the Estonian capital market for risks to move more towards areas that operate or are arbitrating at the border of current capital market regulations. Solutions are sought for ways of operating outside the traditional and regulated financial market, for example through crowdfunding.

Crowdfunding is rapidly evolving in Estonia and offers new opportunities alongside regulated banking, and fund and investment services. Crowdfunding is used as an alternative source of funding by both start-ups and growing companies, and also by private individuals. Crowdfunding has allowed funding to reach projects, initiatives and consumer preferences that traditional solutions for financing may not always have covered. At the same time, seen from the perspective of investor protection, certain risks are shifting to households.

Such very high barriers to entry, where the advantage lies with existing large market players who have sufficient capacity to meet the regulator's expectations, are a challenge for the European Union as a whole, and they expose the large market participants to risk. This issue should not be seen simply from the perspective of a small country, but equally in the wider context of the European Union's risk management and of European Union regional competitiveness.

As certain types of crowdfunding fall into the gaps between existing harmonised regulations, member states have addressed potential risks independently, meaning Europe has created a number of crowdfunding markets with separate barriers. We think these barriers need to be brought down to give way to a European common market. Europe has a common banking market in regulatory terms, so why is there not one in other segments of financing? It would create more competition for businesses and opportunities for those in need of credit or who would like to invest.

And let's not stop there. As technology drives financial innovation, we need to create a working uniform framework for testing such innovation before innovative products are released to the public at large. Again, consumer protection is a value that must be protected, but it is not a valid argument for killing innovation.

In short, technology drives innovation, and regulation and regulators should keep up with the pace of it. The complexity and volume of regulation imposes a cost. We should analyse very carefully whether the current tsunami of new harmonised rules always has a net positive effect or whether smaller businesses should maybe be granted more room. The CMU is an example of a good initiative that has helped address these issues. ●

Arminta Saladžienė

Vice President, Head of Securities Services, Nasdaq, Chairperson of the Supervisory Councils of Nasdaq Tallinn, Nasdaq Riga, Nasdaq Vilnius and Lithuanian and Latvian CSDs

Capital Markets Union – the fuel for the growth of Baltic economies

The Baltic economies present a perfect platform for showcasing the CMU Action Plan. After rebounding from the financial crisis, they have returned to the growth path more resilient as members of the Eurozone and full or accession parties in the OECD.

However, the ecosystem of the Baltic capital market, having sustained a harsh hit, is fragile, limiting the region's competitiveness and its potential for the long-term economic growth. With abundant entrepreneurial ideas and growth opportunities, billions of euros of "dormant" household savings and net positive inflows in pension funds, the case for the viable capital markets is as relevant as ever. Revitalizing the ecosystem and improving access to the capital markets for fast growing enterprises and investors is urgent, and the CMU has the potency to boost and accelerate this process.

SMEs are the engines of the Baltic economies. The majority of companies seeking listing on Nasdaq Baltic have a market cap below 100 million EUR, many in the range of 15-20 million EUR. Success of the Nordic countries, in particular Sweden, is a vivid example that in order for SMEs to get access to public markets on a sustainable basis, an active ecosystem with professional and retail investors, dedicated advisors, favourable policy measures and regulations and more is needed.

To put the Baltic capital markets back on the investor map, new listings are paramount. However, placement power and investor engagement is weak. The Baltic markets are still designated as "frontier" and underrepresented in regional benchmarks, such as MSCI-Europe. This is a limiting factor to attract more institutional flows, and at the same time more liquidity is needed to get into the benchmarks. Finance industry commitment to support new listings is also threatened due to ever rising regulatory burden.

Nasdaq fully supports the CMU Action Plan and its clear goals to improve financing for SMEs and to develop the capital markets. Public-private investment vehicles dedicated to SMEs, financial education of retail savers, incentives for institutional and retail to invest in growth companies are all welcome initiatives. However, there are still other conflicting policy measures. There is room for critical assessment of the compliance and administrative burden on listed companies, intermediaries, retail funds, etc.

"Revitalizing the ecosystem and improving access to the capital markets for fast growing enterprises and investors is urgent, and the CMU has the potency to boost and accelerate this process."

- ARMINTA SALADŽIENĖ

MiFID 2 requirement for unbundling investment research and trading fees is one example. If brokers are not allowed to use trading fees to finance their equity research, there is no longer a business case for doing proper equity research, which leads to a deterioration of the ecosystem especially around smaller shares.

Also, rules which do not specifically support the well-functioning capital markets should not apply to listed companies exclusively. They may indeed serve very important policy purposes, such as social and environmental, but if applied only to this target group, they increase barriers and discourage companies from entering the public capital markets. This effect runs contrary to the CMU Action Plan.

The CMU Action Plan has two sides of the coin. Therefore, it is particularly important for regulators to consider where smaller capital markets stand and evaluate how regional development across the EU could be affected. ●

Peter Palus

Head of Financial Unit, EFC Member, Permanent representation of the Slovak Republic to EU

Capital Markets Union – In search for the new growth drivers in the CEE region

Capital Markets Union (CMU), once completed, will increase resilience of the European economy by reducing Europe's structural dependency on bank financing and by increasing cross-border private risk sharing. Yet, the CMU can also increase Europe's long-term growth potential. It is a classic single market project benefiting all European Member States, but one of particular interest for countries of Central and Eastern Europe (CEE), which are starting to perceive limits to their current economic models.

In relative terms, the CEE region may have the highest potential to benefit from the CMU. While it represents around 20 % of Europe's population and 8 % of its GDP, the share of its capital markets activity is below 3 %. Capital markets in the CEE region are currently around one third as developed as in the EU as a whole. Furthermore, firms in the CEE region rely on banks for around 85 % of their funding, significantly above the EU average. According to AFME, deeper and more liquid capital markets >>>

>>> in CEE could potentially unlock more than 200 billion EUR in long-term capital and more than 40 billion EUR in additional funding every year.

So, what are the ingredients to achieve it?

First, it is necessary to avoid "one - size fits all" approach. The capital markets in European countries are in very different stage of development and size, and structure of the markets also differ markedly. In a similar vein, principle of proportionality needs to be preserved as much as possible.

"In relative terms, the CEE region may have the highest potential to benefit from the CMU"

- PETER PALUS

Second, it is crucial to focus on measures that make access to capital markets easier. The small size of markets in the CEE region together with their fragmented regulatory and legal systems increases compliance costs for businesses. A positive example to tackle this issue is the Prospectus Directive, agreed during the Slovak Presidency of EU Council, which reduces administrative burden, especially for SMEs. Further possible areas to focus on could be simplification in financial reporting standards and standardised credit information on SMEs.

Third, diversification of financing sources should also be high on the agenda. Narrow range of products has long been a drag on capital markets development. CEE region is full of innovative bright minds. And here, Slovakia is a case in point – a country of young and brilliant ideas, in particular in the field of innovative IT industry, many of them looking for alternative sources of financing.

Finally, let's not forget that deep and liquid capital markets cannot be built overnight. To make a big step forward, we should first of all concentrate on the specifics of this region, which holds huge untapped potential. ●

Robert Kitt

Head, Swedbank, Estonia

Capital markets in the Baltics – established banks with emerging pension funds

Financial markets in the Baltic countries of Estonia, Latvia and Lithuania are concentrated around well capitalized, mainly Scandinavian-owned retail banks. Due to historically low savings rates and short capital accumulation history, capital markets outside the traditional banking sector have been rather underdeveloped in the Baltics for years. The latter is however slowly changing, primarily supported by the growing size of local pension funds.

Large foreign ownership has dominated the banking sector in all three Baltic countries since the turn of the millennium. It has served the region relatively well through different cycles. Strong capitalization and profitability of major retail banks have resulted in a good and easy access to borrowing for both corporates and households. In the EC Economic Sentiment Survey, industry and service sector companies in Estonia and Latvia have constantly reported better access to credit for the past 5 years compared to the euro area average. However, despite the abundant credit supply the investment activity has been rather subdued over the recent years. This is primarily due to high uncertainty concerning our major trading partners (primarily Russia and Finland), which is now gradually decreasing and we are seeing again increasing investment demand. Banks in all Baltic countries are well prepared to finance this pick-up.

"Strong capitalization and profitability of major retail banks have resulted in a good and easy access to borrowing for both corporates and households."

- ROBERT KITT

Outside the banking sector capital markets are mainly driven by local pension funds. Although small from the global perspective (from 2,6bio EUR in Lithuania to 3,3bio EUR in Estonia), pension funds have recently started to become a meaningful source for equity financing. In cooperation with the initiatives of European Investment Fund and the EBRD a number of private equity and very recently also one infrastructure fund have been launched. Starting with early stage venture capital and ending with buyout financing altogether almost 500mio EUR of equity capital has been raised over the past 3 years. While it still represents only 0,6% of region's annual GDP, it is expected that new rounds of similar type of funds will continue to be raised.

Due to dominance of small and medium size companies as well as large foreign ownership of corporates the capitalization of Baltic stock exchanges is rather low (from 4% of GDP in Latvia to 11% in Estonia). However, recent privatization plans especially by the Government of Estonia will hopefully bring more activity to region's stock markets. ●

FINTECH AND DIGITALISATION

Content

Issues at stake

Technological innovation is bringing about major changes in the financial sector. All financial activities are concerned and can potentially reap the benefits of digitalisation or blockchain applications: retail and corporate banking, capital markets, insurance...

These changes have the potential to increase operational efficiency and improve customer experience and also to facilitate access to financial services. They however also pose challenges in terms of regulation (e.g. new level playing field, customer protection issues), scalability, standardisation and legal certainty. Cyber-risk, which may be increased with digitalisation, is another major challenge for the financial industry. EU and global cyber-security frameworks have been adopted, but further consistency and coordination efforts may be needed.

EU digital and fintech initiatives

Contributors

Yves Mersch

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

The impact of digitalisation and fintech on post-trade services - an ECB view

We live in times of rapid technological change – change that is making processes, products and services more efficient, and markets even more competitive. Greater efficiency and competition are key drivers of a well-functioning market economy.

But regardless of the technology, when it comes to financial markets, regulation needs to be able to protect the stability and efficiency of the whole financial system. The ECB has been clear on this point, stating that new market entrants (e.g. fintechs) that perform the same functions, assume the same responsibilities and take on the same or similar risks as traditional financial institutions must comply with the same legal and regulatory requirements.

A proper assessment of how the new technology affects financial market participants and operations and, in turn, the related risks and responsibilities is essential. Only then will it be possible to gain a full understanding of the impact of such innovations on the safety and efficiency of capital markets.

The ECB monitors innovations in this field, an activity which helps the institution comply with its statutory tasks. In the area of payment and settlement systems, the ECB is committed to ensuring that the adoption of new technologies by financial intermediaries and market infrastructures does not cause unwarranted financial and non-financial risks to build up in the euro area. For its own part, the ECB is on the lookout for innovative technology that may contribute to the performance of its duties, particularly in respect of financial market infrastructures, where innovation has been and will likely remain a game changer. In that context, Eurosystem market infrastructure services are currently being rolled out (TARGET2-Securities) and new initiatives are being launched (e.g. instant payment settlement) to meet market demands.

One of the most dynamic fields in fintech today is that of distributed ledger technologies (DLTs), which have the potential to change the way payments and securities transactions are processed today. The ECB is conducting experimental work with DLTs so as to assess their implications. Our findings so far suggest that DLTs cannot be the all-encompassing solution at this stage of development. Nevertheless, DLT applications might be deployed in niche markets and possible future use in major market infrastructures should be explored.

A task force, established together with market participants, has found that DLTs could both threaten market integration if they developed in a fragmented way across Europe, as well as provide opportunities to improve integration among European financial markets in areas of post-trading where obstacles still exist.

The approach of the ECB to DLTs and other new technologies is to actively monitor and explore them. It does so in house and in collaboration with other public bodies and market participants. A joint research project, for instance, is being conducted with the Bank of Japan on the use of DLTs in market infrastructure services. This type of cooperation enables all interested parties to form a common understanding of the issues involved and to ensure that new technologies, if and when they are used by financial intermediaries and market infrastructures, do not pose a risk to the safety and integration of European financial markets, but instead increase efficiency and prove beneficial to financial market users and society as a whole. ●

Hans-Ole Jochumsen

Vice Chairman, Nasdaq

How is Nasdaq leveraging technological innovation in the EU at present?

The financial services industry is being revolutionized. The sector is at a turning point in its history as fintech companies are investigating, testing and implementing new technologies which have not previously been utilized in financial services.

With new and exciting areas to investigate such as blockchain, cloud computing, artificial intelligence and machine learning, opportunities are emerging for those financial technology companies who are willing to experiment and revolutionize the industry. We see Nasdaq being at the forefront of these innovations and leading the way in embracing them within its products and services.

Nasdaq currently leverages a variety of technologies throughout services and offerings, allowing securities, derivatives and commodities markets to function efficiently and securely along the value chain. The technologies that we develop both in Europe (particularly in Stockholm) and our various technology hubs abroad are used to the benefit of our marketplaces as well as our technology customers worldwide.

In Europe, Nasdaq is deploying its technology in new and exciting ways. For instance, in Estonia, we successfully investigated and tested the benefits and opportunities of using blockchain as part of a new e-voting platform for our Tallinn Exchange. Nasdaq Clearing, which offers clearing solutions for a variety of European markets, is also exploring how blockchain technology can be used to improve collateral management and services around collateral management that are provided to its members.

New technologies are also being leveraged to provide more security and reliability. For example, Nasdaq is exploring possible uses for cloud solutions with regards to cost-effective data storing and processing. As cloud providers scale up their security measures, Nasdaq anticipates that the financial cloud will turn out to be even more secure than most traditional data centers. Machine learning and artificial intelligence are already showing their potential as vastly improving compliance processes, in particular, with respect to financial market surveillance, as artificial intelligence can help monitor market movements more efficiently and can also be used in making recommendations on specific actions.

With regards to regulation, it is important that any regulatory framework remain technology agnostic to support various types of innovative technologies. As these are evolving faster than legal frameworks can adapt, it is essential that the European Commission and regulators engage actively with the industry to obtain a good understanding of these technologies, their functioning and implications in sectors in which they are developed. The regulatory framework needs to be clear and practical as legal uncertainty and unnecessary burdensome requirements will constrain the use and development of new technological innovations.

National regulators are also creating special initiatives to foster growth and innovation within financial technology, such as the Financial Conduct Authority's Project Innovate in the UK. Within this project, the FCA has established a regulatory sandbox which allows for products and services to be tested within an environment that is not

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>>> constrained by all the normal regulatory consequences. The European Banking Federation has also recommended the creation of a Europe-wide sandbox, in order to foster fintech innovation in cross-border services.

As the first electronic stock exchange and a financial technology pioneer, innovation has always been at the core of Nasdaq's DNA. Today, our mission is to provide industry-leading technology, trading and information solutions to public and private companies worldwide. In keeping with this ambition, we will continue, in Europe and worldwide, to investigate new technologies, to innovate and create new solutions and platforms for its customers, and embrace our role as a pioneer in the industry. ●

Vilius Šapoka

Minister of Finance, Republic of Lithuania

Fintech: forward-thinking European regulation?

The pace of technological changes across the financial sector has recently been magnificent. However, full potential of FinTech is to be unlocked as the major benefits for consumers and real economy still lie ahead. What role should the EU play in order to open a better future?

First, fostering globally competitive European financial sector requires to be wary of overregulating FinTech industry. Regulation in force should correspond to technological breakthroughs, not the other way around. Creative spaces for experiments are necessary, otherwise the innovations will lag. To draw a parallel, though the first cars resembled carriages, it was not wise to stick to old speed limits if progress in the car industry was sought-after. Keeping our legislation proportionate and removing barriers to market entry are of great importance.

Second, more attention should be paid to FinTech solutions, which have been tried and tested in some Member States but not in the whole EU. For example, P2P lending and crowdfunding regulation at EU level could solve cross-border issues and contribute to the smooth operation of the single market. One way or another, financial services provision needs stronger cross-border dimension for the benefit of consumers across the EU.

Third, seeing a reality of rapidly emerging new technologies and accompanying changes of buzzwords, we have to keep our focus on fundamental policy objectives, such as consumer protection and financial stability. The right balance is a must if Europe wants to benefit from FinTech.

Fourth, in order to enhance further growth of FinTech in the EU, we have to remain faithful to the strategic plans of the Capital Markets Union and the Digital Single Market. The entrants of the financial sector could greatly benefit from the EU activity in removing digital barriers between the Member States and contributing to economic growth.

It is up to business to come up with the best possible technological solutions and lead them to fruition, but shaping the future is also impossible without establishing forward-thinking regulation. The fact that FinTech has moved to the front of the European policymaking provides a good reason for hope. ●

José Manuel González-Páramo

Executive Board Member, Banco Bilbao Vizcaya Argentaria (BBVA)

Financial innovation in the digital age: challenges for regulation and supervision

The evolution of economy and society is featured by continuous change. Most of the time, this change is slow and incremental but, every now and then, rapid disruptive changes take place over short periods of time, leading to what are commonly known as "revolutions". We are living now one of these stages of disruption, the so-called "fourth industrial revolution" that produces change at an unprecedented speed, following an exponential rather than a linear pace.

This digital revolution has also arrived in the financial sector. Currently there is no doubt that the financial sector is at a major crossroads. Paradoxical as it may sound, technology could become the major gear shift in the financial sector for decades. Digital disruption may help banks to survive the pressures of low growth, waning profitability and strong regulation, and to solidly re-establish customers' trust and reputation with society. If banks can offer a better user experience, they will again come closer to what customers demand and need to satisfy their aspirations and take advantage of the opportunity of this new age.

Regulators and supervisors act as key drivers of, or brakes on, the changes needed during the transformation of the financial services industry. As a starting premise, regulation in the financial sector is necessary, as is more intensive supervision than in other sectors. Traditional regulation has played an essential role in the development of the financial sector to date, aiming to safeguard the stability of the financial system by ensuring that the vital roles played by the banking sector in the economy do not suffer significant disruption or that the institutions do not collapse.

The promotion of innovation in the financial sector has been a secondary objective for the authorities, if not disregarded altogether. However, the digital transformation of the economy and the society is changing everything, thus forcing authorities to adopt an active position. Regulation and supervision are now challenged to provide a regulatory framework that facilitates the development of the new digital value propositions – which benefit the customer and introduce efficiency gains in the market – while ensuring protection against the associated risks.
The new digital paradigm presents new risks in terms of cyber security, consumer protection, operational continuity and fraud, among others. These are not fully covered by the traditional supervisory and regulatory approach. It is worth highlighting that new digital propositions are at an early stage and they certainly do not pose significant financial stability and consumer risks so far. However, the exponential nature of the new digital infrastructures, business and distribution models and customer solutions allows them to go from "too small to care to too big to fail" in a very short period, requiring authorities to have a far-reaching and anticipated perspective.

Hence, financial innovation in the digital age challenges regulation and supervision. In this context, there is a need for a renewed regulatory and supervisory framework that fully captures the potential of digital innovation and makes the financial system >>>

>>> more resilient against future crises. Although there is no magic regulatory and supervisory formula, any solution should rest on four key pillars:

- The private sector needs to have clear policies on the control and management of new technological risks.
- Knowledge centres and innovation hubs are key contact points for regulators and industry to share common views and gather advice to navigate legal issues better.
- The creation of supervised and safe pre-market testing environments, the so-called regulatory sandboxes, emerges as an option that fosters innovation while preserving systemic stability.
- Authorities should work to increase the knowledge and capacity of their staff about digital innovation, as well as develop a collaborative mindset.

Such a holistic approach is the most reasonable way to seeking a balance between the promotion of the new digital value propositions and the protection against the risks involved. ●

Cora van Nieuwenhuizen

MEP, Committee on Economic and Monetary Affairs, European Parliament

Fintech: we are at the table, or on the menu

Fintech is the new buzzword in the financial sector these days. This has, for some time now, been the case in the United States and Asia, while in Europe we have just started to become aware of the importance of Fintech. If Europe aspires to be competitive and keep its state-of-the-art financial infrastructure, rapid innovation should be the new norm, instead of the exception.

Opportunities are huge, both for industry itself as well as for consumers. Fintech leads to more transparency, more convenience, greater freedom of choice, better and quicker services and lower costs for consumers. The financial industry can also profit enormously from Fintech developments such as Big Data and Robo-advice. Moreover, Fintech lowers costs and ensures better risk management.

That is why I have dedicated myself to putting Fintech high on the European agenda. My report was adopted by the Parliament a few months ago. My key recommendation is that European regulations have to give room to greater developments in Fintech. Europe needs to facilitate, not frustrate, Fintech!

"Fintech leads to more transparency, more convenience, greater freedom of choice, better and quicker services and lower costs for consumers"

- CORA VAN NIEUWENHUIZEN

Priorities

The number one priority in Fintech is cyber security, which also should be priority two and three. The iconic robber who enters a bank, gun in hand and a hood over his head, only still exists in action films from the last century. Nowadays, it is more likely a hacker in his garage or attic with a beer in hand. Cybercrime is a growing problem globally. I have been advocating strongly for greater focus on cybersecurity at banks and other financial institutions, for instance in stress tests.

The future financial sector will be more in need of technical staff, >>>

>>> and less in need of lawyers and economists. Not just to develop algorithms, but also to protect the enormous amount of data coming our way. The same applies to financial regulators; they need to dive into the complexities of Fintech developments, to understand what is going on and how Fintech relates to the real economy, before making any decisions.

New kids

Besides that, ensuring a level playing field is very important. There are many 'new kids on the block who are currently entering the Fintech market. Fintech is not just for traditional banks and insurers. The future customer does not care whether the financial product is from a Big Tech, an incumbent or some hip young start-up. Therefore, the principle of 'same services, same risks, same rules' should apply. Only by giving all the parties involved equal opportunities, will we enhance innovation.

Way forward

Last, but not least, we need to be able to experiment with Fintech solutions in Europe. By allowing the testing of new innovations with the help and support of regulators, the financial sector will gain knowledge and experience, without endangering the interests of consumers. We should focus more on addressing all that Fintech has to offer in order to be able to attract the economic growth related to these new developments. This is because currently, Europe is not in 'pole-position', but has to, just like the Dutch Formula 1 racer Max Verstappen, perform spectacular manoeuvres to overtake the competition. Europe is, just like Verstappen, a potential World Champion. We only need to create the right circumstances! ●

Märten Ross

Deputy Secretary General for Financial Policy and External Relations, Ministry of Finance, Estonia

Importance of integrating technological driven innovation into financial regulation

How important are Fintech and digitalisation for the development strategy of the Estonian and Baltic financial sectors?

It should be stressed that the phenomenon of technologically driven innovation affects both traditional service providers as well as their more specific fintech modifications. Therefore, both supporting of new business concepts and taking into account fintech impact to the more traditional service providers is very important for both overall financial efficiency and stability point of view. Furthermore, considering its bias to have strong links to facilitate cross-border nature of financial intermediation, at least regional view in strategy setting is important.

"There is no reason to think that we can have a Single Market for financial services that has little to do with fintech."

- MÄRTEN ROSS

What are the most promising concepts and technologies used in the region?

There are wide range of fintech elements that reshape the market both in basic retail level but definitely so also regionally. Probably most important ones are those that allow further streamlining and cost cutting in financial intermediation without compromising the investor safety or even more so -- actually facilitating it. That has probably the biggest influence to the real economy as well. Innovations that could be classified as new selling channels are also important, but their fundamental additional value added is maybe less sizeable.

What role do the domestic public authorities play in the development of these new technologies in the financial sector?

Facilitating the change in controlled fashion is the most important role for authorities. To scrap the red tape where it is unnecessary, but at the same time keeping a cold head to separate truly efficiency improving innovation from more questionable circumventing-the-rule-type innovation. And it is quite clear that the object is not just narrowly financial regulation but also wider regulatory environment of entrepreneurship, for example company law. But in the EU single market context one should recall that the important domestic authority's role is also to support EU regulatory process.

Would a European initiative or framework to support Fintech and digitalisation developments in the EU financial sector be useful and if so what could it cover?

Yes, having a European view on supporting and regulating the digitalisation driven innovations in financial sector is very important. There is no reason to think that we can have a Single Market for financial services that has little to do with fintech. If anything, these innovations increase market interlinkages. But that 'yes' assumes that this initiative includes the option of reviewing and reshaping also the existing rules and that at least in some cases the advice could also be inaction or non-regulation. The reason for that is that technology is not just changing the financial sector via introducing new services or businesses. Maybe even more importantly it continues to provide opportunities to reshape the approaches for many essential areas of financial intermediation both in terms of efficiency and risk control and it is not sure if the present detailed regulation is supportive for that. It would be quite counterproductive to keep those acitivities unduly ineffective and thereby hinder more generally European competitiveness. At the end of the day we still talk about pretty much the same animal with fundamentally similar risk-profiles and basic requirements. ●

Aleksi Grym

Head of Digitalisation, Bank of Finland

Keeping up with the digital revolution requires prioritisation and cooperation

It was only a matter of time that the digital revolution began transforming the financial industry, as it had transformed other industries previously. Information technology has always played an important part in finance, but this time is different, because technology is not only making familiar processes and operating models more efficient, but is actually changing how the entire sector works. Finland, along with its Nordic neighbours, has long been at the forefront of digital financial services. Finnish banks have provided online banking services since the late 1990's, and they are now used by 90% of the population. We are in an advantageous position to also embrace the next wave of digital transformation that is now getting started. The Nordics can lead the way by not only developing new and better financial services, but also by rethinking how public authorities can work together with both incumbents and new entrants.

When thinking about which technologies are the most transformational in the financial sector, one cannot overemphasise the significance of mobile devices. The Nordics have some of the best mobile networks and highest rates of smartphone usage in the world, so we are seeing this transformation happening fast. For almost any type of financial service, there is hardly any need to visit a branch anymore. Instead, financial services will become ubiquitous and available anywhere, at any time. As a result, there will be less interaction between two human beings when providing these services. This means that some of the tasks previously done by people, including making decisions requiring judgment, will be taken over by algorithms and artificial intelligence.

The financial sector is highly regulated because financial transactions are inherently risky and consumers need to be protected. As the industry is going through its digital revolution, the public authorities need to go through a transformation of their own, in order to maintain their high level of oversight in the sector. The best way to do this is by working closely with the industry as and when the transformation is happening. New technologies and operating models can be analysed together, so that there is a common understanding of the risks and opportunities involved. Throughout this process, the regulators want to find a good balance between promoting innovation and competition on the one hand, and maintaining financial stability and security on the other.

"One of the greatest challenges is the sheer speed at which things are happening."

- ALEKSI GRYM

One of the greatest challenges is the sheer speed at which things are happening. Getting a regulatory framework in place can take time, but the digital revolution will not wait for anyone. It is therefore important to find the right priorities and to have a forward-thinking mind set. Moreover, the regulatory framework we are building for the digital future needs to have a European scale from the outset. Both the industry as well as the consumers are expecting it, and it is what the single market is all about. ●

Fintech in the CMU

Contributors

Olivier Guersent

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

Fintech: a new powerful driver for EU capital markets

Fintech sits at the crossroads of the Digital Single Market and financial services policy. A connected digital single market is one of the political priorities of the Juncker Commission and also one of the fundamental means through which the Commission is seeking to support the creation of jobs and growth. The recently adopted Consumer Financial Services Action Plan and the Capital Markets Union Mid-term Review both acknowledge the important synergies that exist between technological innovation and financial services.

A thriving and globally competitive European financial sector which can take advantage of cutting-edge technology will bring benefits to the European economy and its citizens. Over the last three years, much work has been done to develop the Capital Markets Union, facilitating the flow of money within the EU and making it easier for companies to access capital and for individuals to invest their money in new ways.

Fintech is playing a key role in shaping the financial services of tomorrow. It is transforming the way in which traditional financial services are provided. The new ways in which technology can be applied to finance hold enormous potential for the uptake of innovative solutions in several (capital) market segments. By facilitating entry of new market players, Fintech can stimulate competition and lower costs for investors, businesses and also consumers, with positive impacts for greater financial inclusion.

The successful uptake of Fintech solutions is expected to be one of the fundamental drivers for the achievement of the Capital Markets Union's objectives. In recent years, technology – particularly the internet – has played an important role in overcoming some of the current barriers and gaps in retail financial services. Looking to the future, the Commission expects that emerging technological solutions (e.g. blockchain, artificial intelligence, cloud computing) will continue their expansion into the financial services space.

The Commission recently concluded its assessment of the responses to the Fintech public consultation, launched in March 2017 and is in the process of designing its policy approach. Overall, responses from the consultation show clear excitement for the potential of Fintech and its opportunities in terms of access to finance, operational efficiency, cost and competition. Most importantly neither the analysis carried out by the Commission Task Force, nor the responses to the public consultation revealed any important lacunae with respect to financial or consumer investor protection risks that would require immediate EU level action.

To ensure that the EU economy, the industry and citizens are able to benefit from digitalisation, the Commission intends to put in place targeted initiatives aimed at reducing barriers for Fintech across Europe, to support the uptake of new technological solutions while enhancing integrity and security. Over the coming months, the Commission will continue to monitor and identify emerging trends and identify new opportunities for proactive EU initiatives, while keeping the market situation under close scrutiny and standing ready to act to mitigate any emerging risks to >>>

>>> financial stability, should it be necessary. In the same vein, as new technologies often pose complex questions about the applicability and interpretation of existing rules, the Commission will make efforts to ensure that the regulatory environment is sufficiently accommodating and permissive so that new technological solutions can emerge and are not stifled by inflexible rules.

The Commission will pursue targeted interventions that are technology-neutral, future-proof and proportionate. It stands ready to embrace developments deriving from technological innovation in the financial sector – that is the basis of our pro-competition and growth-oriented approach to Fintech. However, should Fintech present risks, the Commission will not hesitate to take necessary actions to control and mitigate them, while continuing to ensure financial stability and to preserve confidence in the technology enabled marketplace. ●

Niels Tomm

Representative of the Board, Deutsche Börse AG

FinTech companies – A capital market-orientated "Mittelstand"?

The daily news and chatter on the ongoing Brexit negotiations must not make us lose focus on the other challenge the EU is facing right now, namely to become future-proof for the 4th Industrial Revolution that will change the way we work, produce and live. Once Artifical Intelligence, Blockchain, 3D printing and other technologies will have reached their full potential, the global economy will be a completely new ball game, and the EU needs to remain on top of these developments.

Now more than ever, the EU27 need to stay ambitious in the realisation of this project – to ensure that Europe remains globally competitive and finds itself in an appropriate position to set global standards and act as a role model internationally. The case for prioritizing FinTech developments within the CMU thus needs to be made prominently.

While the original CMU Action Plan was very much driven by the question how to improve financing for start-ups (i.e. seeing the CMU as enabler for start-ups including FinTechs), the Commission is now reflecting on how FinTech business models themselves can contribute to a deepening and broadening of EU capital markets (i.e. seeing start-ups including FinTechs as enabler for the CMU).

This is the right approach, as the CMU and the development of a vibrant European FinTech sector will be mutually reinforcing. The EU has the potential to become home to a globally thriving FinTech and RegTech industry, which will alter the current market structures and existing business models. Technological innovation will not only change the face but also the DNA of the entire financial services sector – and it is crucial that the EU remains at the forefront of innovation and digitalization.

FinTechs will be able to support the development of capital markets in several ways. They are indeed tackling barriers, fostering standardization and disrupting business models, which at the end will contribute to strengthening the CMU and create efficient and cost-effective markets for the end client. Do they need a special regulatory framework for this? No, they do not. As a principle, Fintech companies should not be treated different then established businesses. This is not only a question of level playing field, but a special treatment could potentially hamper FinTechs in a future stage of development, e.g. if the business model only works with a tailored regulatory framework and would not be viable in a real-world setting. >>>

>>> The start-up and FinTech community will be important in supporting the backbone of the EU economy – the SMEs – to become future proof for the 4th Industrial Revolution. From a German perspective, we are frequently referenced for our successful "Mittelstand", which are often technology-driven family businesses that are market leaders for generations. They are indeed a vital pillar of the German economy. However, there are concerns that some of these companies risk being ill-equipped to face the challenges of digitalization and suffer a shortage of skilled labour. Deutsche Börse Group believes that creating an ecosystem bringing these players together with entrepreneurs in the start-up and FinTech area to partner-up can have a catalytic effect, helping both in reaching the next level in their development.

Furthermore it is not just about focusing on the next (or the first) European unicorn of global scale. Rather we will see FinTechs and Start-ups becoming the new European "Mittelstand". There are many companies with the potential to leave the growth stage as sustainable and enduring companies. They will strengthen the backbone of EU economy as the existing SMEs are today. However, there is another aspect that is not acknowledged enough which will be an important factor in strengthening the CMU: These companies will be capital-market orientated. All their company "life", they have been supported by equity capital and not bank loans. Therefore, their willingness to go public can be expected to be higher than the "classical Mittelstand", further contributing to making the CMU a reality. ●

Teppo Paavola

Chief Development Officer and General Manager of New Digital Business, Banco Bilbao Vizcaya Argentaria (BBVA)

Fintech to support the Capital Markets Union

The Capital Markets Union (CMU) remains a key priority for the European Commission, especially after the decision of the UK to leave the European Union, which reinforces the need to achieve more integrated European Capital Markets. A well-functioning CMU will increase private risk-sharing, the resilience of the financial sector and the shock-absorbing capacity of the economy. In this sense, technology, and specifically financial technology has entered financial markets and is acting as a game changer.

FinTech may be described as finance enabled by new technologies, covering the whole range of financial services, products and infrastructure. This definition covers a wide range of solutions from back to front office applications, and for all kind of services, based in technologies such as Cloud Computing, Big Data, Artificial Intelligence or Distributed Ledgers (DLTs). As an example, DLTs can make clearing and settlement more efficient and facilitate the issuance of private companies securities.

Innovative businesses in financial services, whether startups or incumbents, allow faster and more affordable services, increase the role of capital markets and facilitate access to financial services for consumers, and to capital for SMEs. There is indeed a market opportunity in addressing the underserved and the overpriced areas of financial services. The development of a fintech ecosystem and cooperation between incumbents and new entrants is beneficial for consumers and the economy as a whole.

FinTech is an important piece of the CMU and can contribute to achieve its goals, thereby increasing European competitiveness and leadership. Fintech is a >>>

>>> facilitator for increased cross-border activities and may expand the reach of financial services to geographically dispersed customers at a limited cost, as it does not require expanding physical presence. Furthermore, the Commission recognises the importance and potential of fintech activities in its mid-term review published on June 2017. The Commission includes as a priority action to assess the case for an EU licensing and passporting framework for FinTech activities to harness the potential of FinTech[1]. Regulators should react promptly making a risk assessment on new technology uses to introduce new regulations if necessary. This topic was also discussed in the recent Consultation on Fintech[2], which aims at drawing up a Fintech Action Plan, which will complement other actions in the CMU, providing input on how to further support FinTech.

According to a recent report published by the Financial Stability Board[3], Fintech does not pose a risk to financial stability, and identifies potential benefits such as greater efficiency, transparency, competition and resilience of the financial system, and greater financial inclusion and economic growth. The FSB will continue to monitor and discuss the evolution of the potential financial stability implications of FinTech developments.

Nevertheless, the entrance of new players to regulated markets needs to be secured by a level playing field in the industry. In this sense, regulation should be tailored to specific use cases and business models, regardless of the nature of the provider offering them. In highly regulated industries such as financial services, compliance requirements and regulatory uncertainty hinder innovation. To address this issue, several authorities around the world are developing "regulatory sandboxes" in which both incumbents and new players can test innovative solutions in the real market without immediately incurring all of the normal regulatory burden of engaging in the activity in question. ●

1. https://ec.europa.eu/info/sites/info/files/communication-cmu-mid-term-review-june2017_en.pdf
2. https://ec.europa.eu/info/finance-consultations-2017-fintech_en
3. http://www.fsb.org/wp-content/uploads/R270617.pdf

Sébastien Raspiller

Head of Corporate Financing and Financial Markets, Ministry of Economy and Finance, France

To fill the gap with competing markets regarding Fintech, we need a strong CMU

Fintech offers new opportunities for consumers and professionals alike: not only do these technologies allow significant cost savings, they can also increase competition and broaden market access.

Such stakes are in line with the main objectives of CMU, especially the need to better direct European savings towards investments and to strengthen market-based financing, especially venture capital which is key to small and medium-sized companies.

Crowdfunding remains one of the most promising fields of application for Fintech in this regard. Even though the sector has been developing quickly over the past years, it probably remains far below its full potential, including in terms of cross-border distribution.

Robo-advice could usefully foster the development of retail investments, by providing more client-friendly and attractive solutions for savers, and contribute to the diversification of >>>

>>> savings. Digital advice in general is a useful tool at hand for the integration of retail markets in Europe, allowing access to a wider range of products and more competition among providers.

"The use of DLT appears particularly promising for the cross-border distribution of funds."

- SÉBASTIEN RASPILLER

Less mature yet, the use of distributed ledger technology (DLT) could bring radical innovations to the functioning of capital markets and a more direct access to capital markets for retail investors. The use of DLT appears particularly promising for the cross-border distribution of funds. A wider use for the transmission of securities still appears premature, but it could completely in the medium term reshape European capital markets and be a decisive contribution to their integration.

Public policy should strike a careful balance between financial stability, consumer protection and the need to encourage innovation. One way to achieve this delicate equilibrium is to remain as technology-neutral as possible when adopting new legislation, and to reassess regularly the legal framework in light of new actors or activities. Rather than technologies, practices and professions should remain the objects of regulation. However, Fintech can contribute to redefining them or the challenges they pose.

At a European level, a deep reform of the legal framework would be premature, but current passport options can be deemed inadequate to those new small actors, with original business models. Passporting crowdfunding services or digital advice could for example be thoroughly examined, not because of their digital nature but because they provide new type of services, which could be easily offered across Europe.

Fintech has not revolutionized capital markets yet and it may not suffice to make progress towards an actual CMU. However, national and European authorities need to keep an eye open on its developments. Otherwise, Fintech could not only be a missed opportunity for CMU: It could widen the existing gap with competing markets, especially in the United States and in Asia. ●

Lee Foulger

Head of International Department, Financial Conduct Authority (FCA)

CMU and good innovation: a global regulatory challenge

Capital Markets Union is about connecting investors with investment opportunities. It is about breaking down barriers and giving the SME in Poland or Italy the opportunity to tap new sources of funding from Finland or France. Technology makes this more of a reality than ever before.

Financial technology can challenge the status quo. We are seeing new entrants in the market offering services based on Distributed Ledger Technology (DLT) which automates complex and burdensome procedures – such as prospectus documentation – hence giving a chance to smaller firms. Crowdfunding is another quite established example of a new way to match investors to investment opportunities.

At the same time, Fintech can provide better value products and services for consumers. This is why as a regulator, we are committed to promote innovation. It is our strategic objective to make relevant markets work well and to do that we focus on the integrity of markets and consumer protection. We furthermore have a duty to promote competition in the interests of consumers.

What are we experiencing at the FCA? As to be expected perhaps, interest in Fintech and the regulatory support to develop innovation is growing. Through our Innovation Hub, we have seen hundreds of firms, not just new entrants but established players as well, coming with innovative ideas and seeking support to navigate the regulatory framework.

Innovation transcends traditional borders. The co-operation agreements we have signed in the last few months with counterparts in China, Japan, Canada and Hong Kong are evidence of how we can do more together in a global effort.

An industry that grows this fast and knows no borders also presents challenges for regulators worldwide. The recent cyber-attacks are a reminder that digitalisation has its benefits but also poses risks to market integrity, consumers and to our entire system. These examples of global failures are furthermore a risk to the reputation of and trust in financial innovation, which is why we, together with European and international counterparts, are defining global strategies to combat these threats.

"A global approach to innovation can bring huge opportunities to connect a wide group of savers to investment opportunities"

- LEE FOULGER

As regulators worldwide are beginning to set up their own sandboxes, we need to work together to find ways to promote responsible innovation which enhances outcomes for consumers. Our Sandbox is not about lowering standards as failing to prepare firms to join the regulated market will not foster firms that succeed long-term. It is not either about transferring risk onto consumers, since this would risk undermining consumer confidence in innovative products and services.

If innovation is borderless within Europe then it is also borderless outside of Europe. A global approach to innovation can bring huge opportunities to connect a wide group of savers to investment opportunities. This can only be possible with a strong international collaboration, which ultimately is in the interest of both consumers and the long-term future of the industry. ●

Adriana Pierelli

Managing Director, Regional Executive Southern Europe, BNY Mellon

Fintech and the CMU – what regulators need to do

Fintech is a major enabler for the Capital Markets Union (CMU) project.

One of the major objectives of the CMU project is to overcome barriers that have the effect of segregating national capital markets, and inhibiting their growth. One of the promises of fintech is that it facilitates information transmission and processing, so that information can flow as easily across, as within, borders.

There is broad agreement with this analysis. But we need to go further, and to translate this insight into practical policy, and practical action.

The existing reality is that the development of existing securities markets, and of cross-border investment in those securities markets, is constrained by elements of their design.

A good part of securities market infrastructure and many existing processes were designed years ago around a model of domestic retail investors holding domestic securities.

This causes problems for cross-border investors. The problem lies less at the levels of trading or of settlement, as these have seen recent extensive pan-European work, but rather at the level of the post-trade custody process, and in particular the process whereby information about the end investor (identity, tax status, proof of tax status, voting instructions, etc) moves up the custody chain to entities located in the country of issuance (such as issuers, issuer agents, and regulatory and tax authorities).

Existing national processes have been designed to manage this information flow on behalf of potentially millions of domestic retail investors. These processes typically do not work well for wholesale investors, but wholesale investors have the resources to manage the resultant complexities. These processes typically represent a severe barrier for foreign retail investors. In consequence, investments in European securities are negatively impacted by existing barriers.

Fintech developments offer the possibility to overcome these information transmission problems, both for wholesale and for retail investors.

So far many proposals in this area have gone down the road of radical disruption, and of building a completely new infrastructure which would allow for efficient end-to-end processing.

But many of these proposals do not offer solutions for existing securities, and sometimes they are themselves constrained by existing law and regulation, which were written with legacy processes in mind.

"Fintech solutions have great potential in bringing solutions to today's problems"

- ADRIANA PIERELLI

It may well be more pragmatic to take an evolutionary route, and to use fintech solutions to tackle the problems in existing processes.

But even for this route there is no certainty of success. There is still the issue of constraints in existing law and regulation, and there is the potential existence of underlying structural problems that explain why no good solution has so far been found, and that would continue to apply to fintech solutions.

In short, fintech solutions have great potential in bringing solutions to today's problems, and in helping construct a Capital Markets Union, but they will not be successful by themselves.

Policy makers and regulators, both at the European and at the national level, have an important role to play in tackling underlying structural problems, and in ensuring that rules and regulations are adapted to new business processes and models. ●

Paul Symons

Head of Government Relations, Euroclear

Fintech and EU capital markets – The challenge and opportunity

Fintech puts technology at the heart of the financial services offering, fundamentally changing the way in which companies, including market infrastructures, interact with their customers. This proliferation of fintech will have a number of positive impacts for society, including increased competition, a reduction in prices paid by customers, and wider access to financial services.

But there are inevitable challenges.

First, there is the investment challenge. Buying into disruptive technologies at a time when the regulatory compliance burden is so high, and the need for financial stability so important, often translates into risk; despite the potential of these technologies to revolutionise how firms operate. But for those willing to invest in fintech – especially in data, payments and software technologies - a more efficient and cost-effective >>>

>>> business model, coupled with competitive advantage, will be the result.

We must all demonstrate to the wider economy that these technologies will aid growth and development, not hinder or threaten it. Fintech is arguably critical to the successful delivery of CMU. This is why Euroclear is one of a range of shareholders in a new start-up called LiquidShare designed to develop a post-trading blockchain infrastructure for the Small and Medium Enterprise (SME) market in Paris. The aim is to improve SMEs' access to capital markets, improving the transparency and security of post-trading operations.

Secondly, there is the question of how fintech should be regulated. As fintech start-ups generally do not operate like a financial services company, they tend not to be subject to the same regulations that govern more traditional players in the financial system. As a result, there has been a concerted, and very welcome, effort on behalf of policy-makers to understand these new operating models and to reconsider the existing supervisory framework both for fintech companies and also for users of fintech services.

Regulation can act as a brake on innovation. The imperative therefore, for regulators is to strike the right balance between innovation and financial stability. And to identify those areas where existing regulation might need adaptation to ensure a regulatory level playing field for new entrants and established providers. ●

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European Union

Digitalisation in retail banking and payments

Contributors

Madis Müller

Deputy Governor, Eesti Pank

Much better pan-European digital financial services are possible

The ongoing digitalisation of our everyday lives and the availability of connected smart devices mean we can be online and reachable at all times. This has encouraged incumbent PSPs and new market entrants to make better use of existing and new financial technology. This in turn has driven the development of remote identification solutions and allowed the creation of fully app-based PSPs with innovative payment solutions and automated tools for financial planning and advice. While digitalisation has already improved transparency and access to information and services, we need to go still further if the new payment services are to advance digital retail banking and payment solutions at the pan-European level.

Retail customers need a secure digital identity that is accepted throughout Europe.

Digital identities could improve borderless access to financial services by helping service providers reach new customers remotely and letting payment service users use eBanking and payment solutions from foreign providers. There are successful examples of public and private sector cooperation in developing national e-identification and e-signature solutions that let PSPs conduct KYC remotely, and let PSUs authenticate themselves remotely and sign documents digitally. If such e-identity and e-signature solutions were interoperable it could further support the cross-border offerings of services in a digital world.

The European Commission is strongly in favour of building a Digital Single Market and has funded the development of building blocks to make national eID and eSignature solutions interoperable at the European level. Moreover, the Commission's Action Plan on consumer financial services outlines the steps that need to be taken towards an eBanking building block that will meet the requirements of remote identification of bank customers. The PSPs should be encouraged to take advantage of this momentum, as being able to accept all the national eID/eSignature solutions would clearly increase business opportunities for them while also helping them meet the strong customer authentication requirements.

It is quite natural that customers want services that are not only secure but also as convenient to use as possible. This implies that strong customer authentication needs to be made available using solutions based on mobile applications. Several examples of such services have already been developed. In my country, Estonia, an official secure sim-card based mobile-ID solution has been in use since 2007, and it was just recently complemented by an alternative mobile app-based eID/eSignature service developed by the banking industry for the Baltic region.

Managing daily banking activities at multiple PSPs through one application may be the future of digital retail banking and payments.

Digitalisation and the uptake of internet banking has given third party providers the motivation to develop solutions that can initiate payments from the payer's >>>

>>> bank account or aggregate the account statements of different banks. PSD2 has regulated such providers and introduced two new payment services for payment initiation and account information.

Such services could increase competition and not only improve access to better payment solutions, but also provide integrated tools for financial planning and advice. They might give customers access through one digital banking or wallet application to account balances and payment history at multiple PSPs, let them view all their e-invoices or other request-to-pays, and allow them to initiate payments from any suitable account.

We are now in the middle of an important debate on how exactly the new requirements for third party access should be implemented by the banks. After the PSD2/EBA RTS on common and secure access to bank accounts is finalised, decisions are likely to be based on a cost-benefit analysis. While we debate the alternatives, we should keep in mind that access to bank accounts may allow both new third-party service providers and incumbent PSPs to offer customers new and useful products that go beyond just payments. Making sure that banks allow harmonised access would be a move to support the goal of having a truly single market for financial services. However, alternative options still warrant discussion if they are able to support the same objective. ●

Marc Bayle de Jessé

Director General Market Infrastructure and Payments, European Central Bank (ECB)

The changing retail payments landscape in Europe and the role of the Eurosystem

This is a time of unprecedented change for payment markets, and the retail payment sector is no exception. With the advent of new technologies, growing innovation, and changes in the way customers are using payments, the landscape for retail payment services in Europe is transforming. Digitalisation has brought greater speed and convenience to all areas of life, which, in turn, is fuelling customer expectations for faster services. Furthermore, new or adapted technologies, not least smartphone technology, have provided new and innovative ways to pay.

Against this backdrop, the Eurosystem, as a catalyst for European financial market integration, keeps a close eye on technological innovations and works to promote harmonised solutions and approaches across the euro area. Indeed, a major challenge is striking a balance between supporting innovation, on the one hand, and making sure that innovative solutions do not lead to market fragmentation, on the other. There is, for instance, a risk of new fragmentation arising from the development of national, proprietary or closed-loop solutions that are not interoperable.

"TIPS will allow citizens and firms to make payments via their bank anywhere in the euro area foster pan-European solutions and avoid market fragmentation"

- MARC BAYLE

With this in mind, the Euro Retail Payments Board – which includes high-level representatives of the demand and the supply side of the retail payments market and is chaired by the ECB – issued recommendations on a range of retail payment issues: from >>>

>>> person-to-person mobile payments to the pan-European integration of payment initiation services and instant payments in euro. Specifically, in the field of instant payments, it mandated the European Payments Council to develop SEPA Instant Credit Transfer, a scheme for pan-European instant payments. Payment service providers are encouraged to make instant payment solutions in euro available at a pan-European level as of November 2017.

However, the roll-out of instant payments depends not only on the payment service providers, but also on the availability of a safe and efficient underlying market infrastructure that can process instant payments across Europe. This is where the TARGET instant payment settlement service, or TIPS, comes in: a new service which the Eurosystem is now developing. TIPS will allow citizens and firms to make payments via their bank anywhere in the euro area within a matter of seconds; it will be available around the clock, 365 days a year. The service, to be developed in close cooperation with the banking industry in Europe, is scheduled to start operations in November 2018.

Finally, to come back to the broader context: we have now reached a defining point in how the retail payment landscape is shaped going forward, and the Eurosystem's role to foster pan-European solutions and avoid market fragmentation has never been more vital. By providing TIPS, the Eurosystem will make sure that the demand for instant payments is met at European level and will further promote integration in the euro area. ●

Pēteris Zilgalvis

Head of Unit, Startups and Innovation, Digital Single Market, DG for Communications Networks, Content and Technology, European Commission

Digitilisation: the potential of FinTech, blockchain and regulatory innovation

FinTech, the application of digital innovation to financial services, is at the crossroads of the Digital Single Market. While the industry is being digitalized, it also boosts the functioning of the Digital Single Market as this transformation of finance introduces new ways to invest in firms and projects, and new, more efficient ways for consumers to save, invest and obtain loans. For this reason, Commissioner Oettinger and Vice President Dombrovskis established the Task Force on Financial Technology – Fintech in November 2016, foreseeing that it would be Co-Chaired by DGs FISMA and CONNECT but including Directorate Generals across the Commission. It was not intended as a permanent structure but to bring the necessary expertise in the Commission together, cutting across silos, to set a pro-innovation course for the development of Fintech in the EU.

It has been my honor to be its Co-Chair and to have worked with my colleagues across the Commission to prepare the public consultation on FinTech –A More Competitive and Innovative European Financial Sector, which closed on 22 June. The public consultation requested views on fostering access to financial services and businesses, bringing down operational costs and increasing efficiency for the industry, making the single market more competitive by lowering barriers to entry, and balancing greater data sharing and transparency with data security and protection needs.

226 responses were received from banking, startups, other financial services, insurance, national and European regulators and supervisors, trade unions and consumers. The responses were rapidly analysed by the Task Force and the outcomes and follow-up will be announced shortly.

Two areas that were often mentioned and that are the subject of ongoing initiatives were distributed ledger technologies (DLT)/Blockchain and regulatory sandboxes/innovation hubs. An EU Blockchain Observatory and Forum is planned and aims to identify and provide an analysis of the technological and organisational trends of emerging blockchain/DLT issues in an agile manner. It will identify and build on existing initiatives, organising discussions and workshops around topics where action at EU level would be required or would have an impact (e.g. on regulatory issues) in an open, constructive and proactive way.

An initiative on regulatory sandboxes to support innovation in regulated areas was featured in the European Commission Communication on Startups and Scaleups. The Communication proposed exploring an enabling framework for such regulatory experimentation. Its idea is to set up a "safe space" in which businesses can test innovative products, services, business models and delivery mechanisms in the context of regulation, with the regulators. This framework enables firms to manage regulatory risks during the testing stage. The sandbox is intended for testing new solutions, in real life situations, where potential consumer or user needs have to be demonstrated, as well as management of potential risks and observance of binding legal rules. Regulatory sandboxes are not about "de-regulation", but rather an approach based on a two-way regulatory dialogue between an entrepreneur and an approachable regulator.

"FinTech, the application of digital innovation to financial services, is at the crossroads of the Digital Single Market."

- PĒTERIS ZILGALVIS

The Startup Nations Summit (SNS) here in Tallinn in November of this year has proposed that policymakers from outside Europe will test this approach hands-on in the SNS Policy Hack to provide feedback and adapt the process to their own ecosystems. This will be an initiative of the Estonian Presidency of the EU and the European Commission. ●

Alban Aucoin

Head of Public Affairs, Crédit Agricole S.A.

Challenges posed by digitalisation for retail banking and customer relationship

For banks, digitalisation is not new as such; it has been extensively developed for more than 20 years so banks have long been surfing the "digital wave". They are among the largest providers of e-services and of course of e-financial services, directly or through their pure digital banking subsidiaries and a large part of their services is provided through internet. Banks are also among the largest investors in IT systems and digital solutions. Their innovations have already deeply transformed financial services: banking services today are very different to what they were twenty years ago. For banks, technology is an opportunity to provide new and better services at a better price.

The real new challenge is not technological but behavioural. Smartphones have changed the customers' demands: they need a 24/7 service, faster, easier and simpler. This requires major changes in the retail banking industry, which have been implemented for nearly ten years but are still ongoing. Major IT investments are made, client processes are revisited, branches are redesigned, etc. This may help overcome cumbersome regulations which have heightened procedures: during decades the number of printed pages of information required for providing financial services have increased, now with a simple click you can take stock of this dematerialised information.

Banks are the historical Fintech. Indeed Banks have applied technology to finance for decades, in payments but also in credit, account management, secured access to online banking and client relation. What has changed is that new Fintech have emerged, which are either start-up but also huge American companies.

Banks have adapted to this new environment in two ways. First they have fostered corporate innovation, but also partnership in innovation. For instance, Crédit Agricole has developed a network of "Village by CA" that host about 600 start-ups. Second they have developed ventures with other Fintech to accelerate their transformation.

What is key is that customers remain at the heart of banks' strategy. Local financial services or remote financial services, it is up to customers to decide, and neither the bank, nor the technology provider nor the regulator. 60 % of French customers prefer a dedicated adviser with a personal relationship, and if 100 % of account balance checking are performed online or on mobile applications, more than 80 % of financial products are subscribed in a branch. For that reason Crédit Agricole's strategy "a bank 100% human, 100% digital" is based on long-term relationship and proximity as well as innovation and security, irrespective of the communication channel, but also interoperability of the different channels (both physical and digital) according to the customer's wish.

"A bank 100% human, 100% digital" based on long-term relationship and proximity as well as innovation and security, irrespective of the communication channel, but also interoperability of the different channels (both physical and digital) the customer's wish"

- ALBAN AUCOIN

Three aspects are key as regards digitalisation of financial services: security because trust is the cornerstone of financial services; data protection because loyalty is of utmost importance in financial relationship; level playing field to allow fair competition. This is particularly important for payment services when you consider the thousands of daily cyberattacks on payment systems and the sensitivity of personal payment data for consumers. ●

Felix Hufeld

President, Federal Financial Supervisory Authority (BaFin)

Digitalisation – doesn't work without IT security

Back in the 1960s, the German state railway made a splash with its advertising campaign, "Everyone is talking about the weather. We aren't." If you were to ask around in the financial sector at the moment, you would get the impression that everyone is talking about digitalisation. But this time, there is nobody who isn't doing – and there's a good reason for that. Many experts agree that digitalisation is set to bring about profound changes to the world of banking and the financial services.

While the focus was initially on fintech companies, which are hoping to make inroads into the market with flat organisational structures and creative solutions, it is now becoming clearer and clearer that digitalisation opens up opportunities for traditional banks as well. The reason for this is that they have powerful assets that are decisive in the financial sector: customers and trust. Moreover, they are the guardians of a treasure trove of data, which can be used to achieve additional customer value and increased satisfaction. The important catchword here is big data. We should also expect changes to payment transactions. How innovative and, above all, how beneficial these changes will be remains to be seen. The majority of digitalisation projects on the financial market aim to improve the efficiency of existing processes – rather than focussing on products. In the long term, I expect new payment processes to change the way we pay on the Internet and at the till as well. Traditional bank accounts are getting increasingly "smarter", too. The entire world of finance – not just the fintech companies, but the "traditional banks" as well – would be well advised to reconceptualise their businesses for the digital world.

>>>

>>> But innovation can only happen when it is given the space to flourish. To this end, we need principles-based standards to achieve the technology neutrality we seek. AI, algorithms, big data analytics, the Internet of things, cloud computing, blockchains, APIs, and Banking as a Service will be the dominant topics in the banking sector.

The digital transformation of banks also has its challenging side, however, and this doesn't just include increased competitive pressure. New customer interfaces and services require high levels of investment, and all with uncertain prospects of return or results. Moreover, many institutions are operating legacy IT systems, which represent a considerable risk factor because of the increased technical complexity.

To make sure that the financial system remains stable, or becomes more stable, supervisors and regulators have to deal with the risks of digitalisation as well as the opportunities. An initial, seminal set of rules and standards was issued back in 2015 in the form of the Second Directive on Payment Services (PSD2). The goal is to guarantee the security of payment transactions and at the same time create a level playing field and foster innovation in payment systems.

Alongside this, there are further supervisory schemes and initiatives at both the European and the national level concerning IT security. Existing regulatory requirements are also being continually expanded and adapted so that new risks can be dealt with in the best way possible. ●


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Jeremy Wilson

Vice Chairman, Barclays Corporate Bank

Data sharing and open banking, the future of retail banking

Technology is reshaping the financial services industry and consumer behaviour. Data sharing and open banking in particular will define the future of retail and commercial banking. The UK is introducing open banking in January 2018, in advance of any other jurisdiction.

The second Payment Services Directive (PSD2) in the EU has heralded a move towards open banking, enabling digital banking customers to give consent to third parties accessing their accounts, which banks must provide.

This requires not only a cultural shift in banking models but also a change in attitudes of customers who have always been told never to share their banking details. Customers will need to feel confident that they will not be victims of fraud when permitting third parties to access their data; making security a key differential between bank offerings.

However, the new 'open banking' environment introduces a new attack vector which fraudsters and cyber-criminals may seek to exploit. Fraudsters could impersonate registered third parties and third parties with whom data is shared may suffer data breaches.

Customer data protection must always be at the heart of data-sharing environments and will only take on increasing importance as more data on individuals is collated. It is imperative that the industry, policy-makers and regulators work together to seek to mitigate risks to data protection.

Screen scraping, which involves sharing of customer credentials with third parties, should in Barclays view be prohibited. Conversely, the standardisation and use of Application Programming Interfaces (APIs) should be promoted as it not only provides a safer way for customers to share information with third parties but also boosts innovation by lowering the barriers for FinTech players to participate in this new ecosystem whilst improving reliability and efficiency.

End-to-end security across the whole financial services chain must be ensured. It is important that third parties accessing bank customer data are certified as secure and regularly audited and supervised.

Cyber-attacks not only impact the reputation of banks that are compromised but the whole financial system where a key component is trust. To facilitate this Barclays would therefore welcome greater facilitation of cybersecurity information sharing between banks and with enforcement authorities under the General Data Protection Regulation.

"Data sharing and open banking in particular will define the future"

- JEREMY WILSON

Security is of paramount importance to Barclays, we have a responsibility to protect the privacy of our customers, clients and employees. Barclays is therefore actively involved in policy development in this area and is investing in the future of cybersecurity through the Barclays Fintech Accelerator programme and Barclays Cyber Academies, both of which offer specialist qualifications for the next generation of cybersecurity professionals. Barclays also supports the Cyber Defence Alliance, an institution created to facilitate the sharing of cyber threat information between banks and law enforcement authorities. Lastly, Barclays is supporting a workstream spanning the public and private sectors which has been set up to look at some fundamental data sharing principles. That work is being used in developing a code of conduct for data sharing in the financial services sector. ●

Daniel Pujazón

Global Payments, Banco Santander

The opportunities of digitalization for retail banking and payments

Digitalization is an opportunity for the financial sector to become more efficient and generate more value for its customers. In an environment that is compelling banks to reinvent themselves, the digital revolution appears to be the real disruptive force that will drive banks' deep transformation of culture, structures and processes.

A key feature of the financial industry is that it is based on a relation of trust and confidence between customer and financial institution. This is the foundation of a bank's sustainability, allowing it to generate more revenue, more investment and long-term growth. To fully recover this trust, partly lost during the last years of the financial crisis, banks are putting the customer in the centre of their strategy.

In payments, the scenario is even more disruptive. Three key forces are driving change in this space:

1) Customer expectations: Customers expect a seamless user experience across multiple payment methods, an immediate execution of payments and personalized experiences and relationships.
2) Technology: New capabilities are responding to those expectations (distributed ledger technology, instant payments, token security, cloud services, digital value propositions)
3) Regulation: This can reduce some traditional revenues (interchange fee regulation) and create space for new business models that are attracting many new digital players.

"Payments should be seen not only as a business line but also as a strategic tool to preserve and grow the relationship with customers."

- DANIEL PUJAZÓN

In this environment, digital payment solutions are gaining significant scale and profits are shifting towards value-added services (ie, personalized financing offerings based on transactional data).

Potential disintermediation in this new environment will come more in relationships with customers than in the structure of the business. Providing customers with integrated solutions that respond to their needs in a fast, convenient and simple way throughout the whole payment customer journey (pre-during-post) is fundamental to maintaining the customer relationship.

Given this environment, payments should be considered not only as a business line but also as a strategic tool to preserve and grow the relationship with customers and as a generator of transactional data that can be translated into insights to deliver better and more accurate value propositions for customers.

Finally, innovation should become a fundamental pillar of the regulatory agenda, centred on the principle of "same activity, same rules and supervision," regardless of who is providing the service. This will ensure a level playing field that in the end will benefit customers by increasing competition and generating greater choice among better, more-targeted proposals, while providing more safety for the customer and the ensuring the same level of stability for the financial system. ●

Marius Jurgilas

Member of the Board, Bank of Lithuania

Time to change the paradigm of cash

Despite advances in financial digitalization the most important instrument in retail payments still is cash. As the 2015-2016 ECB cash usage survey showed, three quarters of all payments at points-of-sale in the euro area are made in cash.

Cash is king, as it is the only option for an ordinary person to hold onto the ultimate settlement asset – central bank liabilities. Only the members of the gentlemen club of banks have direct access to the central bank reserve accounts. But this is changing. With this change we are changing the paradigm of cash.

"Despite advances in financial digitalization the most important instrument in retail payments still is cash."

- MARIUS JURGILAS

In the absence of trust we demand immediate settlement in something we trust more than the counterparty we are dealing with. Thus there is a structural >>>

>>> demand for a central entity of trust to intermediate economic transactions. Money is that medium of exchange and cash is its ultimate-trust form.

Commercial bank money is a near substitute of cash in most of the times and general public usually is ignorant of the notion of settlement finality or other legal discrepancies that make commercial bank money fundamentally different from central bank liabilities. But those differences become quite obvious and the ultimate-trust feature of cash and benefits of settlement in central bank liabilities becomes apparent during episodes of financial institution distress. And that is one of the reason why public prefers to hold onto the banknotes.

Cash is what the public wants, thus it should be provided. But nobody said that cash must be tangible. The recent developments in technology make feasible broad provision and access to the central bank liabilities in electronic form.

Cash can be digital. But that is no small development of the financial system. It would immediately reduce demand for commercial bank money. Such a change would have fundamental implications on credit growth, financial intermediation, transmission of monetary policy, and role of (central) banks in general.

The foreseeable benefits of such a change in the paradigm of cash are tempting. No need for transaction balances at credit institutions, no need for deposit insurance, no more moral hazard, and maybe finally … financial institutions that are not important enough to bail out. We should give it a try. ●

Fintech in the insurance industry

Contributors

Sandrine Lemery

First Deputy Secretary General, Autorité de Contrôle Prudentiel et de Résolution (ACPR)

Insurance industry and supervision in the digital era

The digital revolution is first of all the revolution of day-to-day use. According to data from Eurostat, 85%[1] of people have access to Internet and 65%[2] are equipped with smartphone today in Western Europe. As digitalization becomes part of our daily life, it has become obvious that business has to adapt to it.

There are three main challenges involving digitalization in insurance sector.

First, insurance companies have to accomplish the digitalization of the customer relationship management. In the digital context, clients are more prone to comparing offers especially by relying on opinions disclosed on the social networks. They are expecting faster, better and more personalized services. But digitalization could also help insurance companies to scale up interactivity and continuity with their clients through mobile apps or chatbots.

Second, insurance companies will have to adapt their products to the new digital era, where customers expect more tailored insurance products. The shift in the range of insurance products has to match the change in customers' needs (insurance on use, personal data insurance, Internet of Things etc.). Success will depend on the capabilities of the companies to take advantage of customers' data in an efficient but ethical way, without weakening the principle of risk pooling. Part of that challenge is also the development of cyber insurance products. Cyber risks are difficult to assess, to quantify, and to price (lack of sufficient data, rapid evolution of capabilities of cyber criminals) but insurance companies have a key role to play in this area.

Third, insurance companies will have to succeed in their own transformation. It entails three challenges primarily: (i) to promote innovation through partnerships with Insurtech and academic world and in-house innovations; (ii) to digitalize human resources by acquiring talents for new jobs, such as data scientists or web designers; (iii) to improve the tools and processes by investing in information systems.

The challenges of insurance companies are to some extent similar to the challenges that supervisors have to face. Prevention of cybercrime is certainly one of the top-rank challenges for the supervision of digital finance. The increasing reliance on interconnected IT systems may raise vulnerabilities to cyber-attacks and the risk of contagion to the whole financial sector. Supervisory actions need to evolve so as to ensure that financial institutions are strengthening their defense. For instance, in France, the ACPR has significantly increased the number of its on-site inspections, including penetration tests. Harmonization of major cyber-incidents reports and the improvement of their quality are also key levers to address this challenge.

>>>

>>> Supervisors also need to adapt their supervision to innovation. The ACPR has created a Fintech Innovation Unit which provides direct regulatory support to FinTech firms that try to launch new products into the market. An advisory Fintech forum has been created allowing a continuous dialogue between Fintech companies and supervisors.

Just as Harvard professor Lawrence Lessig famously said: "the law of cyberspace will be how cyberspace codes it"[3]. In other words, since algorithms are bound to be increasingly present in the insurance sector, especially for customer relationship (cf. chatbots), clients profiling and risks assessment, should regulators leave it to the businesses? Supervisors must devise the necessary means to keep being efficient at this digital age. As a result, supervision will have to be more technological, in part thanks to new tools dedicated to supervision (SupTech), but also and above all by leveraging on human resources capable of understanding and supervising the present and upcoming innovations. ●

1. Digital economy and society statistics - households and individuals -Eurostat.
1. Smartphone user penetration as percentage of total population in Western Europe from 2011 to 2018, Eurostat
3. "Code and other law of cyber space", 1999

Yoshihiro Kawai

Secretary General, International Association of Insurance Supervisors (IAIS)

Digitalisation and the changing insurance landscape insurance

While there may be as many different scenarios as one can imagine, certainly two key drivers shaping the insurance landscape are globalisation and technology. Neither will necessarily follow an unyielding linear trajectory, but the forward progress is nonetheless real and transformational.

"Insurance supervisors must be alert to new technological developments"

- YOSHIHIRO KAWAI

Take globalisation in the insurance sector. Progress towards convergence is occurring. We see it with the work the IAIS is doing to establish global capital standards, contribute to global financial stability and implement fundamental insurance principles--what the IAIS calls "insurance core principles" or ICPs—in markets throughout the world. This will continue through consensus, cooperation and a recognition of shared interests. It will require transparent processes and a respect for sovereign prerogatives.

Digitalisation is the other key driver. It is and will continue to have a major impact on the insurance sector and present supervisors with opportunities and challenges. In a recently released report, the IAIS highlights the potential impact innovative financial technologies ("FinTech") may have on insurance sector competitiveness, consumer choice, interconnectedness, business model viability and regulatory oversight. The report, entitled "FinTech Developments in the Insurance Industry", also >>>

>>> examines the challenges and opportunities insurance supervisors face in this rapidly changing insurance environment. There are many. FinTech innovations clearly have the potential to change fundamentally the way the insurance sector serves policyholders. Because of both the scope and pace of change, insurance supervisors must be alert to new technological developments and make necessary adjustments in their supervisory practices and skills.

The IAIS report analysed the potential impact of FinTech and made a number of findings: FinTech may disrupt the insurance sector by reducing insurance market competitiveness over the long term; cause traditional insurers to exit the market; result in more individualised insurance products which could affect (price) comparability and consumer choice; increase insurance sector interconnectedness due to the use of a limited number of technology platforms; and lead to changes in insurer business models if profit margins come under pressure. In addition, FinTech may increase the focus on improving the customer experience and affect the treatment of customers, possibly creating issues of affordability of insurance products or even increased financial exclusion. It may also create issues concerning the use, ownership and protection of data.

These developments pose several challenges for insurance supervisors, including:

- Balancing the risks and benefits of innovations and creating an environment that fosters innovation through approaches such as regulatory sandboxes or innovation hubs.
- Evaluating and, if needed, adjusting the prudential regulation framework.
- Considering the adequacy of current reporting requirements in monitoring trends.
- Understanding how innovations work and are applied.

Contemplating the future of the insurance sector in this time of unmatched innovation is exciting. ●

Erica Arnold

Chief Group Enterprise Services Officer, Zurich Insurance

FinTech: enhancing impact

Zurich's strategy is about focusing on its customers and serving them in simple, fast and convenient ways. Innovative technologies play a key role in this endeavor. They help us enhance customer experience through shifting towards a more predictive and therefore preventative view of risk, as well as productivity-improving initiatives with an overall focus on impact.

Advances in technology are challenging insurers profoundly, by changing customer behaviors and raising their expectations. Our customers are connected, better informed and can more easily switch between providers. However, new technologies provide opportunities to become more creative, differentiated and efficient.

To accelerate the digital transformation of our operations, Zurich works in partnership with FinTechs. We have a strong "currency" as incumbents. Our partners get access to professional executives and to a global test bed, whilst we get to explore new innovative approaches. We believe in this collaborative ecosystem - there is no monopoly on good ideas.

For instance, in the UK, cognitive computing using neural networks has reduced the time taken to assess medical reports and value personal injury claims. These previously took around one hour for a claims handler to process. It now takes a machine a matter of seconds. Claims settlements have become faster and operational costs lower, which can ultimately lead to lower premiums. And the automation of routine tasks frees up time to focus on customers, creating unique service outcomes.

A key question to consider is how to govern Artificial Intelligence (AI) when it is used in a business context. In some AI engines, a substantial number of interactions may fail before a fault is spotted. This is relevant across many industries. Appropriate checks and balances are therefore vital; be they system or human-based. For fully automated processes, we use a wide array of controls, including sample tests, and the "four eyes principle" confirmed by a human. We do not necessarily believe that the solution lies in increased regulation, but it is clear that these areas should be on any company's risk register with appropriate mitigating action planned. Furthermore, a focus on monitoring outcomes and trends rather than the construct of the algorithm is potentially more effective, given the fast changing nature of technical solutions.

"The automation of routine tasks frees up time to focus on customers."

- ERICA ARNOLD

Overall, we encourage a close dialogue with regulators regarding the implementation of existing FinTech regulatory requirements. This will achieve increased regulatory certainty. Also, the FinTech regulatory framework should provide equal treatment for the same business activity, be principled based and provide consistency between regulatory frameworks relevant to the use of digital technologies in the insurance sector.

Zurich is supportive of the initiatives undertaken by the EU and we look forward to further engaging with EU stakeholders to realize the benefits FinTech can produce. ●

Gino Del Sesto

Head of Government Relations,
MetLife Europe

Guiding principles for digitalization in insurance

Digitalization is transforming all industries. Insurance is no different. The rate of change is phenomenal, and there are huge opportunities – with more automation and analytics. With increased digitalization, however, come genuine risks – privacy issues and cyber threats. In addition, policymakers must seek to strike a balance between promoting innovation and preserving financial stability and consumer protection. On digitalization in the insurance sector, there are two considerations worth highlighting.

Firstly, from a consumer needs perspective, digitalization in the advice market should be complementary to human advice. Online forms of financial advice are becoming more prominent, but automated or 'robo-advice' may not always be the best solution for all consumers, given individual situations and the complexity of their needs. Technology has a role to play but it should complement other channels, allowing consumers to choose the advice model most appropriate for them. Consumers are best served when advice is tailored to their preferences, situation, and goals. It is important that development of mass-market advice is not focussed on digital solutions to the exclusion of all human interaction, but rather on how technology can be part of an overall advice solution where consumers can choose how advice is best delivered to them. Customizing for client segments and ensuring that customer needs are met will be a complicated task. There is a risk that digitalization causes "disintermediation" and drives distribution back to the manufacturer. This would threaten a healthy multi-channel distribution environment.

Secondly, the notion of "same risks, same rules" must apply. Legislators must establish a level-playing field to address the concern that specially licensed FinTechs could be subject to a less onerous regulatory regime. Instead, they should be able to offer services and products in competition with established financial institutions. We support consistent, activities-based standards for any emerging business models. Regardless of the type or scale of company, certain activities warrant the same capital and regulatory requirements because of the significance of the associated risks posed to consumers. Regulators will also need to ensure that they have the expertise to oversee automated models and algorithms - not just assume that a digital model is more effective and controlled and that development will work itself out in the sandbox. It is clear, however, that the right balance must be found between ensuring fair and suitable oversight, controls and regulation whilst not stifling innovation.

We support digitalization and technological change that focuses on consumer demand and safety- putting the customer first. Consumers do not want technology for technology's sake, but need to see the added value. It's better to have change for improvement's sake, not for change's sake. ●

Katja Würtz

Head of Consumer Protection Department,
European Insurance and Occupational Pensions Authority (EIOPA)

How to best embrace innovation while ensuring supervisory convergence?

Technological innovation is of strategic importance for the insurance and pensions sector. The changes stemming from digitalisation have an impact on all of the steps of the value chain.

There are multiple potential benefits arising from digitalisation, both for consumers and for the industry. For example, the availability and capacity to process data enables undertakings to develop more efficient underwriting and claims management processes. At the same time consumers can benefit from more tailored and personalised products and services.

Certainly, in today's globalised and digital economy, innovation is a source of growth and a key competitive factor. With this in mind the European Commission has correctly flagged FinTech and, therefore, also InsurTech as one of its core initiatives to contribute to deepening and broadening of the EU capital markets.

However, one should also keep in mind that there are certain risks associated with digitalisation that supervisory authorities need to examine carefully. This is for instance the case with the need to ensure that the greater availability of information about consumers and their behavior is always used in a manner that treats consumers fairly. Digitalisation could trigger an increasingly fragmented insurance value chain, raising challenges from a supervisory perspective, similar to the increasing exposure of undertakings to cyber risks. The latter represents both a threat but also an emerging opportunity for the insurance sector as a result of the increasing demand of cyber insurance policies.

EIOPA will continue to closely engage with supervisory authorities, consumers, incumbents, start-ups, academics, and IT experts to assess the impact of digitalisation in the insurance and pensions sectors. Continuing to organise workshops, EIOPA's immediate work in the area of digitalisation >>>

>>> will focus on Big data, cyber risks and supervisory approaches related to financial innovation.

- First, EIOPA will carry out an in-depth assessment on the use of Big data by insurance undertakings (both incumbents and start-ups) for pricing purposes, underwriting, claims management, and sales and/or marketing.
- Second, EIOPA will assess how cyber risks affect insurance undertakings and what impact underwriting of cyber risk policies risk could have for the rest of the sector.
- Third, EIOPA will develop a regulatory mapping of supervisory initiatives such as regulatory sandboxes, innovation hubs and public-private partnerships in different jurisdiction, with a view of benchmarking best practices.

EIOPA believes that regulatory and supervisory authorities have a key role to play in enabling the benefits from financial innovations while ensuring consumer protection framework and financial stability. With this in mind, technological neutrality, proportionality, market integrity, and consistency from an activity-based perspective should be the key guiding supervisory principles in this area.

Going forward, to achieve greater consistency in supervisory convergence practices, EIOPA will closely coordinate with the other European institutions and bodies, as well as other relevant international actors. Effective supervision will contribute to a better functioning of the single market and ultimately support the European Commission's Capital Markets Union. ●

Nathalie Berger

Head of Unit Insurance and Pensions, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Digitalisation and insurance

Digital developments

Insurance policyholders are increasingly becoming digital customers and expect various benefits from digitalisation, including:

- Better access to insurance products;
- Better pricing of insurance products;
- Ability to compare the features and prices of insurance products;
- Availability of insurance products on demand;
- Easy access to policy documentation;
- Faster and efficient processing of insurance claims.

Direct online selling of insurance, in particular motor and travel insurance, is growing. Digital signatures allow the customer to take out an insurance policy with no contact with the insurer. Simple standardised types of insurance can be compared using comparison websites. Most interaction between the policyholder and the insurer can be electronic.

Cyber-risk

Cyber-crime is both a risk and an opportunity for insurers. An operational risk, in so far as they can themselves be victims of cyber-criminals seeking to steal the sensitive personal data which they possess. An opportunity, in that a new market for underwriting cyber risks of other companies is opening up. As always with new markets, pricing is a challenge in the early phase of the cyber insurance market.

Big data

The traditional process of insurance underwriting was based on an evaluation of information submitted by the proposer. The digital world substitutes that proposal through quasi-real-time collection of data, also known as big data, from a wide variety of sources. Connected physical devices (the 'Internet of Things', IoT) also generate continuous data relevant to motoring, health and properties. The associated challenge for insurers is therefore to make use of the data which they possess by proposing new products, or changes in coverage of existing products, to their customers without violating the right to privacy of the policyholder. For example, medical data held for the purposes of health insurance must not be used to propose non-health-related products to the customer.

Regulatory responses

Existing insurance and pensions legislation takes account of digital developments in a number of ways:

- Solvency II is technology-neutral and contains sufficient flexibility so that insurers can hold the appropriate capital, notwithstanding the changes to the customer risk profile in the increasingly digitalised world. The risk management requirements in Solvency II contain only generic principles that would be relevant to cyber risks; these need to be given more attention in future evaluations of Solvency II.
- The recently-adopted Commission proposal for a Pan-European Personal Pension (PEPP) explicitly provides for online distribution of this important new product.
- The Insurance Distribution Directive, adopted by European Parliament and Council in 2015 and scheduled for full application in February 2018, brings comparison websites under the heading of insurance intermediaries and regulates direct online selling of insurance by insurance producers.

The Commission aims to be at the forefront of innovation and enable the use of technology for the benefit of customers. Financial services regulators need to assess the impact of digitalisation on the insurance business and identify how legislative or non-legislative actions can deliver better insurance products. This is why the Commission recently held a wide-ranging public consultation on FinTech issues. The replies are currently being analysed and the Commission will shortly propose actions aimed at reaping the benefits of FinTech innovation. ●

Dr. Frank Grund

Chief Executive Director, Insurance and Pension Funds Supervision, Federal Financial Supervisory Authority (BaFin)

Digitalization – a challenge but not a threat for insurers

All incumbents in the insurance sector are actively developing their digitalization strategies for their in-fore business. Improving workflows and data processing is necessary for a lot of undertakings. In the German market many companies have different tariffs and – rather old – legacy systems in place. Digitalization will help to harmonize and modernize this IT landscape. And the insureds will benefit due to reduced running costs and better customer service.

The new market entrants do not have this legacy and start with a green field approach. They are focusing on customer centered processes and thus they can bring added value to the market. The new competition forces incumbents to modernize their product offering. Digitalization will thus influence the existing insurance landscape – but I assume more in an evolutionary, than in a disruptive way.

A downside of increasing digitalization is that it will make all companies more vulnerable for cyber-attacks. Therefore, insurance companies need to invest in cyber security. However, in contrast to other industries this is also a business opportunity for insurers as the market for cyber policies is one of a few potential growth markets for the industry.

Digitalization will have an impact on every line of business – from private to industrial lines. But the benefit for insurers and insureds will be dependent on the level of interaction: the more insures are interacting with their customers the more benefit can be realized. That is likely the case for existing private lines, like health and motor. For new products like mobile phone or ski coverage – even on a daily basis – digitalization is a prerequisite for the product offering.

"The existing legal framework has to be applied!"

- DR. FRANK GRUND

The EU regulatory framework establishes a clear set-up of the supervisory mechanism: national competent authorities are supervising their national markets and EIOPA's main responsibility is to achieve a true harmonized and convergent market. Digitalization might make this split of responsibilities more difficult. New digital products can be distributed easily via freedom of services across Europe. EIOPA's responsibility in regard of a harmonized supervisory culture will thus become more challenging. The existing legal framework has to be applied! ●

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Cybersecurity risks

Contributors

Denis Beau

Second Deputy Governor, Banque de France

Cyber-resilience or the challenge of permanent motion

The last decade has witnessed large operational evolutions cyber-based and the related development of new services and technologies in the financial world, from payment services to financial market infrastructures. These new features produce benefits in terms of efficiencies but they also entail heightened threats to operational resilience for critical actors, as well as for the financial ecosystem as a whole.

The recent harmful and globalized cyber-attacks like « Wannacry »and « Nopetya » show that these are not empty threats. They create a strong impetus for vigilance and for revisiting the traditional risk-based proportionate approach with regards to operational requirements as the actors of the financial system become more interdependent, create a network which is becoming more complex and involve an increasing number of new entrants –either Fintechs, or major IT service.

While cyber-based technologies are creating heightened operational vulnerabilities, they can also provide part of the solution to address them. Even if interdependencies and amounts of data to be monitored are becoming massive, artificial intelligence, combined with big data tools, can help to conduct early detection of unusual behaviours. The advent of blockchain and the promotion of strong cryptographic features to reinforce security as well as the use of distributed architecture to alleviate single entry point constraints, might also address some concerns.

Authorities have already taken steps to incentivize an appropriate reaction from the financial system stakeholders. In Europe, decisive actions have been taken with the NIS directive but also with the PSD2 directly in the area of payment services. It is essential for regulators to ensure –without any complacency- secure communication interface for the access by new actors -payment initiation and aggregation providers- to payment accounts, which offer a direct door to banks' information systems. With regards to financial market infrastructures, CPMI and IOSCO have developed in 2016 a cyber-resilience guidance, which could apply as well to other financial entities, around few critical layers: (i) identify the assets and the vulnerabilities, (ii) protect the infrastructure, (iii) detect the attack, (iv) respond to it and (v) recover from it.

Further awareness is nevertheless needed especially at the international level to ensure the consistent adoption of a cyber-resilience framework among all financial stakeholders, as interdependencies are global: cyber resilience shall be thought as state of constant vigilance and motion. Being cyber resilient is not a fixed posture, it is a movement. In this direction, the customer security program deployed by Swift already sets a milestone by raising awareness of customers and financial market infrastructures worldwide. Coordinated action by authorities, notably through joint crisis exercise as well as constant information and experience sharing, is also needed to contribute to build a safer financial system. ●

Pēteris Zilgalvis

Head of Unit, Startups and Innovation, Digital Single Market, DG for Communications Networks, Content and Technology, European Commission

Cybersecurity: the EU approach to FinTech and finance

The European Commission's public consultation FinTech: A More Competitive and Innovative European Financial Sector underlined the importance of cybersecurity. It stated, Security and operational integrity and resilience are essential preconditions for confidence that confidentiality, integrity and availability of data and that of financial assets and infrastructures are assured. It emphasised that the most important challenge is likely to be the security, resilience and recovery of those systems against potential cyber-attacks.

Questions were asked in the consultation about what additional (minimum) cybersecurity requirements for financial service providers should complement existing requirements and what kind of proportionality should apply, what regulatory barriers or other possible hurdles impede or prevent cyber threat information sharing among financial services providers and with public authorities, and what cybersecurity penetration and resilience testing in financial services should be implemented and what is the case for coordination at EU level? 226 responses to the public consultation were received and have all been analysed by the European Commission's Task Force on Financial Technology –FinTech. In regard to current initiatives, it can be seen that the finance and banking sector is among the most mature sectors of Operators of Essential Services as defined in the Directive on Security of Network and Information Systems (NIS) in terms of cybersecurity practices. The sector exhibits multiple opportunities and challenges in relation to the implementation of the NIS Directive.

The opportunities include improving information sharing concerning cybersecurity incidents between public and private organisations, as well as between private entities themselves; improving/increasing governmental support to financial services cybersecurity and resilience; harmonization of cybersecurity leading-practices and incident reporting procedures throughout the EU, possibly also in response to related regulatory requirements (NIS, GDPR, etc.); increased collaboration between EU institutions and authorities on cyber-security related matters in defining the strategy, requirements and interdependencies; and collaboration with other regulators from other sectors: (a) with sectors on which the financial services industry relies on (e.g. telecommunications, energy etc.), and (b) authorities supervising regulatory regimes having impact directly or indirectly on cyber-security requirements, for example, data protection.

Among the challenges are increased regulatory complexity, partial coverage of the financial sector by the NIS (only credit institutions, trading venues and central clearing parties) and application of lex specialis requirements while other financial sectors (e.g. payments, insurance, asset management, ...) fall outside the scope of NIS, renewed regulatory and oversight fragmentation of financial services sectors due to national approaches in cybersecurity, and double-reporting of incidents to a variety of competent authorities. ●

Eric J. Pan

Director, Office of International Affairs, U.S. Commodity Futures Trading Commission (U.S. CFTC)

Making our markets more resilient against cyber threats

Cyber security is one of the CFTC's highest regulatory and policy priorities. The growing size and scale of cyberattacks presents a direct threat to market integrity and financial stability. For this reason, Acting Chairman Giancarlo has said that making the U.S. derivatives market more resilient to cyberattacks is essential to the mission and oversight of the CFTC.

The CFTC passed cybersecurity (so-called "system safeguards") regulations in the immediate years after the passage of the Dodd-Frank Act for core market infrastructure, including futures exchanges, clearinghouses, swaps trading platforms, and swap data repositories. At the end of 2016, the CFTC further clarified these rules and added cybersecurity testing requirements. The CFTC's rules require that these entities maintain a program of risk analysis and oversight to identify and minimize sources of operational risk, including: business continuity-disaster recovery planning, systems operations development and quality assurance, and enterprise risk management or assessments. The entire program of risk analysis and oversight, including systems testing, should be based on generally accepted industry standards and best practices, such as those by the U.S. National Institute for Standards. >>>

>>> Since the U.S. financial markets and institutions are increasingly automated and interconnected globally, the CFTC recognizes the importance of domestic and international coordination on cybersecurity. The CFTC regularly engages with other U.S. regulators, including participating in the U.S. interagency Financial and Banking Information Infrastructure Committee. Internationally, the CFTC actively participated in CPMI-IOSCO's 2016 guidance paper, which focused on cybersecurity for financial market infrastructures and promoted the use of testing as an "integral component" of any cyber resilience framework, and is actively involved in several other international workstreams.

"Market participants are the first line of defense against cybersecurity incidents. The CFTC seeks to encourage and support market participants in this effort."

- ERIC J. PAN

Market participants are the first line of defense against cybersecurity incidents. The CFTC seeks to encourage and support market participants in this effort. Acting Chairman Giancarlo has observed that combating cyber threats is best accomplished through a "bottom-up approach" which "involves a close and dynamic relationship between regulators and the marketplace....[and] requires the continuous development of best practices, defensive strategies and response tactics through the leadership of market participants...."

There can be no doubt that financial regulators must make the issue a high priority, and it is important to have both sustained regulatory coordination and a close and effective relationship between regulators and private industry. ●

The views expressed in this article are my own and do not necessarily reflect the views of the Commissioners or other staff of the CFTC.

Marc Bayle de Jessé

Director General Market Infrastructure and Payments, European Central Bank (ECB)

Building cyber resilience across the EU

Digitalisation and globalisation have opened up new opportunities for individuals and companies to obtain information, conduct business and communicate. The flipside is that the huge increase in the number of users and amount of data on digital platforms, in cloud computing and across networks has also created more potential channels for cybercrime.

Against the backdrop of the rising number of cyberattacks on the financial sector, it has become clear that traditional risk management, IT security and business continuity measures to protect operations from critical failures are not enough. Financial institutions and financial market infrastructures need to find new ways of ensuring resilience against cyberattacks. Cyber resilience goes beyond technology – it also encompasses governance, business processes and company culture.

Given the extensive interlinkages and interdependencies in the financial system, markets' overall cyber resilience depends not only on the resilience of each individual financial institution and financial market infrastructure, but also on that of interconnected institutions and infrastructures and their service providers. So the response to cyber risk must also be a collective and united effort. Cross-border and cross-authority collaboration needs to be enhanced to avoid different levels of cyber resilience within the financial sector and to ensure that authorities adopt similar approaches and focus on similar priorities.

In June 2017 the ECB hosted a strategic high-level meeting on cyber resilience for pan-European financial market infrastructures. Bringing together market actors, central banks and (other) competent authorities at European level helps to raise awareness and launch joint initiatives to develop effective solutions for the market, share best practices and foster trust and collaboration.

Another key component of improving sector-wide cyber resilience is the efficient sharing of information on threats. We need a strategy for overcoming the fragmented nature of information-sharing in Europe, as well as a shift in mentality to move beyond incident reporting towards also sharing ex ante operational, tactical and strategic threat intelligence.

"Financial institutions and financial market infrastructures need to find new ways of ensuring resilience against cyberattacks."

- MARC BAYLE

Last but not least, we need market-wide exercises and cyber simulations. ENISA, the European Agency for Network and Information Security, is the first entity to conduct EU-level cyber incident and crisis management exercises for both the public and private sectors in the EU and European Free Trade Association Member States. The TITUS exercise, a crisis communication exercise involving euro area financial market infrastructures, was carried out in 2015 and was the first of its kind. Setting up such exercises for financial institutions and financial market infrastructures at pan-European level should allow them to build up their knowledge of potential threat situations and their expertise in handling them. ●

Stephen Scharf

Chief Security Officer, The Depository Trust & Clearing Corporation (DTCC)

Knowledge is power

It is true to say that cyber crime is a phenomenon that almost everyone in society is aware of today. Even the most infrequent of email users are familiar with the occasional unsolicited message from a seemingly innocuous sender with fraudulent motives. As increased adoption of the internet takes hold in developing countries and as computer literacy grows, cyber criminals are becoming more knowledgeable and their tactics more sophisticated. At the same time, however, the industry's ability to successfully prevent and respond to these cyber attacks is improving through what some might consider one of the most basic forms of defence – information sharing.

Phishing is one example of how cyber criminals' methods of attack are becoming more sophisticated. What were previously targets of chance have turned into targets of choice. For example, phishing emails used to be sent en masse, based on the principle that quantity increased the likelihood of infiltration. However, increasingly cyber criminals are investing time and resources into researching their target recipients in order to construct a comprehensive, credible email. "Spear fishing", where attacks are sent to a select group, and "whaling", where attackers go after a single high value target, are becoming common and are often executed for the purposes of financial gain. One method of financially targeted phishing is known as "ransomware", a crime where malicious software encrypts an IT system until a certain sum of money is paid. Typically, ransoms are quite small, which means many firms may find it easier to pay them in order to regain access to systems. But the best defence to ransomware is a strong internal defence, with solid back-ups of critical data which can be restored in the event of an attack.

Phishing scams are just one way in which cyber criminals are carrying out malicious attacks but are a good example of how IT systems can be compromised because of what appears to be a legitimate email. Fortunately, however, CIOs and CISOs are changing their response, realising that information sharing is fundamental to building resilient cyber defence programmes. This comes in several forms. Firms have become substantially better at automated information-sharing around real-time vulnerabilities and threats. Many have also improved their manual information-sharing culture, with ever-increasing dialogue around the types of threats firms are seeing and the forms of defence that provide the greatest value.

A robust information sharing network – which should include details on the type of adversary, the technique they are using and specific technical descriptions of what the attacks look like – should be complemented by continuous testing of environments to ensure there are limited system or application vulnerabilities. Continuous testing and mitigation of vulnerabilities combined with software and the proactive monitoring of administrative rights can stop a majority of intrusions from succeeding. These protocols should also be complemented by appropriate patch management to mitigate software vulnerabilities and help stop cyber attackers from penetrating IT systems and propagating cyber attacks. The WannaCry incident was an example of how firms quickly shared amongst themselves, patches were installed as needed, and the impact of the attack was reduced.

Ten years ago, a cyber criminal could theoretically break into an institution and find themselves right next to a company's crown jewels – but not even know it. As a result, the impact of a breach might have come down to sheer luck. In contrast, modern cyber criminals are doing their homework and are able to target very specific elements of firms' IT systems with a clear idea of what they are looking for. The industry's response therefore should be to make sure firms have solid foundations to expand their cyber defences in order to stay one step ahead and to share information around potential or actual attacks as much as possible. ●

Stefan Gavell

Executive Vice President and Head of Regulatory, Industry & Government Affairs, State Street Corporation

Cybersecurity – A case for regulatory convergence and cooperation

Ten years after the start of the financial crisis, the final components of global regulatory architecture are being finalized, making the repeat of such an event unlikely. But the next crisis will be different than the last, and Cybersecurity is top of the list as a potential culprit. The regulatory architecture required to address this threat is similar to that put in place post-financial crisis, requiring strong controls at individual institutions, agreed international standards, and wider cooperation on areas such as threat intelligence.

At State Street, our information security program is based on the ISO 27001/27002 framework. In addition, we have established risk assessment and data security processes heightened vendor risk management and a sophisticated threat analysis function that identifies, assesses and defends against increasingly sophisticated cybersecurity threats. And similar to other, more traditional risks, an important part of our focus is the development of a culture of (cyber) security within the organization.

But while national regulators are increasingly focused on cyber-security, cooperation is also necessary beyond the traditional regulatory perimeter. In the US, major banks established the Financial Systemic Analysis & Resilience Center in 2016, to enhance collaboration >>>

>>> among its members and with the US government to help reduce cyber threats to the financial system.

The next layer of cooperation requires the adoption of consistent international standards. Along with the ISO 27000 standards, the US National Institute of Standards and Technology (NIST) Framework for Improving Critical Infrastructure Cybersecurity, (CSF) are being adopted as the basis for a global standard. State Street along with others in the industry are in the process of transitioning our program to the CSF. UK CBEST testing is another "best of breed" practice that could be adopted regionally or internationally. Organizations such as the Financial Services – Information Sharing and Analysis Center could play a helpful role in this regard, if expanded internationally.

Just as in other areas, consistent standards and adoption of best practices are key to presenting an effective defense against cyber risk. To this end, we need to leverage existing bodies established in the wake of the financial crisis such as the FSB, BCBS and IOSCO. But in addition, we need to build channels to national intelligence agencies and their international equivalents. Doing so will require new energy and dedication from firms, their regulators, and commitment to a cyber-agenda from national and international policymakers. ●

Will Semple

Cyber Threat Detection & Response, PwC

Operational risk management needs to become "cyber aware"

Cyber risk is one of the greatest risks facing the financial services industry, as highlighted recently in the Stocktake of IT risk supervision practices by the European Central Bank (16th November 2016).

When trying to define a cyber risk appetite, the typical answer from executives is that there is zero tolerance for data breaches. Whilst this is said in good faith, trying to implement this in practice is nigh on impossible.

Operational risk management frameworks are designed to manage these challenges; however, they have not matured at the same rate as the risks have evolved. Cyber risk does not wait for monthly reporting before it's at an unacceptable level.

To hinder the process further, cyber risk is commonly misunderstood and poorly articulated.

Cyber risk is often seen as an IT problem with a lack of accountability from the business. First-line security operations are often left to address the risk without a clear strategy and funding, and they lack appropriate challenge from the second-line, who may suffer from talent shortage or lack necessary technical skills.

This results in a technology-focused approach, whereas more mature organisations have transformed this into an information risk discussion, with the leaders talking at the business level incorporating the technology, people and process dimensions of cyber risk.

Without an effective cyber-aware operational risk model, it is extremely hard to quantify the appropriate level of investment in information security against the threat and risk environment or a mechanism to measure potential benefits of these investments.

Below are some practical approaches of how to understand cyber risk and how to start embedding this information into the operational risk management framework:

- Establish pragmatic guiding principles that will lead the approach to managing cyber risk and security practices. Principles agreed at board level provide a transparent, consumable vision through top-down objectives.
- Engage threat intelligence services to understand the threat landscape. Understand threat actor sophistication and motivations for targeting the business alongside susceptible adverse threat events (historical or hypothetical).
- Identify and assess the vulnerabilities associated with the critical economic functions and crown jewels. Crown jewels can be people, processes, data and technology that are crucial to conduct business effectively or must be significantly protected.
- Conducting an independent maturity assessment. Independent assurance reduces the risk of middle management fog, whereby the reported capability effectiveness may not consider cyber risk holistically across the business processes.
- Enhance existing risk taxonomy by mapping cyber risk to business risks. Bridge the gap between the business and IT and create a common business risk language. This includes enhancing existing operational risk management frameworks and risk registers to be more cyber-aware with cyber risk assigned as a contributing factor to key business risks and not as an isolated risk that is managed independently. The connection to business risk is ever more integral to ensure residual risk is managed to an acceptable level.

These are the first steps an organisation must take to transform internal operational risk management frameworks to become more "cyber-aware". ●

FINTECH AND DIGITALISATION

AML, KYC, data and competition challenges for digital banking

Contributors

Jesper Berg

Director General, Financial Supervisory Authority, Denmark

Can technology take the fight against money laundering to the next level?

The fight against money-laundering and terrorist financing has come to the forefront of public awareness in recent years following much publicized cases such as the Moldova Papers and the tragic events in Paris in 2015. This is an issue that is high on the political agenda, and which I have set out as one of seven key strategic issues for the Danish FSA in the coming years.

The fight against ML and TF is changing, as technological advances and the proliferation of electronic transactions brings forth both new risks but also new opportunities.

We believe that technology should be able to help financial institutions in their efforts in the area, moving from manual procedures to a larger degree of automated procedures – and taking advantage of the huge amount of electronic data available, especially in the Nordic countries.

In Denmark, we have a good starting point for such efforts. NemID, the national eID scheme provided by banks and the public sector in co-operation, could serve as a starting point for KYC procedures. NemID currently has 4.9 million registered users and can be used for a wide range of public and private services, with current use running above 60 million transactions a month. Furthermore, much information is readily available from both public and private sources and can be cross-referenced as it is often tied to the social security number that all Danes are allotted at birth.

The use of such data also entails risks. It requires financial institutions to have an extremely high level of IT-security to ensure that confidential data are not compromised – in particular at a point in time where criminals are increasingly moving in to the digital world. To the extent that KYC-services are provided by external suppliers, it also requires financial institutions to adequately control the risk that such outsourcing gives rise to. In the final instance, the AML/CFT responsibility can never be outsourced, and the financial institution needs to retain sufficient understanding and control of any third-party providers, and to ensure that the use of such KYC-utilities is adapted to the specific risk-profile of the given financial institution.

It also requires financial institutions to have a high level of IT-ethics. Data collected for AML/CFT purposes must only be used for such purposes – unless it is made entirely clear to the customer, that it will be used for other purposes – and the customer consents. Data collected from confidential sources with a specific KYC purpose must not be used for anything else at all.

We often hear that financial institutions hesitate in applying new procedures in the KYC area as they worry whether regulators would accept these. While we can never approve or promote certain commercial solutions, we as regulators should recognize this constraint and act as catalysts in the introduction of new and better tools in the fight against ML and TF.

Smart use of data in KYC can ideally both lift the burden for financial institutions, ensure a high level of quality in the process and give customers a better experience, thus benefitting both financial institutions, customers and society as a whole. ●

Massimiliano Alvisini

General Manager Europe & CIS,
Western Union

Challenges to digital payments - marrying innovation with effective supervision, regulation and competition

Consumers are changing the way in which they access and move their money. In response to this Western Union has expanded its digital offering – in the first quarter of 2017 alone westernunion.com money transfer transactions increased 27%. We now have online transaction sites in 40 countries, including across the EU, and mobile apps in 18 markets. These allow consumers to send money to over 200 countries and territories around the world.

While consumer behaviour is changing and adapting to innovation the regulation we face has yet to fully keep pace with the technological changes in these markets. The Payment Services Directive has given rise to increased numbers of players offering money transfers. This benefits consumers and encourages innovation by these players.

One of the significant challenges the industry faces is the complicated nature of overlapping and interlinked regulatory requirements and supervision. The panoply of national and European regulatory requirements covering authorization, conduct and supervision are overlaid by an increasingly complex web of data privacy, cybersecurity and law enforcement agencies. With the use of new technologies the involvement of these agencies is ever increasing. This imposes cost and burden upon the business and ironically makes the experience less seamless for consumers.

What is the solution? New technology – so called RegTech applications - can assist the industry to meet its ever growing regulatory and supervisory obligations. Additionally, more could be done at the EU level to coordinate the work of the different regulators and supervisors, for example by streamlining reporting requirements and fostering cooperation between national authorities across borders. In this way innovation could contribute towards building a true Single European Market.

One other quick win for the EU that would help companies cut through some of these overlapping requirements would be the wider use of E-Identification (e-ID) in commercial transactions, such as online payments. Whether a company needs to fulfil its requirements in the field of anti-money laundering, terrorism financing, know your customer requirements or cybersecurity, the ability to electronically verify that a person is who they say they are in a non-face to face environment will be transformative to businesses throughout the EU. It would make customers' lives much easier, would promote cross-border trade while bringing safety and security.

Any system of e-identification should be interoperable and cross-border in nature. The easiest way to achieve this would be for each EU Member State to recognize one system of online identification for commercial uses. EU Member States should mutually recognize these systems across-borders.

In this way technology does not only serve businesses to perform their regulatory and supervisory obligations but it also contributes to the creation of a Digital Single Market. ●

Diederik van Wassenaer

Global Head Regulatory & International Affairs, ING Group N.V.

Data and data strategy: regulatory challenges

In order to deal with the many challenges caused by the use of Data, Banks must have a clear Data strategy. An important part of this strategy must be the focus on safety and efficiency of data management, raising employee awareness, dealing with ethical questions and cybercrime. The strategy should be mindful of the fundamental shifts in customer behaviour. But also real time processing and settling of transactions and an exponential rise in the number of transactions which Bank's process need to be taken into account when determining a data strategy.

"Data management and data protection are very sensitive issues."

- DIEDERIK VAN WASSENAER

It goes without saying that data management and data protection are very sensitive issues. Private data are increasingly becoming part of the public domain (e.g. through Facebook). Therefore, Banks should carefully design and implement their data strategy and make sure that there is a high degree of awareness in their organisations of the strategy and good understanding of data privacy rules among their employees.

An important and challenging feature of EU AML rules, is that the top-holding of a EU banking group must apply

the AML rules and standards applicable to it, to all its subsidiaries and branches, wherever incorporated. This might lead to conflict of law issues when countries apply local bank secrecy laws. Banks must be mindful >>>

>>> of the conflicting regulations within the EU and also between EU and other regulations (and the hefty fines which can be levied and reputational damage to the Bank in case of a breach of data protection rules).

Secondly, there is a trend to include data protection clauses in seemingly unrelated laws and regulations applicable to banks without any visible consultation with data protection authorities or between such authorities and Bank supervisors. Complying with one piece of legislation may result in breaching another. Examples of such conflicting legislation can be found in the Payment Services Directive (PSD2) and the Market Abuse Regulation and the Anti-money laundering directive.

And finally and very importantly, the new General Data Protection Regulation ("GDPR") which will come into force from 25th May 2018, introducing a wide range of reforms to the European data protection regime. The GDPR introduces a number of changes to the concept of "consent" as a condition to lawful processing of data, as well as updating and revising general principles of processing and a new "legitimate interests" provision. These principles seem clear, but they are in fact, multi interpretable. The primary aim is to protect the rights and interests of the data subjects. The consequence of this is that Bank's will use their privacy statements to make clear how they will deal with these requirements. As this concerns Regulation, it seems counter intuitive to have kept the language somewhat vague. This will be aggravated by the fact that although the European Data Privacy Board may be given a role in terms of guidance and interpretation, supervision is completely in the hands of local privacy authorities in the Member States, each of whom will have their own agenda's. We would favour a more streamlined and harmonised approach, because these conflicts of law cause risks to banks that only the regulators can solve.

Finally, banks are not well suited to undertake the law enforcement roles under AML directives and they should be better informed –and protected- if they are asked or forced to do so. ●

Jochen Metzger

Director General Payments and Settlement Systems, Deutsche Bundesbank

Banks will have to embrace big data

For a long time, providing payment services was a privilege reserved for banks but now other actors are elbowing their way in. Digitalisa-tion has created new payment environments such as e-commerce, opening the door for new players to assume a role in all manner of transactions initiated by consumers via the internet. First of all, there are search engines like Google and Yahoo that register, collect and systematically organise the multitude of ideas and interests expressed by an individual consumer. In addition to delivering products, sales platforms like Amazon, eBay and Taobao also collect the more concrete purchasing desires exhibited by customers. Payment platforms like PayPal or Alipay offer specialised tools for payment via the internet whilst also collecting valuable data on the real needs of their cus-tomers. Up to now, the client's bank account details were not accessible in this manner as only that individual's bank had the right to see these highly valuable data.

After prolonged disputes on the question as to whether bank clients should have the right to allow third parties to view at these data so as to initiate a payment or to offer a merged overview of various accounts, the new version of the Payment Service Directive (PSD2) ushers in regulated access to accounts in cases where the bank client has given his or her consent. For third-party providers, as they are known, this will mean that they acquire the status of a "payment institution" and will henceforth be subject to supervision. For banks, this will mean allowing such access on a general basis by means of API (Application Programming Interface).

The exact details of how such regulated access to bank accounts should be organised are still under discussion. However, banks will clear-ly have to find a way of dealing with this new situation. They no longer have the luxury of relying on exclusive access to their clients. In this new PSD2 world, new business models are possible – and necessary. From the banks´ perspective, the worst case scenario would be one where they end up being pure infrastructure providers with only very loose relationships with their clients. But open access to ac-counts would also offer banks a new opportunity in as much as they could present clients with offers based on all the various accounts they maintain. On the one hand, banks are in a good starting position because of the stable and trustful nature of their client relationship. On the other hand, the new PSD2 world will extend the opportunities available to competitors with a completely different background, for instance FinTech start-ups or the big internet platform suppliers.

"Access to accounts would also offer banks a new opportunity."

- JOCHEN METZGER

In a nutshell, there will be challenges for all stakeholders in the new PSD2 word. Banks will need to focus more on making constructive use of the data and client trust they enjoy. They will have to speed up their timelines for product developments in order to keep up with their new agile competitors. And consumers will be faced with the challenge of keeping track of all the payment authorisations they have given to an array of online actors. European regulators will be obliged to make sure that the opening up of payment services to wider competition does not conflict with the objective of improving and harmonising data protection. Moreover, as the discussion surrounding the EBA's regulatory technical standards for access to bank accounts has made clear, it is difficult to devise principles based on legal pro-visions that are precise enough to enable exact technical implementation while still allowing somewhat more leeway than that offered by the technical specifications. ●

Carolin Gardner

Policy Expert (AML/CFT), European Banking Authority (EBA)

The use of innovative solutions in the CDD process: opportunities and challenges

Financial innovation is not new. Firms in the financial services industry have long been driving innovation to reduce cost, improve customer experience or make their internal processes more efficient. What is new is the speed of financial innovation, the pioneering use of new technologies and the demands this places on both, financial services firms and regulators who need to keep pace with new developments.

Financial innovation is not confined to new products and services. It extends to the development of new solutions to specific compliance challenges. Compliance with customer due diligence (CDD) obligations is one such challenge because it is associated with significant costs and customer inconvenience. Furthermore, in an increasingly digitised economy that relies on customers accessing services remotely, compliance with rules that may be predicated on the customer being present for identification purposes can hamper innovation.

Financial institutions' CDD obligations are set out in Directive (EU) 2015/849. The Directive does not set out in detail what financial institutions must do to comply; but it is explicit that the extent of CDD measures must be commensurate with the money laundering and terrorist financing (ML/TF) risk identified.

"...it is possible to promote financial innovation and to make the fight against ML/TF more efficient, proportionate and effective"

- CAROLIN GARDNER

CDD therefore offers considerable scope for innovation. Getting it right means that solutions that draw on biometric data, cloud computing and machine learning can transform CDD processes by superseding the need for traditional identity documentation and face-to-face verification of identity. But there is also a risk that innovation, if ill-understood or applied, may weaken financial institutions' ML/TF defences and, by implication, undermine the integrity of the financial markets in which they operate: this is because effective CDD is key to robust anti-money laundering and counter-terrorist financing (AML/CFT) systems and controls.

The implications are clear:

- regulation needs to be fair and consistent across the internal market to prevent regulatory arbitrage;
- regulators must strike the right balance between fostering financial innovation and setting clear expectations about the robust management of ML/TF risks. AML/CFT controls should not be compromised in the name of financial innovation; and
- regulators and financial institutions must have the tools they need to make informed decisions on the appropriate use of innovative CDD solutions. This includes a shared awareness of the opportunities and limitations associated with different innovative CDD solutions.

By pursuing these goals, it is possible to promote financial innovation and to make the fight against ML/TF more efficient, proportionate and effective. ●

FOLLOWING EUROFI EVENT

5, 6 & 7 September 2018

Vienna - **Austria**

IMPROVING FINANCIAL STABILITY

Content

Issues at stake

Much progress has been made since the financial crisis to mitigate systemic risks in the financial sector. As measures to reduce the systemic risks posed by banking and derivative activities are being implemented, following the G20 commitments, additional measures are being proposed for addressing the systemic risks associated with asset management and insurance activities both at the EU and global levels.

Legislative frameworks have also been proposed for managing the recovery and resolution of systemically important banks, insurance companies and CCPs. Brexit however raises new issues regarding the supervision of third-country entities, notably CCPs that clear large volumes of euro-denominated transactions.

CCP systemic risk issues

Contributors

Mario Nava

Director, Financial System Surveillance and Crisis Management,
DG for Financial Stability, Financial Services and Capital Markets Union,
European Commission

Central clearing: mitigating systemic risk through enhanced supervision

On 13 June 2017, the Commission adopted a proposal 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 to enhance the supervision of central counterparties (CCPs) providing clearing services in the Union established both in EU and non-EU countries. The proposal aims to ensure a more consistent and robust supervision of CCPs, given their growing systemic importance and the impact that the expected 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 continues to grow, whilst taking into account the role and impact of third-country CCPs in the clearing of financial instruments relevant to the stability of the EU financial system. To achieve this, the proposal introduces changes in the supervision of both EU and third country CCPs.

Concerning EU CCPs, the Commission proposal establishes a more pan-European approach to supervision in order to promote further supervisory convergence and streamline the decision-making process. The proposal also fosters a closer cooperation between supervisory authorities and central banks issuing EU currencies. By centralising at EU level the supervisory work within a European supervisory mechanism, the proposal eliminates the duplication of tasks between national authorities.

Additionally, the proposal reinforces the supervisory framework for non-EU CCPs wishing to provide services in the EU. It builds on existing third-country provisions in Regulation (EU) No 648/2012 (EMIR) and will make recognition and supervision of third-country CCPs more rigorous for those CCPs which are of systemic importance for the EU while ensuring that a level playing field is maintained between EU and non-EU CCPs.

Specifically, the proposal introduces a new "two tier" system for classifying third-country CCPs. Non-systemically important CCPs will continue to operate under the existing EMIR equivalence framework while being subject to greater monitoring by ESMA. Systemically important CCPs will be subject to stricter requirements such as: compliance with the necessary prudential requirements for EU-CCPs, while taking into account their compliance with the comparable third-country rules; confirmation of compliance with any additional requirements central banks of issue may have imposed in carrying out their monetary policy tasks; the agreement of the CCP to provide ESMA with all relevant information and to enable on-site inspections, as well as the necessary safeguards confirming that such arrangements are valid in the third country.. The necessary criteria

>>>

>>> to determine the systemic nature of a CCP are envisaged to be determined in a delegated act of the Commission.

Depending on the significance of the third-country CCPs' activities for the EU and Member States' financial stability, a limited number of CCPs may be of such systemic importance that the requirements are deemed insufficient to mitigate the risks they pose. In such instances, the Commission may, upon recommendation by ESMA that shall act in agreement with the relevant central banks of issue, decide through an implementing act, that a CCP should not be recognised and would only be able to provide clearing services in the Union if it establishes itself in the Union.

Following the publication of the Commission's proposal, the ECB adopted on 22 June a Recommendation to amend Article 22 of the Statute of the European System of Central Banks and of the ECB to clearly empower it to carry out its role as central bank of issue under the Commission's proposal amending EMIR.

The Commission proposal is being discussed in the European Parliament and Council in parallel with the November 2016 Commission proposal on a framework for the recovery and resolution of CCPs. Together, once adopted, they will contribute to a safer clearing landscape in the European Union. ●

Jochen Metzger

Director General Payments and Settlement Systems, Deutsche Bundesbank

Revamping the European regulatory regime for central counterparties after Brexit

The UK vote to leave the European Union and the subsequent vow of the British government to exit the Single Market left financial markets puzzled, in the UK, in continental Europe, and in financial centres all across the globe. Cut-ting the ropes makes an historical turning point, as the City of London, bridgehead to Europe for global banks, har-bour for financial giants, and home to one of the largest stock exchanges in Europe, is tightly embedded into the EU market. Recently, special attention was given to the fact that two central counterparties (CCPs) with considerable clearing volume of Euro-denominated derivatives are located in the UK. Due to UK's membership in the European Economic Area, these CCPs are nowadays regulated through the European Market Infrastructure Regulation EMIR, with participation of relevant member states' authorities in supervisory colleges under the aegis of the Bank of Eng-land as home authority. There is however uncertainty about future requirements for CCPs in the UK. Whatever reg-ulatory regime will apply within UK in the years to come post-Brexit: From a continental perspective, the current third-country CCP provisions of EMIR cannot be deemed sufficient for non EU clearing activities of such systemic importance.

"Situations where liability and control diverge must be avoided at any rate."

- JOCHEN METZGER

The European Commission has acknowledged the need for enhanced supervision for systemically relevant non-EU CCPs and came up with >>>

>>> a proposal for amending EMIR. It foresees to allocate third-country CCPs actually into three categories by the degree of systemic risk they could incur. CCPs that are considered less systemically important would fall under today's third-country arrangement, which basically relies on the supervision by the CCP's home au-thorities under the domestic regulatory framework. Systemically important CCPs would need to comply with the prudential requirements of EMIR and be subject to direct supervision by EU authorities. A CCP of substantial sys-temic importance may be denied recognition by the European Commission and face the requirement to establish it-self in the EU for the provision clearing services in order to ensure the financial stability in the EU or its member states.

Not surprisingly, those proposals triggered a number of supporting and critical reactions. In any case, it is in crucial for authorities in the EU to at least maintain today's information and control rights vis-à-vis the UK CCPs, as EU tax-payer's money could be at stake when it comes to rectifying a situation where inadequate risk management at the level of the CCP causes destabilising effects on EU currencies, EU markets and EU banks. Situations where liability and control diverge must be avoided at any rate. In future, the rights of authorities in the EU – including the central banks responsible for the relevant EU currencies – in view of exterritorial CCP supervision in UK depends on the UK authorities' willingness to cooperate. The fact that those CCPs are subject to a system of multiple supervisors may make the enforcement of individual control rights – which may be of key importance in times of crisis – difficult or impossible without the support of the relevant home authorities.

As of today, there is uncertainty on whether and under which conditions London-based CCPs will be allowed to offer clearing services to EU banks. Therefore all market participants should closely follow future developments in order to stay on rather safe ground. ●

Robert Ophèle

President, Autorité des Marchés Financiers (AMF)

We need both enhanced supervision of offshore CCPs and a clear location policy

The Commission proposal, which develops an appropriate risk-based approach to third-country CCP supervision including both an enhanced supervision for systemically important third-country CCPs and a location requirement for the most important of them, is appropriate. Even if specific criteria remain to be defined, I would consider adequate that CCPs clearing large volumes of euro-denominated transactions and providing essential services for the EU financial system are first and foremost concerned by the location requirement, while third country CCPs on which EU clearing members and end-users have large exposures denominated in non EU currencies are submitted only to an enhanced supervision.

"Supervision of CCPs is a rather complex process since it involves market authorities, central banks and bank supervisors"

- ROBERT OPHÈLE

The requirement that systemically important third-country CCPs should comply with these new EMIR provisions is key insofar as it ensures that the EU financial stability standards are met and that EU CCPs and third country CCPs are on a level playing field. However, we must be careful that it is applied strictly, and hence be vigilant not to allow "comparable" compliance to water down this requirement.

Supervision of CCPs is a rather complex process since it involves market authorities (since you clear market instruments), central banks (for liquidity and collateral management and for settlement in their currency of issue) and bank supervisors (for clearing members and in some cases because the CCP is a credit institution). The involvement of ESMA is particularly important since it will both review the equivalence of third-country CCPs and pay specific attention to the protection of the EU financial system from excessive clearing members' exposures to third-country CCPs.

But introducing a location requirement in the EU to clear large volumes of euro-denominated transactions remains essential to ensure that EU authorities have the final say on the financial stability implications of these activities, which are critical to the smooth financing of the EU economy. We cannot allow a situation where offshore CCPs serving significant volumes of euro-denominated activities would be subject to conflicting actions from their domestic regulators and supervisors on the one hand and relevant EU authorities on the other hand, at the expense of the stability of euro area markets. And even if the regulatory framework of the third country is perfectly appropriate and the supervision efficiently enhanced, allowing that in some sensitive activities all euro-denominated instrument could be cleared in that country would entail a loss of sovereignty difficult to accept: the loss of the equivalence recognition would no longer be credible due to a lack of substitute.

This is why the introduction of a location policy in the Commission proposal was highly anticipated and is much welcome. However, we need a clear location requirement, and more certainty on the regulatory treatment of existing CCPs to allow them and other market participants to get prepared and manage adequately the consequences for the provision of financial services in the EU. Therefore, in order to back the location policy, there is a need for defining a set of objective criteria to be developed jointly with central banks, which are the reference authorities for financial stability. ●

Dr. Alexandra Hachmeister

Chief Regulatory Officer,
Deutsche Börse Group

The foundations of financial stability: supervision and enforceability

When Timothy F. Geithner, then president of the Federal Reserve Bank of New York, called a meeting on the future of Lehman on Saturday, 13 September 2008, no one could then imagine what financial markets would look like nine years later.

Today, thanks to a determined G20 agenda, we are in much better shape from a financial stability perspective. A multitude of legislations, principles, standards and industry commitments ensures stable and resilient financial markets.

"Supervision needs to be complemented with enforceability"

- DR. ALEXANDRA HACHMEISTER

The current European supervisory set-up has shown very satisfactory results and has been able to maintain market stability even in times of market stress, like the day following the Brexit referendum. Communication channels and coordination between the industry, national and European supervisors have worked efficiently.

However, the departure of the EU's largest financial centre makes rethinking our supervisory set up a necessity. We all face the monumental task of managing the exit of the UK and to ensure it does not impact all that we have achieved in terms of financial stability.

As rightly mentioned by European Commission Vice-President Valdis Dombrovskis "the continued safety and stability of our financial systems remains the key priority (...) we need to make certain adjustments to our rules to ensure that our efforts remain on track".

First, effective supervision with clear responsibilities, rules for decision-making and procedures are desirable to avoid redundancies and allow for efficient processes, as time matters when it comes to financial stability. Due to the particularities of CCPs and given their connection with banks as clearing members, supervisory topics related to financial stability and risk management require the involvement of macro-prudential authorities of the likes of the European Central Bank (ECB) and the participation of resolution authorities that are equipped to tackle cross-border linkages, such as the Single Resolution Board (SRB).

Second, coordination of supervision both within the EU and with third countries is important to ensure a level playing field in global capital markets. Its guiding principle must be based on reciprocal market access under the same conditions and effective control of entities of third countries that are active on EU markets.

However, supervision alone is not enough and can only work if the EU has the ability to intervene and require additional measures from third country CCPs in order to mitigate systemic and liquidity risks. Ensuring that the central banks of issue (CBIs) – and notably the ECB – have clear mandates in this regard will be key to maintaining financial stability in the EU27.

Should these guarantees prove insufficient to achieve this objective, the EU needs to be able to protect its regulatory framework and require third country CCPs to move under its jurisprudence.

The stakes are high when analysing the costs of the last financial crisis – and the EU27 can simply not weather another storm without a proper supervisory system that is complemented with clear enforceability mechanisms. ●

Jakob von Weizsäcker

MEP, Committee on Economic and Monetary Affairs,
European Parliament

Difficult choices will have to be made

The proposals of the European Commission to strengthen the third-country supervisory regime for CCP makes sense at the European level, especially in light of Brexit. The proposal offers a sliding scale of options from traditional third-country equivalence to exterritorial supervision to location based policies. Rather than starting with any particular outcome irrespective of the risks involved, the appropriate third-country supervisory regime is to be determined as a function of risk which would appear to be sensible. Furthermore, the US supervisory experience shows, not least in London, that extra-territorial elements of supervision for CCPs are feasible in practice.

However, the question does arise how well such dual supervision can work in times of crises where the interaction between the supervisory role and the recovery and resolution role becomes relevant. For example, situations might emerge where different supervisory choices could lead to significantly asymmetrical financial stability and fiscal implications across jurisdictions.

While it will be difficult to exclude the possibility of divergent interest in times of crises, enhanced loss-absorption by CCPs which is currently under international discussion, could go some ways towards making >>>

>>> such situations less likely and less critical in practice.

"... difficult choices will have to be made between the responsibilities of financial market supervision, banking supervision and central banks."

- JAKOB VON WEIZSÄCKER

Furthermore, inside the EU or at least the euro area, responsibilities for supervision and for recovery and resolution could be moved to the European level in order to deal with cross-border effects within the union, similar to what has been achieved with Banking union. In that context, difficult choices will have to be made between the responsibilities of financial market supervision, banking supervision and central banks.

Not making these difficult choices would be dangerous. While a properly European set-up stands to offer significant benefits compared to the status quo, a European architecture without clear responsibilities and no European institution with the hat on in times of crisis, could end up leaving us worse off than with the present imperfect regime. ●

Laurence Caron-Habib

Head of Public Affairs, Strategy and Corporate Development,
BNP Paribas Securities Services

EMIR review – Looking for the best outcome for Europe

As announced alongside its legislative proposal on EMIR Review published on 4 May 2017, the European Commission released another text proposal concerning the supervision of CCPs on 8 June 2017. This new legislation addresses the cases of both European and non-European CCPs, with the objective to increase supervisory convergence in this area, and ensure that the sovereignty of the EU authorities in the exercise of the monetary policy and in the prevention of the systemic risk in the Euro-area is effective.

"... it will be crucial to ensure that re-domiciliation of euro-denominated clearing, if implemented, applies to all players, and not only to European ones."

- LAURENCE CARON-HABIB

This monetary sovereignty of the euro-denominated trading and clearing is seen as crucial to ensure the financial stability in the Euro-zone, particularly in the context of Brexit and beyond. The three options proposed by the European Commission are aiming to address different types of scenarios, including mandatory re-domiciliation of euro-denominated clearing in the EU in case of highly systemic CCPs.

As a global clearing member, the BNP Paribas Group is thoroughly following this topic. While in principle in favor of the re-domiciliation scenario, we are looking closely at the potential implications of these new rules on the provision of our services to the clients.

BNP Paribas provides its services globally, regardless of the location of the client, therefore our main objective is to make sure that final investors will not be adversely affected as a result of the envisaged measures. The industry is analyzing a number of different scenarios in order to understand the various types of risks that would have to be addressed, such as fragmentation of liquidity, increased margining costs, and operational risks potentially resulting from the re-location of the clearing portfolios. A constructive dialogue has also been established between the public authorities and the industry in order to develop a common understanding of the most pressing issues and the right type of strategy for the way forward.

In this process it will be crucial to ensure that re-domiciliation of euro-denominated clearing, if implemented, applies to all players, and not only to European ones. The new regulatory framework should not create competitive disadvantages between the different players with the potential for regulatory arbitrage. Otherwise this could lead to the exit of European financial institutions from the clearing space due to prohibitive costs of providing clearing services to both EU and non-EU counterparties.

As EMIR review may not be sufficient to achieve this crucial objective, it is also important to identify what other actions should the public sector undertake in order to arrive at a solution that would on the one hand safeguard their sovereignty and effective control of transactions that may create systemic risks for the Euro-zone, and ensure, on the other hand, a level playing field between the EU and non-EU players. ●

Verena Ross

Executive Director, European Securities and Markets Authority (ESMA)

Leveraging on key achievements of EMIR on the way to harmonised supervision of CCPs

The G20 Pittsburgh commitments and their implementation in the EU through the EMIR Regulation were cornerstones in making global and European derivatives markets safer and more resilient. In particular, the establishment of robust supervision over CCPs under EMIR should be counted among one of the major achievements of the post-crisis regulatory agenda. The mixed oversight model, relying on national authorities' ongoing supervisory work, combined with joint efforts undertaken within EU CCPs colleges proved to be a considerable improvement. In addition, ESMA's supervisory convergence work carried out in the form of peer reviews; opinions, guidelines and Q&As; the validation of CCPs' risk models by ESMA; and the first-ever EU-wide CCP stress-test represented important further steps in the process of building a common supervisory approach to these increasingly important market infrastructure providers in the EU. However, practical experience has also shown that differences across national authorities' supervisory approaches still remain. While the colleges are proving to be useful tools, there are limits to what they can achieve in terms of genuine supervisory consistency.

Therefore it should be welcomed that the EMIR review proposal by the European Commission aims at presenting a next step in establishing even stronger and more consistent supervision in the area of EU CCPs, leveraging on the strengths of the current model.

The parts of the EMIR review legislative proposal, which relate to the third-country CCPs, are in ESMA's view a significant improvement compared to the current regulatory framework. While keeping the EU as an open market for third-country infrastructure providers, based on the principle of equivalence embedded in EMIR, the introduction of some checks and balances in relation to systemically important recognised CCPs would be critical from the EU financial stability perspective. As a side note, ESMA believes that a similar model should be explored for other third country firms that are important for the EU capital markets (such as CRAs and benchmarks).

"While keeping the EU as an open market for third-country infrastructure providers, the introduction of some checks and balances in relation to systemically important recognised CCPs would be critical from the EU financial stability perspective."

- VERENA ROSS

ESMA stands ready to put in place processes allowing for efficient regular monitoring of equivalent legal frameworks in non-EU jurisdictions. In doing so, we would build on our strong cooperation with third-country regulators as well as with the European central banks of issue.

Finally, I believe the EU legislators should consider carefully the decision-making processes and governance arrangements so that effective implementation and efficient on-going work of ESMA, and other authorities involved, can be ensured. ●

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Market-based finance risks

Contributors

Joanna Cound

Head of Public Policy, EMEA, BlackRock

Market finance has come a long way: looking ahead to the Capital Markets Union

Mark Carney highlighted in his July letter to G20 leaders the role that asset management plays in channelling investment, promoting international capital flows, and reducing over-reliance on bank funding. The FSB's acknowledgement of the EU's progress in addressing financial stability concerns – in particular in relation to money market funds and securitisation – similarly reflects how far the regulatory framework has come.

European capital markets today are the result of joint efforts by the EU, global and national authorities to shore up products and practices. The Capital Markets Union (CMU) formalises the intent to go further, increasing the flow of capital to companies, infrastructure and projects in all corners of Europe. The development of market finance in the EU must remain a priority, despite the UK preparing for Brexit.

Market finance is at once global and personal. Asset managers are able to leverage investment excellence around the world, to return value to savers, pensioners and companies. One of the EU's most successful exports is the UCITS brand – pre-dating the CMU but embodying its ethos. Recognised in over 75 markets, with thousands of cross-border registrations, UCITS funds channel capital from diverse investors into innumerable investments, with European equities popular among them. The result is the best of all worlds; European savers benefit from global fund management expertise, protected by EU rules.

Looking ahead, putting the retail investor at the heart of future initiatives is key to realising the potential of the CMU. Consumers will benefit from the Commission's ongoing efforts to facilitate the sale of cross-border UCITS within the EU and to address the pensions savings gap through the Pan European Personal Pension. The ability to pool, manage, and invest capital from both the EU and abroad across borders lowers the cost of capital and enables it to flow more widely – including to harder to reach growth companies.

As new products and practices emerge, a pragmatic approach to supervision must balance investor protection with room to innovate. Faced with the new, regulators must define the risks they seek to mitigate before implementing measures to address them. Macroprudential tools designed to manage balance sheet risk are not a fit for the agency model of asset management. At best, they are unsuited to the goal of mitigating risk. Worse, they present new challenges, from encouraging procyclical trends, to hindering natural price adjustments. Centralising policy levers aggregates risk and erodes the very dispersion that is a key source of the stability of market finance.

Instead, the most effective way to manage risk in market finance is to regulate at the product and activity level across the ecosystem. Efforts are already underway in multiple jurisdictions – FSB-IOSCO have made important recommendations in this regard, and future EU initiatives should reflect international standards. With the cash positions of many households and institutions higher than ever, investors must have access to investment opportunity. Inappropriate use of macro tools must not be allowed to reduce the role of market finance in funding the real economy, just as confidence appears to be returning to investing in European assets. ●

Rodney Comegys

Global Head of Risk Management, Vanguard

The structure and prudent regulation of funds effectively prevents systemic risk

During the 2008-2009 global financial crisis, several large banks collapsed, jeopardising depositors, creditors, and even the broader financial system. This systemic crisis gave rise to substantial financial reform, most notably in Europe, EMIR, AIFMD and CRD IV. The history of financial panics, including the 2007–2008 financial crisis, demonstrates that systemic risks typically originate in entities that possess at least one of two characteristics:

- Significant leverage and interconnections with other systemically important companies through such leverage.
- A significant mismatch between the terms, or maturities, of assets and liabilities.

These characteristics act as mechanisms that can transmit financial distress from one institution to others and, potentially, to the financial system as a whole.

Regulated funds and fund management companies exhibit none of these characteristics. Like any economic actor, a fund or a fund manager can experience idiosyncratic risk, however; funds and their managers lack the mechanisms to transmit risks to the broad financial system due largely to their structure and the rules that govern them. Profits and losses experienced by fund shareholders have no direct impact on the fund manager's financial stability. The behaviour of regulated funds and fund investors through a variety of isolated and systemic crises substantiate this claim.

Since the global financial crisis, new regulations and low interest rates have led to changes in the bond market, however; there is no conclusive evidence of a material decline in market liquidity, and funds continue to effectively manage liquidity risk. Regulated funds (including UCITS and US 1940 Act mutual funds) are heavily regulated with respect to liquidity and leverage requirements. It is also a fundamental fiduciary duty of fund managers to manage portfolios so as to preserve the ability to satisfy investor redemption requests. A dynamic liquidity risk management program that includes an assessment of a fund's ability to fulfil shareholder redemptions is a valuable analytical tool that should be employed by all funds. Compared to banks, most funds have little to no leverage and typically use derivatives to manage investment risk and improve efficiencies, not to amplify the risk profile of the fund.

A regulatory regime, such as stress testing, designed for highly leveraged and interconnected institutions such as banks is inappropriate, even unworkable, for unleveraged funds and the management companies that provide services to them. Such a regulatory mismatch would do nothing to enhance the stability of the financial system. Worse it could threaten to disrupt the capital markets and drive up the cost of investing for millions of investors who use funds to invest for retirement, education, and other long-term financial goals. ●

Dennis Gepp

Senior Vice President, Managing Director and Chief Investment Officer, Cash, Federated Investors LLP

The liquidity conundrum

More liquidity equals less systemic risk. Liquidity is the single most important tool in preventing runs on funds. If a fund, any fund, has sufficient liquidity, there can be no need for investors to run. Regulators understand this, as do politicians, and even investors. That is why queues only form at a bank when fears of liquidity shortages emerge. That is why fund managers, especially liquidity product managers, held ample liquidity during the liquidity crisis of 2008 and still do. And why even before the EU passed its Money Market Fund reform (MMFR), they were voluntarily managing to high levels of liquidity. However, liquidity is not the cure for all ills, especially when regulators are making the provision of liquidity that much harder. It's like the regulators saying "an apple a day keeps the doctor away" but then taking away all the apples. Not surprisingly, one ends up having to see the doctor!

A perfect example of the liquidity problem is in MMFR and the illogical provisions which permeated the final text and have the potential to taint future fund regulations. The MMF regulation requires daily and weekly liquidity for CNAV and LVNAV of very high, yet I believe, appropriate levels of 10% daily and 30% weekly liquidity; sufficient to withstand even extreme financial crises. Additionally is the importance to know your clients. If your client base is transient, that needs to be identified and managed to accordingly; if your client base is concentrated, that is also a factor mandating higher liquidity. These are sound and sensible requirements.

However, it is the next phase of regulation where focus is lost, politics and member state positioning interferes >>>

>>> with what is best for investors and the best interest of the EU is ignored. Government Securities and Repurchase Agreements (Repo) transactions are two critical liquidity elements. They are even more important where regulations penalise banks for providing short term liquidity.

"High quality government securities are the most liquid securities an investment fund can own"

- DENNIS GEPP

High quality government securities are the most liquid securities an investment fund can own, yet in MMFR can only count towards a portion of a fund's required liquidity and will do so until Member States acknowledge that not all EU Government Securities are high quality.

Repos are typically an overnight or weekly fully collateralised way of obtaining liquidity, not a means of leveraging funds. MMFR has limited repo to only overnight. There is the theoretical 2 day repo but there is no market for it. By regulation the EU has killed a key source of fully collateralised weekly liquidity.

The EU wants, and fund managers need, access to liquidity. Fully collateralised repos and high quality government securities are liquid and should not be constrained. If managers cannot meet their liquidity requirements they cannot offer liquidity management products. As the highest quality banks do not want to take on short term cash, investors, who the EU should be protecting, are left with either lower quality banks or going it alone in the market, limiting diversification and the benefits extensive credit reviews that funds provide. Please do not mandate liquidity and take away the ability to provide it. ●

Frédéric Bompaire

Head of Public Affairs, Finance and Strategy, Amundi

Liquidity and leverage of funds: not much room for excesses in the EU regulation

Supposed vulnerabilities of funds stem essentially from either liquidity mismatch or excessive leverage, according to FSB analysis. We share this view and we do not consider as difficult to solve other issues such as lending agency, market making or performance guarantee, because they are not within the scope of the agency business model of asset managers and should be regulated when conducted by asset managers as if they were run by banks or other prudentially regulated entities.

"Regarding funds' leverage, EU regulation has proved very solid and effective."

- FRÉDÉRIC BOMPAIRE

Regarding funds' leverage, EU regulation has proved very solid and effective. UCITS are not authorized to borrow money, except up to 10% for cash adjustment; they are also prevented from showing a market exposure higher than twice the capital received. Exposure includes investment as well as derivative positions and the possibilities for netting are now well defined, though they do not always apply in an harmonized way. We feel that UCITS is a clear and world recognized framework that participates to the success of the EU fund management industry. We further believe that stability in the architecture and the main characteristics of the rules is of utmost importance. Hence, we do not encourage legislators to open the file again with a UCITS 6 proposal. Non-UCITS funds are AIFs and must be run by AIFMs which are subject to another directive. A very interesting part in AIFMD is the difference that it introduced between AIFs that may or may not use substantial leverage, i.e. have a net market exposure in excess of three times the capital. We like this split in AIFMD and believe that it is both easily workable and totally consistent with the real objective of AIFMD to cover shadow banking activities that hedge funds may conduct out of any prudential regulation. When assessing leverage, the market exposure has proved its efficiency and for UCITS the addition of a VaR measure allows for a sharp risk-based control.

When considering liquidity, we follow FSB's advice to take stock of the various tools existing to manage liquidity mismatch in the fund industry. However, our view is that before focusing on tools we should agree on the initial assessment of the liquidity parameters of a fund: frequency, notice period, lock up, payment delay... For most funds, except those investing in structurally illiquid assets, it is possible to avoid introducing lock-ups or long notice periods or payment delays. The question is more for them to educate investors so that they realise that having a 2 day notice period or a weekly valuation will protect their interest. Instead of subscription/redemption fees that can be source of conflicts of interests, we prefer the mechanistic approach of swing pricing. Though, it can be argued that there is no need to introduce it. As long as there are no abuses, the mutualistic approach that it is fair to share the costs of in and out-flows, knowing that each investor benefit from it when joining or leaving the fund, is as valid as the liberal view according to which each investor pays for the charges that its buy or sale order will create. Other tools are more drastic and look more as an organized liquidation tool (side pocketing or payment in kind) than a quick fix of a liquidity mismatch. In conclusion, liquidity management tools are good to have at hand, they require judgment and discretion in their use by Asset managers and education so that client investors understand them better. ●

Mario Nava

Director, Financial System Surveillance and Crisis Management, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Measures for mitigating financial stability risks in EU asset management frameworks

Many jurisdictions have been reviewing their regulatory frameworks for asset management with a view to determine if and how to strengthen existing guidance and requirements, in particularly with regard to open-ended funds. Last January, the FSB published policy recommendations to address structural vulnerabilities from asset management activities, focusing on four areas: liquidity mismatch between fund investments and redemptions; leverage; operational risks; and, securities lending activities. IOSCO is currently consulting on amendments to its 2013 Liquidity Risk Management standards to operationalise some the FSB recommendations.

In the EU, investment funds can be broadly categorised as UCITS (Undertakings for Collective Investment in Transferable Securities) and AIFs (Alternative Investment Funds). EU investment funds have more than €15 trillion asset under management (AuM) in April 2017. In particular, the success of UCITS, which dates back to 1985, is evidenced by the rapid growth of AuM from €3.4 trillion at the end of 2001 to more than €9 trillion by April 2017. Strong asset growth was seen across all categories of UCITS in 2016, where the largest growth among the mainstream categories was seen in bond funds, which increased 8% thanks to a surge in investor demand.

The existing EU frameworks for asset management – i.e. UCITS and AIFMD – already contain measures aimed at mitigating financial stability issues, in particular with regards to liquidity transformation and leverage. For instance, they require fund managers to have appropriate and effective liquidity management systems and procedures and to maintain a level of liquidity in the fund appropriate to its underlying obligations (i.e. assets). Furthermore, EU-rules mandate the availability of liquidity management tools (e.g. gates, side-pockets, suspension of redemptions), including specific powers for national competent authorities to activate them. On leverage, UCITS sets a clear limit, while AIFMD provides national competent authorities with the possibility to impose a limit on the use of leverage for financial stability reasons. In any case, asset managers have to report to investors on the use of leverage.

Nonetheless, the Commission is dedicated to keeping the EU regulatory frameworks fit for purpose and has recently started the process of reviewing the AIFMD. As a first step a call for tender was launched in order to obtain an external evaluation of the operation of the AIFMD and will be followed by a public consultation.

In the meantime the Commission will continue to closely monitor the development of activities of the asset management sector in the EU in light of the potential financial stability risks, also taking into account the ongoing work by the ESRB, FSB, IOSCO on asset management, but also in the area of shadow banking. ●


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Resolution of banking groups

Contributors

Elke König

Chair, Single Resolution Board (SRB)

MREL – the way ahead

Adequate levels of MREL are crucial to ensure the resolvability of banks. They contribute not only to the resolvability of individual banks, but also to financial stability as a whole and are a key instrument to replace bail-outs with bail-ins and safeguard taxpayers' money. The SRB is making good progress in refining its MREL policy and developing MREL targets for the banks under its remit.

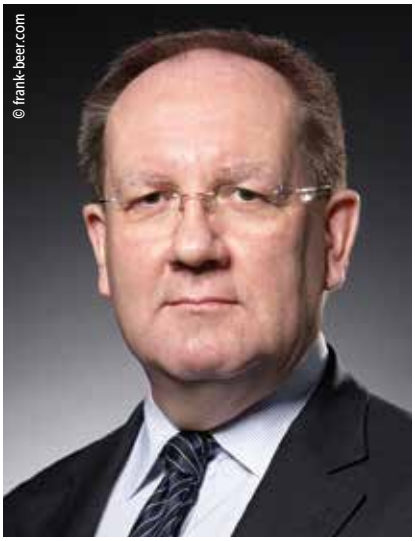
MREL targets are individually tailored to each bank, and the SRB has taken a number of measures to inform banks about the MREL process. In 2016, the SRB organised numerous workshops with banks, including discussion of informative (non-binding) MREL targets. We also published a document setting out the approach taken to MREL in 2016 and the way forward, and more is planned and already communicated for 2017.

The SRB aims to strike the right balance between flexibility and hard requirements in setting MREL. Banks differ in their business model, operational structure, risk profile and other factors. These specificities are taken into account by the SRB when drawing up resolution plans. Rather than a "one-size-fits-all solution", final MREL levels as part of the resolution plan will be a function of each institution's resolvability assessment, and will be designed to support implementing the specific resolution strategy, if need be.

MREL requirements are set on the basis of the current legal framework. In 2017, the SRB has started to develop binding targets for major banking groups, which resolution colleges will discuss in the fourth quarter. The SRB aims to develop MREL requirements for these groups in late 2017/early 2018. MREL of not less than 8% - but on a case by case basis possibly well above – will generally be required for the largest banks. In case of a resolution the Single Resolution Fund requires a minimum level of burden sharing and if a bank enters resolution it is important that there are enough bail-inable liabilities to attain the required level of burden sharing.

Our policy decisions will be in line with the applicable legislation and, in this context, we of course carefully monitor the developments on the Commission's proposed banking package from November 2016. Among other changes, the Commission has proposed to implement the TLAC standard as a Pillar 1 requirement for G-SIBs. It is important to keep in mind the differences between TLAC and MREL: TLAC sets minimum requirements for G-SIBs, while MREL is a broader concept that applies to all banks. As mentioned, MREL requirements are set on a bank-specific basis and also potentially provide for a wider set of eligible liabilities (TLAC-eligible instruments must be unsecured and subordinated, with few exceptions). It has to be noted that G-SIBs and other systemic institutions compete in the same markets and might have similar systemic footprints; therefore a level playing field needs to be ensured and cliff effects avoided. The SRB therefore favoured a Pillar 1 requirement for both. Moreover, the SRB urges finalisation of the reform of the creditor hierarchy and eligibility criteria. It is also critically important for the final proposal to maintain flexibility for the resolution authority to take timely action to address breaches of MREL where necessary and to make sure that only liabilities that can really be bailed-in count towards MREL.

Overall, MREL implementation is a multi year process that is proceeding well in spite of the regulatory uncertainty. The next years will be crucial for developing binding MREL targets and ensuring that they are met. ●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Felix Hufeld

President, Federal Financial Supervisory Authority (BaFin)

Banking resolution: more than just a credible tool

To safeguard the stability of the financial system and ensure the efficient resolution of failing banks, supervisors and resolution authorities are committed to applying the EU Bank Recovery and Resolution Directive (BRRD) consistently and transparently across Member States. Experiences from recent cases provide important insights for possible future improvements to the framework.

Wider scope for moratorium tools and the importance of liquidity

The resolution of Banco Popular Español (BPE) on 7 June 2017 followed a rapid deterioration of its liquidity position. Resolution action by the Single Resolution Board (SRB) was made possible since the three conditions for resolution were met: the bank was declared "failing or likely to fail" by the ECB, there was no supervisory action or alternative private measure that could prevent the failure, and a resolution was seen to be necessary in the public interest as the bank was deemed to be systemically relevant. Importantly, the resolution scheme as approved by the European Commission involves neither State aid nor aid from the Single Resolution Fund.

The case demonstrated that bail-in and sale of business are credible tools to ensure that the owners and creditors pay for the institution's resolution rather than the taxpayer. It also highlighted the potential benefits of a more comprehensive moratorium tool to stabilise the liquidity position of the bank while assessing whether a failing bank meets the conditions for resolution and preparing the application of resolution tools. Stopping the outflow of deposits, which was a major factor in the Banco Popular case, should be part of the toolbox.

In contrast to BPE, Banca Monte dei Paschi di Siena (MPS) received State support via a precautionary recapitalisation as the bank was deemed to be solvent and the State support would not be used to offset losses (incurred or likely to be incurred) but a potential capital shortfall brought to light by a stress test. Further, a provision of State guarantees enabled the bank to maintain sufficient liquidity. The different paths taken for MPS and BPE highlight, among other points, the importance of liquidity prior to and during resolution.

Harmonisation of insolvency law

The cases of Banca Popolare di Vicenza and Veneto Banca did not come as a surprise, as both banks had been reporting losses since they came under direct ECB supervision in 2014.

After the ECB declared the banks as "failing or likely to fail" on 23 June 2017, the SRB concluded that resolving these banks was not in the public interest as they did not provide critical functions and their liquidation would not endanger financial stability. Resolution action could therefore not be justified and the banks were subject to normal Italian insolvency proceedings. It must be noted that the liquidation by way of insolvency proceedings of the Veneto banks at least partially involved the application of resolution-like tools based on the BRRD (built into a special insolvency regime) >>>

>>> in the form of sales of assets and liabilities of the institution concerned without the shareholders' consent.

While the BRRD does not exclude senior bonds from bail-in, the insolvency proceedings were driven by State aid rules and only required loss absorption by the owners and subordinated creditors. Harmonising bank insolvency law as an essential complement to the BRRD could be an important component in the creation of a more level playing field, supplementing a more coherent approach to a capital markets union. As a minimum, the framework for State aid in the banking sector needs to be adjusted in order to prevent inconsistent outcomes between resolution and national insolvency procedures.

Loss-absorbing and recapitalisation capacity in sufficient quantity and quality

The recent cases emphasise the need for substantial loss absorbing buffers (minimum requirements for own funds and eligible liabilities (MREL)) in sufficient quantity and quality.

In addition, and this is also a lesson we have learned, in crisis management data quality and prompt data availability is decisive for the success of any resolution measures. The importance of this rather technical issue should not be underestimated.

Ultimately, recent experiences demonstrate that there are legacy issues to be addressed; however, the transition from stabilisation towards a more long-term orientated policy approach is forging ahead. ●

Gunnar Hökmark

MEP, Committee on Economic and Monetary Affairs, European Parliament

A new reality has emerged

The new banking crisis legislation has for sure changed the logic and the common behaviour on the European Banking market. Governments have had to adopt to new rules and framework. Investors and depositors have seen a new reality emerging, and bankers have seen that business are not as usual, if it ever was.

This goes for the resolution of Banco Popular, the management of the problems of Monte dei Paschi and the liquidation of the two smaller Italian banks that has captured a lot of interest in the public debate. In all these three cases it is very clear that the new legislative framework has been in place and has set the standards for how banks in different sorts of crisis´ shall be dealt with.

But first, let me underline one thing. As a rapporteur for the BRRD and now for the updating of this legislation following the international agreement on common standards for TLAC, I have never lived in the belief that new legislation should eliminate economic, financial and political problems you face when banks are in a crisis, or even worse when you deal with a banking crisis threatening the economy as a whole. It will always be more of damage control than an elimination of damage.

How you manage the damage control will define how the markets will prepare for future damages and foresee all the problems different actors will need to face. It is about a new market discipline and clear and foreseeable rules for recovery, resolution, and of course liquidation, facilitating rapid decisions and an efficient resolution procedure.

However, these facts do not exclude that there will be times and situations when public interventions are needed, >>>

>>> not replacing the responsibility of the owners and main investors, but making it possible to limit a crisis in a bank to that bank or to the financial sector without entering a deeper financial crisis damaging the whole of the economy.

This is a reason for why it was important for me to see to that there was an opportunity for Governments to facilitate precautionary recapitalization for banks not in a crisis, but not as capitalized as they should, provided strict requirements were met. A recapitalization means dilution of the present ownership, not giving tax payers' money away.

"It is very clear that the new legislative framework has been in place and has set the standard."

- GUNNAR HÖKMARK

Of the same reason, it was important to give opportunity for public funding, provided that the owners have lost their capital and investors have suffered losses.

It is with this perspective that we now can see that the new rules are in place, and not being circumvented. One can discuss, of course, if all preconditions for recapitalization have been met, if the combination of state aid and liquidation was in the spirit of the new legislation and if there were different rules applied in Italy and Spain. But nevertheless, it was the new rules that everyone had to adopt to. Everyone knows from now on that damages in a banking crisis means damages for the owners and investors, and that we have entered a new reality. That´s a change of scene and a new logic that will have positive consequences for the future. ●

Thomas Pohl

Head Governmental Affairs International, UBS

Supervisory trust and cooperation are essential to prevent further fragmentation of financial markets

The FSB recently finalised its guiding principles on internal TLAC (iTLAC) for G-SIBs. These guidelines aim to provide for the right balance between global resolution planning based on single-point of entry recapitalisation versus adequate self-sufficiency of material entities, yet taking due consideration of the fact that such entities would benefit from support by the group.

At the same time, there has been an increasing trend of local requirements to enhance self-sufficiency of individual banking entities to a very high level. Thus, striking the right balance between global strength and ability to steer through a crisis and, if necessary, resolution process, and local self-sufficiency, increasingly becomes a pressure point.

The EU intermediate parent undertaking (IPU) proposal, for example, requires third-country banks to install an intermediate parent setup with high self-sufficiency requirements, leading to further fragmentation of capital and liquidity. In particular, the IPU requirements do not distinguish between banks according to the systemic relevance of their European footprint, nor do they take into account the significant improvements achieved in both resilience and resolvability, through stronger balance sheets, more robust liquidity and risk management, and the build-up of significant resolution funding. This would seem to signal a significant policy shift away from the long-standing EU approach of relying on consolidated supervision by home-country supervisors.

"It will be important to implement any EU requirement flexibly to avoid adding complexity to the operation of global recovery and resolution plans ..."

- THOMAS POHL

Where indispensable to address resolution concerns, the powers to require an IPU already exist under the BRRD. Making the IPU requirement mandatory conflicts with the liberal societal expectation that firms are free to organise their affairs in the most effective manner, subject to adhering to regulatory standards; is not necessarily aligned with cross border fiscal implications; is disproportionate as no similar organisational requirements exist for EU-headquartered firms; and may also negatively affect appetite for cross-border direct investments by third countries.

It will be important to implement any EU requirement flexibly to avoid adding complexity to the operation of global recovery and resolution plans, while minimising implementation and incremental run the bank cost which will need to be borne by the consumers of financial services. To achieve this aim, alternative organisational structures should be considered and third country branches should not be in scope. There also needs to be a realistic conformance period.

As the US considers relaxing certain requirements for foreign banks' US intermediate holding companies, more international dialogue and coordination is needed to get the balance right between the risk and resource management advantages of centralisation and local requirements for self-sufficiency.

The FSB guiding principles on iTLAC and the information exchange and coordination proposals contained in the FSB guidance on Continuity of Access to Financial Market Infrastructures show the way, promoting financial stability through collaboration between jurisdictions. ●

Julie Galbo

Group Chief Risk Officer and Head of Group Risk Management and Control, Nordea Bank AB

An open and transparent dialogue between banks and regulators is key to ensure resolvability of banks

Harmonization between MREL and TLAC is very important for Nordea, as a large G-SIB bank acting on four local markets, with both international and local competition. Requirements for the same bank should not differ in total levels, subordinated part of the requirements, timing, or instruments to meet the requirements. I believe that TLAC should be the leading tool for bail-in, setting the scene for MREL.

Both MREL guidance and additional TLAC create flexibility beyond the minimum requirements, something that potentially is needed but harmonization is crucial. I see a significant risk that MREL guidance can be used with national discretion for other purposes than resolvability. One issue is double counting of capital requirements, whereby banks in countries with high capital requirements will also be forced to meet high MREL requirements.

Nordea has taken a number of steps to reduce complexity and increase resolvability. The most notable step is the legal structure change at the beginning of this year. We merged our bank subsidiaries in Denmark, Finland and Norway with the parent bank in Sweden and are now operating in a branch structure.

The simplified legal structure facilitates the preferred, single-point-of-entry resolution strategy. It also facilitates simplified resolution decision making procedures, reduces the need for using ring fencing tools to protect financial stability in host jurisdictions and provides better conditions for ensuring operational continuity. All in all – the simplified legal structure reduces the overall complexity of the group and the end-result is a more resolvable Nordea Group.

Nordea is also undergoing a digital transformation that will further increase resolvability. We are currently developing a new payment platform and a new core banking platform as well as creating one common data repository. These initiatives will transform Nordea into a more efficient, flexible and transparent banking group - all of which are key factors in being fully resolvable.

I believe the best results are achieved together, by an open and transparent dialogue between banks and regulators on resolution, loss absorbing capacity and resolvability. ●

Tracey McDermott

Group Head Corporate, Public and Regulatory Affairs, Standard Chartered Bank

Solving TBTF – a case for trust among regulators

Mervyn King famously said that institutions were international in life but national in death. It is this conundrum that has driven the significant focus since 2007 on international standards to solve TBTF. For these to succeed they must demonstrate some key characteristics:

- they must be adequate, substantive technical content must address the future risks to the banking system;
- they must be clear and timely - there must be sufficient time to incorporate and implement solutions into banks' forward planning requirements;
- they must be consistent regulators and should aim to ensure a level playing field across jurisdictions/blocs as principles pass into regulation.

Regulators then have the difficult task of delivering their goals without damaging essential economic activity or imposing disproportionate burdens. Banks must also, even as the memories of the crisis start to fade, play their part by adhering to the spirit as well as letter of the rules on a cross border basis not seeking paths of least resistance.

But even if regulation meets all these criteria doesn't mean it will succeed. Institutions, investors and other regulators need to be certain that every other regulator will follow the same approach in difficult market conditions when the rubber really hits the road.

The current TBTF roadmap contains examples of good progress and areas where lessons can be learned going forward.

Resolution colleges are well functioning and increasingly effective. Work on business planning benefits from the TLAC standard, with important detail to follow to give clarity on internal LAC across groups. Work on recognition of international resolution actions includes successes on contractual recognition of stays on termination, in particular the ISDA stay protocols. Banks and regulators have worked in a constructive partnership to achieve this outcome but it is likely that a more formal international framework for recognition of resolution action will be needed for a longer term solution.

But plenty of challenges remain. Home and host authorities will need to intensify co-operation as they tackle increasingly sensitive issues with differing national political interests. Subsidiarisation requirements through local holding company rules risk stifling the synergies of cross border banking business. And where reviews of existing resolution regimes occur, whether they be of the BRRD or outside Europe OLA, the benefits of existing progress cannot be taken for granted. Uncoordinated regulation or a breakdown of the post – crisis consensus on the importance of effective resolution planning would threaten the real economies of all those countries who are home or host to the largest international banks.

I am looking forward to discussing these challenges further at our panel in Tallinn. ●

Systemic risks and resolution in the insurance sector

Contributors

Burkhard Balz

MEP, EPP Coordinator in the Economic and Monetary Affairs Committee, European Parliament

Global systemic risks in insurance - Accountability and risk-based valuation as key words

While knowing that the adoption of the revised set of standards for the international regulation will be pending until at least 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 now 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 is 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 a 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.

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. ●

Theodore K. Nickel

Commissioner, Wisconsin Office of the Commissioner of Insurance & President, National Association of Insurance Commissioners (NAIC)

An activities-based approach to systemic risk for the insurance sector

The objective of an activities-based approach (ABA) should be the identification of activities or common exposures of insurers that are highly correlated with financial markets and which, in the event of a market stress, could not only create capital and liquidity challenges to the firm with implications for policyholders, but also transmit or exacerbate a shock to the financial system with implications for the public more broadly.

This objective is thus distinct from that of an entity-based approach, which attempts to identify firms whose distress or disorderly failure would potentially cause significant disruption to the global financial system. In contrast, an ABA recognizes that firms do not necessarily have to fail to transmit or exacerbate shocks to the financial system.

Two key design elements of an ABA are identifying the mechanisms through which a firm's activities could potentially transmit risk to the financial system and determining a way to assess the systemic impact. Two means of transmission commonly identified are the asset liquidation and the exposure channels. In assessing systemic impact, it is essential to consider risk mitigating impact of other activities of the firm, as well as the risk mitigating impact of supervisory processes.

"State insurance supervisors are well-positioned to assess macro prudential implications"

- THEODORE K. NICKEL

An ABA framework for the insurance sector is still in its early stages of development and thus questions remain about how to appropriately implement it. There are lessons to be learned from similar approaches used in other financial sectors, as well as a need to avoid the many pitfalls of an entity based approach.

Traditional, core insurance activities do not pose a systemic threat to the financial system, and given its nature, insurance can even help mitigate systemic risk. Nevertheless, there is a need to remain vigilant in light of changing market conditions and evolving insurer practices and to update the supervisory toolbox as needed. Key to successful risk monitoring is a solid supervisory and reporting framework that encourages cooperation from insurers and supports transparency, expertise that understands insurer operations and risks, and credible data and tools for analytics. While many of the same supervisory tools for micro prudential surveillance also serve a macro purpose, one outcome of an ABA could be to highlight any additional tools that may be needed to better measure or assess systemic risk. >>>

>>> As we are almost a decade past the financial crisis, it is an appropriate time to evaluate the effectiveness of some of the supervisory mechanisms put in place after the crisis and to take a fresh look at new approaches, including an ABA and its role as a complement to or replacement for the entity-based approach. Whatever approach is ultimately taken, U.S. state insurance supervisors are well-positioned to assess macro prudential implications, including systemic impact, in order to protect policyholders, promote stable insurance markets, and contribute to financial stability. ●

Jad Ariss

Group Head of Public Affairs and Corporate Responsibility, AXA

Systemic risk in insurance – much has already been achieved!

Ten years after the outset of the global financial crisis, much has been achieved to make the financial system safer. The insurance industry, through the identification of so-called Global Systemically Important Insurers ("G-SIIs"), was part of the FSB-led effort to prevent potential systemic risk. Several policy measures and supervisory tools have been developed by the IAIS, ranging from joint supervisory and group-consolidated oversight to comprehensive systemic and liquidity risk documentation as well as group recovery and resolution plans. Cross-sectoral regulations have similarly been enacted in the field of derivatives clearing or shadow-banking activities. Local macroprudential tools are also being developed as showcased by the creation of an insurance recovery and resolution regime in France along with new market-wide supervisory powers. Last but not least, advanced microprudential frameworks with strong macroprudential ramifications are now in place, such as Solvency II in Europe with the first reporting exercise displaying a strongly-capitalized sector (median SCR ratio of 209% in 2016).

"Favour consistency of existing regulation over the creation of new layers"

- JAD ARISS

Having this in mind is it not time to favour consistency of existing regulation over the creation of new layers? From this perspective, the IAIS decision to postpone the development of an HLA and to investigate the potential benefits of an activity-based approach could be an opportunity to fix existing flaws in the current entity-based methodology. More importantly, this should serve to ensure an accurate consideration of actual - and properly systemic - risks posed by the insurance industry, in light of existing risk management practices and supervisory tools ("residual risk"). Any macroprudential framework that fails to effectively take them into account along with the specificities of the insurance business model would not be sustainable and ultimately damage the provision of key services and financing to the economy. Resolution frameworks are no exception, where a balanced approach must be found in order to avoid detrimental obstacles to efficient firms' capital management and financial structure.

It is therefore instrumental that the IAIS and supervisors agree first on an adequate approach focusing on the actual systemic risk left with the insurance sector, before rushing into new policy proposals, the implementation of which should also be carefully looked at – particularly in the EU - from the perspective of preserving the level-playing field across jurisdictions. ●

Yoshihiro Kawai

Secretary General, International Association of Insurance Supervisors (IAIS)

Insurance sector stability: monetary context and systemic risk framework

This is a critically important topic for the IAIS. I would like to share a couple of observations concerning the potential impacts of the low for long monetary context on the stability of the financial sector.

"It is important to grasp fully the role of insurers in the wider financial system"

- YOSHIHIRO KAWAI

The low interest rate environment has a considerable impact on the solvency of particularly long-term insurers. The situation is aggravated in cases where generous interest rate guarantees have been provided. That said, insurers seem to have adapted well and have shown resilience despite the ultra-low interest rates for a prolonged period of time. There has been a reduction of interest rate guarantee-based insurance products and an increase of unit-linked products, where the policyholder bears the investment risk. There is Improved maturity matching of asset and liabilities (where this was not already common practice), and Improved risk management. We are seeing some changes in asset allocation (eg the move from government bonds to more corporate bonds, the consideration of new, alternative types of investments or slight increase relative to other investments, such as infrastructure projects, direct loans, and real estate. >>>

>>> As the big central banks start (or hint at) tightening monetary policy again, life insurers are seeing some relief. Investment returns are slowly improving and the value of technical provisions (calculated on market-adjusted valuation basis) is falling.

In light of this experience, regulators adjust(ed) regulatory frameworks, eg adjustments to reduce volatility in capital resources, counter-cyclical adjustments to capital requirements, and new local rules to build reserves against the losses from interest rate guarantees, to name but a few.

Regulators and central banks have shown increased interest in the role of insurers as part of the wider financial markets, especially with regard to the role of insurers as important long term investors. The investment behaviour of long term (life) insurers is of particular interest. The on-going analyses of potential procyclical behaviour of insurers has produced largely inconclusive outcomes so far.

Another area of interest is he participation of insurers in shadow banking (or – more narrowly perhaps – credit intermediation) and linkages to (ie interdependences with) other financial sector participants, banks and asset managers, in particular.

In light of these points, I think it is important to grasp fully the role of insurers in the wider financial system and their contribution to financial stability. In fact, we need to make sure that any revision of the global systemic risk framework for insurance companies takes account of their role. The approach needs to be well-embedded in the wider context of financial sector regulation and limit loop holes such that systemic risk does not build up outside the regulatory perimeter. At the IAIS, contributing to financial stability is a key part of our mission and at the heart of our work on systemic risk assessment and the current assessment methodology for global systemically important insurers (G-SIIs). ●

Nina Arquint

Head of Group Qualitative Risk Management, Swiss Re

OAG discounting: amplifier of systemic risk, source of respective cost?

Adjusted liability discount curves are a key component of EIOPA's matching adjustment, one of the transitional measures for Solvency II and are also used by the International Association of Insurance Supervisors (IAIS) in the development of a potential future Insurance Capital Standard (ICS). For the ICS, the most prominent discount adjustment method is the "Own Assets with Guardrails", where the adjustments increase with the expected returns of the insurer's own investment portfolio. Proponents commonly claim that risk-free, market-consistent liabilities make their investment portfolio look artificially volatile and therefore promote procyclical behavior. In mild crises, it is probably true that volatility is reduced, however, the effect reverses, and volatility is amplified when crises become more severe. This risk may be systemic.

Proponents of adjusted discount curves argue for the need to eliminate "artificial volatility" caused by market price fluctuations in default-prone investments. They make the case for a system which distinguishes between rational ("signal") and irrational ("noise") components of the credit spread. In reality, there is no systematic approach to distinguish between signal and noise. Instead, discounting liabilities with an adjusted, non-risk free rate curve gives insurers a strong disincentive to sell assets in periods of mild distress (where spreads are widening, but no defaults materialize) to avoid creating a sudden mark-to-market loss. An insurer using a riskfree rate curve has no such disincentive to rebalance a risky asset portfolio given potential market signals, since the impact is already fully recognized on the balance sheet and economic P&L. Management may make an unbiased decision to unwind positions at the onset of turmoil, in order to avoid significantly higher future default losses.

Insurers who use adjusted discount curves are therefore much more likely to hold onto assets through periods of market turmoil, either making no losses when credit defaults do not materialize, or significant losses if the crisis becomes more severe and leads to credit defaults. In this case, insurers' incurred losses would be amplified, so that they would potentially be incurred not only by shareholders, but also by policyholders as well. If several major insurers were impacted within a short time period – which is very probable in periods of severe stress – this would potentially undermine confidence in the insurance industry and in the markets themselves.

The risk of a credit crisis with significant joint defaults in the investment book is real. IAIS needs to analyze the tsunami potential of the associated systemic risk. Moreover, for the impacted insurer, the incurred default risk is borne by (in the following order):

1) shareholders
2) junior and senior bondholders
3) policyholders

The IAIS urgently needs to develop its Margin Over Current Estimate (MOCE) concept to adequately quantify the return that reasonable investors will ask for this risk. It is part of the cost of producing insurance under an OAG / Matching Adjustment regime. ●

Sandrine Lemery

First Deputy Secretary General, Autorité de Contrôle Prudentiel et de Résolution (ACPR)

Insurance sector: would a recovery & resolution framework be of any value?

Some stakeholders sustain that a recovery and resolution (hereafter R&R) framework is less needed for the insurance than for the banking sector. Insurers would be less interconnected than banks. It would not be demonstrated that they have critical functions. Their liabilities would be long-term and therefore rapid intervention "in a matter of hours" would not be necessary. Those stakeholders also support, if a R&R framework were to be implemented, that it should only apply to systemic insurers.

However, past insurance failures demonstrated that even for non-systemic or non-critical insurers, administrative resolution process can markedly enhance the situation of policyholders. Court-led insolvency procedures are generally slow and not flexible enough as a court will generally not have the capacity to depart from the pari passu rule. If, for instance, the insurance liabilities of an insurer amount to 100 and covering assets only amount to 40, and if a transferee accepts to take over only a part but not all of the insurance portfolio (e.g. only the policies of a certain geographic region or of certain lines of business) and accepts to fund all of the corresponding shortfall, this departs from pari passu (because transferred policyholders will received 100% of their claims), but it is nevertheless preferable to a situation where all policyholders only get 40% of their claims.

These are some pros of a national R&R regime covering a wide range of insurers. Of course national regimes are not sufficient. If not all deeply interconnected, many insurers are "internationally active", especially in the EU. This makes necessary the establishment of an EU R&R framework, which would be particularly useful in crisis preventions and management.

In this context, the French government has decided to introduce a national R&R framework. The ACPR will be the resolution authority for the insurance sector and the general R&R framework will apply to all insurers submitted to S2 Directive. However, only insurers whose premium income is above a certain threshold will be required to draft pre-emptive resolution plans, and ACPR will draft resolution plans for these insurers, conduct resolvability assessments and have the power to require these insurers to remove obstacles to their resolvability. On a case-by-case basis, R&R planning could yet also apply to insurers below the threshold, or insurers above the threshold could be exempted.

However, legal constraints do not make it possible, at this stage, to vest ACPR with powers to restructure (write down and / or bail-in) insurance or other debt. An EU initiative would decisively help to mitigate and surmount these obstacles. In this context, the ACPR warmly welcomed the publication of the EIOPA Opinion recommending a (minimum) harmonized R&R framework in the EU. ●

Edite Ligere

Barrister, Vice President, Global Regulatory Policy, Global Government Relations, MetLife Inc.

Identifying and addressing global systemic risk in the insurance sector: the way forward

In February 2017, the International Association of Insurance Supervisors ("IAIS") formed its Systemic Risk Assessment Task Force ("SRATF"). The purpose of the SRATF is to, inter alia, develop the concept of the assessment of global systemic risk in the insurance sector based on activities rather than entities. The SRATF are currently engaged in a constructive dialogue with the industry to assist the SRATF in its cross-sectoral analysis of systemic risk.

We believe that an activities-based approach to systemic risk should focus on a small range of activities connected to the systemic risk transmission channels of asset liquidation and counterparty exposure. As this approach will more comprehensively and effectively address systemic risk, it should eliminate individual global systemically important insurer ("G-SII") designations. Is will also demonstrate the ineffectiveness of additional capital as a mitigant for the risk transmission.

The anatomy of an activities-based approach should: (i) be based on a definition of systemic risk that requires an impact on the financial system as a whole, not just on individual institutions and their policyholders or investors; (ii) address the sources of systemic risk using tailored supervisory measures based on the systemic risk transmission channels; (iii) include all relevant participants in an activity that may pose a risk to global financial stability; (iv) take into account internal best risk management practices and relevant micro-prudential rules that may mitigate/eliminate systemic impact; (v) include quantitative metrics, which provide greater certainty about identifying and managing risks; (vi) apply the principle of proportionality and include de minimis thresholds; (vii) enable the development of a cross-sectoral perspective of systemic risk and its management across all market participants; (viii) promote the primary regulator's role as supervisor, while recognizing recommendations from regulatory bodies and market commentators to the primary regulator regarding potentially systemic activities developing in the financial sector; (ix)

address risks to global financial stability arising from both a "domino" and a "tsunami" view of systemic risk; and (x) replace the bank-centric G-SII methodology which does not adequately reflect the insurance business model.

At present, the question of whether an activities-based approach will be complementary to or a replacement of entity G-SII designations remains open. We are optimistic that as the activities-based approach is developed, the IAIS will recognize that an activities-based approach better captures all material risks and is the only credible approach to capturing systemic risk in the insurance sector. ●

Nathalie Berger

Head of Unit Insurance and Pensions, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Recovery and resolution and systemic risk in insurance – the current thinking

Over the past years, the EU has taken numerous initiatives to improve policyholder protection and to create a single market for insurance. Solvency II introduced harmonised and tailored capital requirements, allowing for a consistent assessment of the robustness of EU insurance companies. It also set up a ladder of supervisory intervention and detailed reporting tools, thus ensuring a close monitoring of insurance undertakings by their supervisory authorities. However, over the same period, new risks in insurance have developed, especially due to the low yield environment.

Solvency II contains specific requirements for the actions to be taken by national supervisors when the Solvency Capital Requirement (SCR) is breached. It also contains provisions for specific cases when supervisory authorities can extend the recovery period. Various supervisory approaches are followed in Member States to limit the impact of the failure of insurers. The achievement of the policyholder protection objective primarily depends on the measures taken at the national level. However, insurance is an international business and the freedom of choice in the single market requires a consistency of these measures across Members States, particularly for cross-border insurance policies.

On 5 July 2017, EIOPA adopted a report recommending EU action on recovery and resolution for the entire EU insurance market. The European Systemic Risk Board (ESRB) is also working on a report on the same subject. The Commission will carefully consider both those reports once available.

Thinking about systemic risk in the insurance sector has evolved since the failure of AIG. Several bodies are now working on the topic; not only the International Association of Insurance Supervisors (IAIS) and EIOPA, but also the IMF and the ESRB. The IAIS continues to develop its methodology to identify global systemically important insurance institutions (GSIIs), which are already subject to reinforced supervision. In application of the G20 commitments, the supervisory measures applicable to GSIIs include the obligation to draft recovery plans, thus allowing early remedies in case of financial troubles. The IAIS is also working on "Higher Loss Absorbency", a kind of capital add-on for G-SIIs which is envisaged to apply from 2019, but this is still in development.

Alongside this entity-based approach to systemic risk, an activity-based approach is also under consideration by the IAIS and other institutions. In addition to the concept that some insurers may engage in non-traditional activities and thus be exposed to additional risks, the activity-based approach focusses on the implications of common activities in the insurance sector. Where relevant, the approaches taken towards systemic risks in the banking and asset management sectors should also be taken into account, to ensure consistency across financial institutions while preserving the specificities of each activity. In the EU insurance sector, before deciding on the way forward at international level, reflection on all these concepts and developments need to mature and take into account the extensive set of supervisory tools already available, notably Solvency II. ●

NEXT EUROFI EVENT

The Eurofi High Lever Seminar 2018

25, 26 & 27 April

Seminar organised in association
with the incoming Bulgarian EU Council Presidency

Sofia - **Bulgaria**

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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.

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

The membership of Eurofi comprises many leading global and European financial institutions from different sectors of the industry (banking, insurance, market infrastructures, asset management, credit rating agencies…).

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25, 26 & 27 April 2018
Sofia - **Bulgaria**

5, 6 & 7 September 2018
Vienna - **Austria**

April 2019
Bucharest - **Romania**

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