Views

The EUROFI Magazine

VIENNA | SEPTEMBER 2018

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Using opportunities to strengthen the region's resilience

The Eurofi Financial Forum 2018

Vienna | 5, 6 & 7 September

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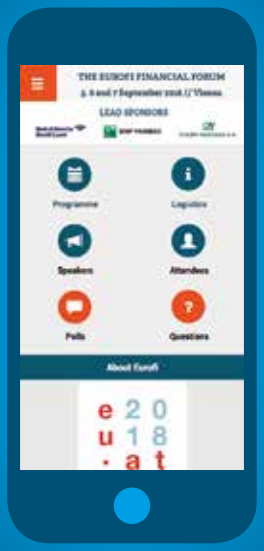

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The Eurofi Financial Forum

VIENNA | SEPTEMBER 2018

EDITORIALS & OPENING INTERVIEWS

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The Eurofi Vienna Financial Forum

Over 800 representatives of the European and international public authorities and the financial industry are gathered in Vienna to discuss key policy issues impacting the financial sector, the macro-economic environment and new trends such as technology and sustainable finance. How to tackle the potential impacts of Brexit and changes in global regulatory coordination will also be major topics of discussion during this Eurofi Forum.

All these changes are both challenges and opportunities to review the overall financial services objectives of the EU27 and define how key policy initiatives such as the Banking Union and Capital Markets Union may be adjusted or completed to increase the competitiveness and integration of the EU27 financial sector, as the European elections are approaching. One major subject of discussion during this Eurofi Vienna Forum will also be how the Economic and Monetary Union can move forward and how private risk sharing can develop in the EU with a further integration of the EU financial sector.

Most of the 200 speakers taking part in the Eurofi Vienna Financial Forum have expressed their views in this Magazine, providing a comprehensive overview of thoughts and proposals regarding these issues. We thank them very warmly for their thoughtful contributions and are sure that you will read them with great interest. ●

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

David Wright

President, EUROFI

Common projects - Global or European - are needed that stand the test of time

A warm welcome to EUROFI, Vienna - our 19th edition, and the 1st time we have been hosted in this magnificent city.

We are deeply grateful to the Austrian Presidency of the European Union for all their assistance and hospitality. We also thank most sincerely our lead sponsors, sponsors and all members of EUROFI for their continuous support, without which our prestigious events could not be realized.

We will be more than 900 participants and speakers at EUROFI, Vienna from all over the EU and from the United States, Japan, Switzerland....to whom we accord a special welcome.

About 6 months have passed since EUROFI Sofia. Is the world in a better place? Has the European Union made decisive strides forward?

I see a deteriorating international political situation, worsening medium term scenarios, surges of dangerous, unhealthy nationalism and xenophobia, escalating "quick-fix" populism and far less willingness to find collective solutions, timely solutions in the public interest to the complex problems we face.

Perhaps the only bright spot is that the global economy remains relatively robust. Growth still remains strong in Asia, particularly in China and India, in the United States and to a lesser extent in the EU. Unemployment has fallen from the financial crisis peaks, public debt is under slightly more control, interest rates in the main are modest and inflation in OECD countries still low. There are few signs yet of any serious systemic financial dangers lurking.

But puncturing this fair economic and financial picture are squalls of unnecessary, transactional, bilateral trade disputes, started by the United States, resulting in retaliatory tit-for-tat responses from the EU, China, Canada and others.

Frankly, is there anyway or anywhere a car for example, or a steel bar could possibly be construed as issues of national security, especially since they are produced so extensively nationally?

These trends are extremely worrying and would be even more so if there are direct spillovers affecting trade in financial services.

The best approach surely is that international trade disputes should be negotiated with counterparts in the WTO, if necessary deploying

the disputes settlement procedure - a vital international safeguard that needs further strengthening. Maybe other WTO rules need to be modernized, fine, then the way forward is to sit down with partners and work out how.

Unless these global trade tensions are dissipated quickly everyone risks losing : global financial confidence will be dented; there will be less cross-border investment; enhanced currency volatility and turbulence; and accelerating capital flight from EMCs etc. Let us ardently hope that the recently announced EU-US bilateral trade talks can make progress quickly and show a sensible, balanced and legally sound way forward.

If, however, regrettably, the U.S wants to withdraw from multilateralism, marginalise the WTO and other international bodies, and largely seek the bilateral route then the EU, leading with others in a broad coalition of the willing, must step up, defend and work to reinforce the multilateral institutions, including the global financial ones - the FSB, Basle, IOSCO, IAIS etc.

Other different factors of growing concern are the evident economic and financial fragility of Turkey, the EUs' huge and important neighbor and the continuous evidence of massive levels of money laundering, corruption and tax evasion in many parts of the world eroding public confidence in politics, democracy and the rule of law.

In the EU there is now a clearer pathway forward on economic and banking union but the slow speed of delivery, masking fundamental disagreements on some aspects and a lack of trust, are not building sufficient confidence in the long-term viability of EMU. Empirically there are still huge structural and current account disequilibria at the heart of the Eurozone which are unsustainable and which must be addressed expeditiously through symmetric adjustment mechanisms in the future.

Even though the ECB has been the European rock during the financial crisis and has shown great dexterity in its deployment of monetary policy, the EMU job must be completed. As usual we will be debating all aspects of these questions in Vienna.

On Capital Markets Union, so important for the future financing of the EU economy, most practitioners admire and support the concept of the project but feel, strongly, that insufficient progress has been made, particularly in view of the projected departure of the United Kingdom from the EU in late March next year. What is the right way forward?

What should be the priorities for the next European political cycle that begins next year? Surely sustainable/green finance, fintech and the encouragement of long-term investment, along with making the PEPP work will be among them - all subjects on our Vienna agenda.

The tragedy of Brexit regrettably remains with us. The outcome remains unpredictable, the politics fiendishly complicated. One must hope that the negotiators on both sides find sensible, pragmatic outcomes that respect both the integrity of the EU, its single market and customs union and the sovereignty of the departing state. It makes no economic or financial sense whatsoever to draw up an exit Treaty that neuters future bilateral trading between close neighbors. But the essential point is what will be the conditions?

If equivalence is to be the designated approach for much of the future financial trading between the EU and the UK, erga omnes improvements to the EUs decision making process and its predictability would seem a sensible goal, plus widening its scope.

Our role at EUROFI is to stimulate debate on the key European economic and financial issues. Let us be imaginative in Vienna, creative, thoughtful, forward looking and open to ideas that will benefit the public interest and strengthen our European project. Finding these solutions is hard. Even more so given the growing impatience of public opinion partially related to the new, instantaneous digital culture of today.

But in my experience there is nothing more satisfying or rewarding than building together good, common projects - Global or European - that stand the test of time, with appropriate, professional levels of collaboration between the public and private sectors and other stakeholders.

There is no time to waste. ●

Q&A

Hartwig Löger

Federal Minister of Finance, Austria

Using opportunities to strengthen the region's resilience

WHAT ARE THE PRIORITIES OF THE AUSTRIAN PRESIDENCY IN THE FINANCIAL AREA?

Our presidency coincides with a difficult phase in the European integration process, including the Brexit negotiations and the next Multiannual Financial Framework. Moreover, the European Union is faced with considerable external challenges and uncertainties, such as increasing trade protectionism and geopolitical tensions. Last but not least, the upcoming European Parliament elections in May 2019 are another reason why the Austrian Presidency is expected to reach progress and/or finish negotiations on a large number of files.

From the ECOFIN-Council's perspective, first and foremost we are determined to make substantial progress on the completion of the Banking Union. In this context, we will particularly strive for an agreement with the European Parliament on the so-called Banking Package, containing a broad range of further risk reduction measures which contribute to further improving financial sector stability. Furthermore, at the recent Euro Summit, Leaders requested the Council to start work on a roadmap for beginning political negotiations on the European Deposit Insurance System, while at the same time adhering to all elements of the June 2016 Council Roadmap in the appropriate sequence.

A second area that we regard as particularly important concerns the European Commission's proposals on addressing the problem of Non-performing loans, which negatively affects the Banking sector's lending capacity and also its profitability. In this respect, our main focus will be the Commission's proposal on the introduction of a prudential backstop within the framework of the CCR, aiming at ensuring sufficient loss coverage by banks for future NPLs. In addition, the Austrian Presidency would also

like to reach progress on the second legislative proposal in this context, regarding the development of secondary markets and the out-of-court enforcement of collateral.

Finally, our third priority in the financial area refers to the Capital Markets Union, which will provide the business sector with a greater choice of funding sources and offer new opportunities for savers and investors. Important elements in this context are the Commission's proposal on the introduction of a pan-European Personal Pension Product (PEPP), amendments with respect to the European Market Infrastructure Regulation (EMIR REFIT, EMIR CCP Supervision) and the review of the European System of Finanancial supervision (EFSF).

ARE WE ON THE RIGHT TRACK CONCERNING THE EMU FOLLOWING THE CONCLUSIONS OF THE EU COUNCIL OF JUNE 2018? WHAT SHOULD BE THE KEY ELEMENTS FOR DEEPENING THE EMU?

The conclusions of the EU Council of June 2018 point in the right direction, with the focus laid on the completion of the Banking Union and the further development of the European Stability Mechanism. As to the latter, it is meanwhile agreed that the ESM will provide the common backstop to the Single Resolution Fund, entering into force at the end of the transitional period in 2024 at the latest, depending on the progress reached in risk reduction measures. There is also consensus that the common backstop will be part of a more comprehensive reform of the ESM, including a reinforced role in designing and monitoring programs.

Regarding the general framework of the EMU, I share the view that further efforts are needed in order to strengthen the growth potential and to promote competiveness and productivity. However, instead of creating additional coordination mechanisms and financial tools, we should rather focus on streamlining and implementing already existing instruments. Together with the reduction of legacy assets (especially non-performing loans) and an increased conditionality this will also lead to a stronger EMU.

I am confident that convergence among Member States will increase, as we have seen substantial catch-up effects in Central and Eastern European economies since their EU membership. Nevertheless, more needs to be done to further close the gap between Member States, including the still existing north-south gap. I am truly convinced that the common currency provides major benefits for all EU member states. However, it is clear that it also entails some macroeconomic challenges.

A currency union withdraws the economy's ability to depreciate its currency in order to gain competitiveness. Against this background, a currency union demands an increased focus on structural reforms to equalize competitiveness imbalances but also needs some form of fiscal coordination to dampen economic shocks. I am convinced that the existing rules together with the above mentioned new elements provide an appropriate toolkit to increase the stability of the euro zone. The current positive economic environment provides a window of opportunity to implement more ambitious structural reforms and to increase fiscal buffers.

WHAT ARE THE SYNERGIES BETWEEN THE BANKING AND THE CAPITAL MARKET UNIONS?

Both the completion of the Banking Union and the Capital Market Union are important steps in order to increase the efficiency of European financial markets, enhance competitiveness and strengthen the resilience of European economies. The Banking Union creates a stronger and better supervised European banking system and therefore increases financial stability. It contributes to breaking the vicious circle between banks and the public sector, which has been one of the key issues in the past crises. In parallel, the Capital Market Union leads to a more diversified financial system and aims to unlock capital around Europe. Through deeper financial integration and spurred cross-border investment it facilitates financing for European companies and therefore supports European growth and increases its resilience to shocks. Both projects need to go hand in hand. Furthermore, in the context of rising international competition on global financial markets, strengthening the single market will improve European competitiveness and its position in international financial markets.

WHAT ARE THE MAIN IMPEDIMENTS FACED BY PENSION FUNDS AND INSURANCE COMPANIES TO FURTHER FAVOUR LONG TERM INVESTMENTS IN THE EU?

Fostering long term and sustainable investment is an important policy goal. However, we have to be very cautious in choosing the right means to implement this goal. The ultimate aim of capital requirements is to protect the stability of financial markets and the rights of customers and beneficiaries. Therefore it is important that capital requirements continue to follow a risk-based approach. Favouring particular types of investments without robust evidence-based justification could create significant risks to financial markets and customers. This fact should be taken seriously and be considered during the Solvency II review in 2020. As far as accounting is concerned, we should not abandon the approach according to which financial statements must give a true and fair view of the financial situation of the company. ●

Q&A

Univ.-Prof. Dr. Ewald Nowotny

Governor,
Oesterreichische Nationalbank

Much has been done to make the euro area more resilient, but work is not yet finished

10 YEARS AFTER THE START OF THE 2008 FINANCIAL CRISIS, IS THE FINANCIAL SYSTEM SAFER?

10 years ago, the collapse of Lehman triggered the most severe crisis since the Great Depression in the 30ies of the past century. What we can say for sure is that the combined efforts of central banks, together with governments and the International Monetary Fund, constituted an unprecedented joint crisis management on a global level. This joint approach successfully served the common goal of stabilizing the world economy as well as the European economy. Since then, Europe has implemented an impressive number of reforms: European firewalls were established, among others the European Stability Mechanism (ESM) for the euro area, and these firewalls are provided with substantial financial firepower in order to be able to address potential challenges arising from any banking or sovereign debt crises in the future. Furthermore, the European financial system has become much more resilient as capital buffers have roughly tripled over the past decade. In addition, we have set up – at least in the euro area – a new architecture for the supervision and resolution of failed banks. However, we still don't have a common scheme to guarantee deposits from savers and we still have a lot of work to do in order to implement the Capital Markets Union.

HAS THE BANKING UNION ALLOWED TO BREAK THE SOVEREIGN-BANK LINK AND IS FURTHER PROGRESS NEEDED?

The crisis has not only helped to introduce reforms, it has forced us into action. In a nutshell: We have made enormous progress, which was unseen before. But the work is not completed yet. In my view the NPLs are still a looming problem, especially in some South European member states, we all know that. And we also know that in some countries the banks are the biggest buyers of sovereign bonds. And for all that we have no quick solution and

to be honest here as well, it will take time to eventually break this interdependence between banks and states.

IS THE CMU INITIATIVE AS IT IS CURRENTLY STRUCTURED AND BEING IMPLEMENTED LIKELY TO ACHIEVE THE GOALS THAT HAVE BEEN DEFINED, BY 2019? HOW IS BREXIT BEING TAKEN INTO ACCOUNT IN THE CMU ACTION PLAN? HOW DEPENDENT IS THE CMU ON A STRENGTHENING OF THE POWERS OF ESMA?

The CMU Action Plan has delivered already several concrete results and more initiatives are in the pipeline. In this context it has to be noted that individual European countries are at different levels as regards the implementation of the CMU. Therefore, the promotion and development of country-specific initiatives requires different national strategies. A stable legal framework, efficient administration, a predictable tax environment with a simple tax system for SMEs, primarily drives a well-structured business environment. There are concerns related to the proportionality of EU law. Particular attention should be paid to "small jurisdictions" according to the state of development of capital markets.

On Brexit, the UK and EU financial services markets are highly interconnected. UK-located banks underwrite around half of the debt and equity issued by EU businesses. If Brexit negotiations do not bring about mutually beneficial arrangements for services and investment, this could lead to a situation where the UK and the EU will not have current levels of access to each other's markets.

On dependence of the CMU on a strengthening of the powers of ESMA, a kind of "Single Capital Markets Supervisory Mechanism" could ensure that there is one rulebook, with one interpretation. There is a need for a consistent application, which is an appropriate allocation of supervisory responsibilities between ESMA and the national competent authorities based on the principles of subsidiarity and proportionality. Regulatory gaps must be closed. Furthermore, to reduce the market fragmentation, the actual diversity of market structures and market players must be based on the same core foundations. There is a need for truly integrated, harmonized, low-risk and low-cost trading infrastructure in Europe.

WHAT ARE THE SYNERGIES BETWEEN THE BANKING UNION AND THE CAPITAL MARKETS UNION? HOW DEPENDENT IS THE CMU ON A FURTHER INTEGRATION AND STRENGTHENING OF THE EUROPEAN BANKING SECTOR AND THE FURTHER DEVELOPMENT OFTRANSNATIONAL BANKING GROUPS?

Banking Union and Capital Markets Union are two central policy initiatives for financial integration in the EU. Banking Union increases the flexibility of the banking sector, simplifies sector consolidation and improves the credit market. Banks are active as service-providers, investors and issuers. Capital Markets Union contributes to diversify sources of finance for businesses and creates a risk-sharing channel. Within a significantly more integrated capital market, banks would no longer need to develop a local expertise for each national capital market. Banks and capital markets are within the financial system more or less closely interconnected. Against this background, the Banking Union and Capital Markets Union can be described as mutually reinforced initiatives.

In my view, the successful implementation of the CMU will definitely benefit from a further strengthened banking system, as more resilient banks support the smooth functioning of capital markets and are more likely to act as market makers for certain capital market instruments. Ideally, they may buffer extreme price movements in times of crisis. In addition, prospering banks will be able to invest more resources into the development of new capital market products and services. Furthermore, an increasingly integrated banking system should also support the integration of capital markets in the EU.

As to the expected contribution of the creation of transnational banking groups to the CMU, I think that banks may offer complementary information and funding services. As a case in point, they may offer the issuance of bonds, as banks may provide a number of advisory and administrative services for the issuers. Moreover, transnational banks may offer securitization. This is done by pooling and repacking certain types of assets into interest bearing securities. Other markets participants who are focusing to invest in these special market segments buy these securities. At the same time, banks may strengthen their own capital position, as capital markets reduce the financing cost of equity, and enable banks to raise additional equity to expand their lending operations.

On cross border consolidation, I would like to emphasize that regulation in Europe is still less harmonized than it should be. This acts as a brake on cross-border consolidation. As regulations are directly applicable in all Member States, they should ensure a high level of harmonization within the Banking Union. Creating a common political will is sometimes more difficult between all Member States. It needs a more integrated approach to benefit from the Banking Union. Capital and liquidity should circulate freely within the banking groups. Furthermore, completing the Banking Union is not just "reducing risk and let the banks shrink to health". The underlying economic conditions need to become better and the euro area and the Banking Union have to offer an environment that encourage more cross borders mergers and acquisitions in the euro area. ●

Q&A

Valdis Dombrovskis

Vice-President and Commissioner for Euro and Social Dialogue, Financial Stability, Financial Services and Capital Markets Union, European Commission

Deepening the Economic and Monetary Union and building more resilient economies

WHAT SHOULD BE THE KEY ELEMENTS FOR DEEPENING THE EMU AND IS THE EMU PROJECT ON THE RIGHT TRACK?

We are on the right track, but we are not there yet. The current economic situation – with growth in all Member States – provides a good opportunity to push forward with remaining reforms, both at EU and Member State level.

During the crisis, we observed a disruption in the process of convergence among some Member States. Some have blamed this on the fact that independent monetary policy and nominal exchange rate depreciation are no longer feasible policy tools for countries in the euro area. But I disagree on both counts. When it comes to monetary conditions, they have been supportive throughout the euro area since the financial crisis. And as for currency depreciation, this tool has not been particularly effective before EMU, and in fact it carries economic costs. It does not address deep-seated structural weaknesses hampering competitiveness or overstretched fiscal positions, and actually it can make it harder for the government to finance its budget deficits. So I believe the euro is not at the root of the problems that Member States have gone through.

However, the crisis did reveal that several Member States lacked the right economic structures to prevent and respond to build-ups of macroeconomic imbalances and the economic recession that followed. Much has been done to remedy this situation, and this work should continue. In particular, Member States need:

- Product markets that foster competition and innovation;
- Labour markets that respond to cyclicality and support mobility and transitions; and
- Financial markets that direct funding to the most productive uses and increase shock-absorption capacities.

The EU now has several tools to help Member States address these structural challenges, such as:

- The European Semester, which flags immediate reform needs and builds up peer pressure.
- The Macroeconomic Imbalances Procedure, which helps to identify, prevent and correct threats to economic stability.
- The Structural Reform Support Programme, which offers technical support for the design and implementation of reforms in Member States upon their request. In July, we reached a political deal to double its funding until 2020, and to create a work stream for Member States wishing to join the euro area.

However, more is needed to help Member States improve their resilience and real convergence capacity, and this is reflected in our recent proposals for the next Multiannual Financial Framework. We have proposed an expanded Reform Support Programme, to boost support for structural reforms in Member States through both financial and technical support, with a total budget of €25 billion. We have also proposed a European Investment Stabilisation Function, to mobilise up to €30 billion in loans to help stabilise public investment levels and facilitate rapid economic recovery in cases of large asymmetric shocks.

HOW TO RESTORE CAPITAL MOBILITY BETWEEN THE EUROZONE COUNTRIES? WHAT ARE THE ECONOMIC MEASURES REQUIRED FOR RESTORING A COHERENT MONETARY UNION IN MACRO-ECONOMIC TERMS ?

The EU is continuously working to tackle obstacles to the cross-border flow of capital and to create a single market for financial services. This is first of all because capital mobility is one of the key elements in the EU single market, enshrined in the Maastricht Treaty. But it is also because it is essential for financial integration in the euro area.

Alongside resilient economic structures, European financial integration is crucial for improving the absorption of asymmetric shocks. It would also promote real growth, by allocating capital to its most productive uses across the EU. And it would boost private risk-sharing across borders in the EU, thereby reducing the risk for public risk-sharing, arising for instance from the need to recapitalise banks.

In the initial phase of the EMU, financial integration increased, with capital flowing from capital rich to capital poor countries. But with the financial crisis, this process stalled, and capital flows went into reverse. However, we are all well aware that an important share of that capital has not been directed to its most productive use to begin with. Therefore, while re-establishing the pattern of the initial EMU phase, one needs to ensure that the capital goes to productive uses. This will be beneficial for a well-functioning EMU and for resolving external imbalances.

Our two flagship projects, the Capital Markets Union and the Banking Union, are dedicated to the goal of delivering a single market in financial services.

As part of the Capital Markets Union, we have proposed a wide-ranging set of measures, including reform of the EU's supervisory architecture, new rules for pan-European personal pension products, an EU framework for covered bonds, a proposal to improve the access to public markets for SMEs, and an enabling framework for EU crowdfunding platforms.

In March 2017, we also launched an Action Plan to strengthen the EU single market for retail financial services, which remains heavily fragmented, as well as a related proposal for consistently cheaper cross-border payments in euro within the EU. This ties in with our efforts to harness the potential of digitalisation to improve consumer access to financial services across the EU, as part of our March 2018 Fintech Action plan.

Lately, we are starting to see positive developments. Recent reports show that financial prices, especially of equity returns, bond yields, and some bank lending rates are converging. Nevertheless, intra-area financial flows are still much weaker than before the crisis, with especially weaker cross-border lending between banks. Partly, this is due to the ECB's intensive allocation of liquidity, which reduces the need for banks to borrow or lend cross-border. But doubts about the solvency of some EU banks and the sovereign-bank bias has also played a role, as became clear during the sovereign debt crisis.

This leads me to our work to complete the Banking Union, by jointly reducing and better sharing financial risks. On the risk reduction side, we are seeing tangible progress, as our banks are now stronger and better capitalised. In addition, the reduction of non-performing loans (NPLs) is continuing apace, including in the countries with the highest levels. ECB data for end 2017 shows that the EU's NPL ratio is now below 4%, for the first time since the crisis. To support and cement this trend, the Commission proposed in March a package of proposals, which has been well received by Member States.

As for risk-sharing in the Banking Union, the mechanisms for single supervision and single resolution are in place. Recently, Member States have advanced with their discussions of the latest outstanding issues on the single resolution fund. However, Banking Union will not be complete without a backstop to the Single Resolution Fund and a European Deposit Insurance Scheme. Given the progress achieved on reducing risks in the banking sector, it is now justified to tackle this head-on.

WHAT ARE THE SYNERGIES BETWEEN THE BANKING UNION AND THE CAPITAL MARKETS UNION? WHAT CAN STILL BE ACHIEVED IN THE PRIVATE RISK SHARING AREA VIA THE BANKING AND CAPITAL MARKET CHANNELS BY 2019?

The Capital Markets Union and the Banking Union are both necessary to promote a stable and integrated financial system in the European Union.

Europe's more than 5000 banks play a crucial role in our financial system. That is why the Banking Union is key for the financial stability of the euro area. It helps to provide a level playing-field for banks and to reduce the bank sovereign link, enabling banks to be judged in the first place based on the business they do. But the Banking Union is still incomplete, with important progress remaining, as I mentioned in my answer to the previous question.

Our banks also play an important role on our capital markets, whether as market makers and service providers, investors, or issuers of securities such as bonds and securitisations. In fact, banks and capital markets complement one another. While banks are well placed to pursue long-standing relationships with established companies, capital markets are well placed to fund smaller and innovative companies, which drive growth and job creation.

The financial crisis also showed that Europe is not taking full advantage of the ability of deep capital markets to absorb shocks. Here we should learn from the experience of others: in the US, an estimated 70% of local shocks are absorbed through financial markets. In the euro area, the figure is less than 30%. To benefit from these advantages of deeper and more diverse capital markets, we need to further develop capital markets, interconnect them across borders, and complete the Capital Markets Union.

To conclude, it is high time for all actors – EU Institutions, Member States, supervisory authorities and market operators across Europe – to step up their work to make the Banking Union and the Capital Markets Union a reality. And in my speech at the Eurofi 2018 Financial Forum in Vienna I will say more about the Commission's priorities for further progress this year. ●

Q&A

J. Christopher Giancarlo

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

An opportunity to work together to achieve growth and more resilient global financial markets

TEN YEARS AFTER IS THE START OF THE 2008 FINANCIAL CRISIS IS THE FINANCIAL SYSTEM SAFER? HAS SUFFICIENT PROGRESS BEEN MADE AT THE GLOBAL LEVEL IN THE MITIGATION OF RISKS POSED BY STANDARDISED AND NON-STANDARDISED OTC DERIVATIVES AND BY MARKET-BASED FINANCE ACTIVITIES?

The global financial system is safer than during the pre-crisis period. The key components of the G-20 reform efforts have been implemented across all major jurisdictions. The largest global financial institutions, those who make up the core of the financial system, are much better capitalized, especially compared to the pre-crisis period. The swaps markets have been fundamentally transformed. A large fraction of transactions and risk exposures are now being centrally cleared, CCPs are subject to more robust oversight, and uncleared swaps are generally subject to margin requirements. At the same time, the largest dealers are subject to internal and external business conduct rules, and regulatory reporting has started giving the official sector better visibility into swaps markets activity.

However, the work of regulators is not done. There remain some lingering concerns about the resilience of the markets – the process that facilitates risk transfer and price discovery – especially their ability to absorb shocks. Various authorities, both in the United States and through international bodies like the Financial Stability Board, are assessing changes to the bank capital rules, in particular, the Supplemental Leverage Ratio and its unintended adverse impact on the cleared derivatives markets. I remain concerned about the liquidity provisioning in the markets, especially the traditional role of the bank-dealers, who have historically been able to rely on their balance sheet capital to facilitate risk transfer, especially by large end-users.

While we now have lots of data, there also is more to be done to improve the quality and usability of the data. The swaps markets are complex, and notional values are not meaningful. As demonstrated

by the ENN (entity net notional) measure developed by CFTC economists, we need to get to relevant risk measures, either directly from the firms or using the regulatory data.

HOW TO ENHANCE THE CROSS-BORDER APPROACH IN FINANCIAL SERVICES AT THE INTERNATIONAL LEVEL? WHAT IMPROVEMENTS ARE NEEDED AS A PRIORITY AND WHAT ARE THE PROPOSALS OF THE CFTC IN THIS REGARD?

The CFTC has been a consistent leader among the world's authorities in enacting effective regulation and oversight, implementing most of the G20 mandated swaps reforms.

We now have more than four years of U.S. experience with the current CFTC regulatory framework, with its strengths and weaknesses. Four years provides a significant sample size to evaluate the effects of these reforms and their implementation. Based on a careful analysis of that data and experience, we are in position to recognize success, address flaws, recalibrate imprecision, and optimize measures in the CFTC's initial implementation of swaps market reform, including its cross-border approach.

One initial observation is that, as the CFTC's regulatory counterparts in other jurisdictions continue to implement swaps reforms in their markets, it is critical that the CFTC endeavor to ensure that its rules do not unnecessarily conflict with other jurisdictions' rules and fragment the global marketplace. For this reason, I believe it is imperative that the CFTC should operate on the basis of comity, not uniformity, with non-U.S. regulators. The alternative is a world in which every regulator asserts global jurisdiction, leading to an untenable state of overlapping and duplicative regulations. This is not the right approach to cross-border regulation.

To this end, I believe the CFTC and its non-U.S. counterparts must recommit themselves to work together to implement an equivalence and substituted compliance process based on common principles in order to increase regulatory harmonization and reduce market fragmentation. The best way forward is through deference. Regulatory and supervisory deference is a key principle to a cross-border approach that fosters economic growth and resilience without jeopardizing the bespoke laws or practices that underpin the domestic markets around the world. It gives us the best of both worlds – it builds harmonization between markets and also preserves the ability of primary regulators to act and regulate their markets as appropriate.

DO THE PROPOSALS MADE BY THE EU AUTHORITIES TO IMPROVE THE SUPERVISION OF THIRD-COUNTRY CCPs THAT MAY HAVE SYSTEMIC IMPLICATIONS FOR THE EU STILL RAISE CONCERNS FOR THE US? WHAT ADJUSTMENTS MIGHT BE NEEDED?

The amendments to the European Market Infrastructure Regulation (EMIR 2.2) proposal, including recent changes adopted by the European Parliament, continue to raise concerns for the United States because of its potential to increase regulatory and supervisory costs on American businesses, even those American businesses that do not operate in the European Union. The expansive extraterritorial reach of this proposal is a cause of deep concern.

Under the proposal, third country CCPs that are deemed systemically important to the EU would face increased regulatory and supervisory oversight by European authorities, including the European Securities Market Authority (ESMA) and European Central Bank. ESMA would have legal competence to require third country CCPs to comply with all provisions of EMIR. Without some legal measure to ensure otherwise, this likely will result in conflict with how the CFTC regulates and supervises these CCPs. This is due to the fact that the EMIR regulations apply to the clearing activity of the third-country CCP within the EU as well as the clearing activity of the third-country CCP outside the EU.

Both the EU and the United States have CCP regulatory regimes that are consistent with international standards; however, there are some differences between our laws that reflect the fact that our respective markets have different characteristics and customs. Under the current comparable compliance framework set forth in the EU proposal, it is far from certain whether European authorities will embrace deference and respect U.S. laws that have been customized to fit the needs of U.S. market participants.

If such an approach is not followed, U.S. markets, in particular U.S. futures markets, will face harm. Our futures markets are critical to the success of U.S. businesses that conduct billions of dollars' worth of transactions on these markets every year and critical to our food and energy supply chain. It should not be a surprise that the United States will not tolerate such disruption.

At a minimum, two adjustments should be made to EMIR 2.2: (i) adding an explicit commitment to preserving the recognition conditions that govern how U.S. CCPs are regulated and supervised today pursuant to the CFTC's 2016 agreement with the EU on CCP equivalence; and (ii) limiting the application of EMIR only to EU clearing activity or euro-denominated clearing. These adjustments would send a signal that the EU is committed to strengthening its cross-border relationships around the globe. ●

Q&A

Ryozo Himino

Vice Minister for International Affairs,
Financial Services Agency,
Japan (JFSA)

Remedies for conflicting regulatory demands

WHAT ARE THE MAIN ISSUES REGARDING THE CONSISTENCY OF THE IMPLEMENTATION OF GLOBAL BANKING AND FINANCIAL STANDARDS ACROSS THE DIFFERENT PARTS OF THE WORLD?

The global regulatory community has pursued two objectives: making the financial system more resilient and avoiding market fragmentation. Your question relates to the second objective. On this front, we have both good and bad news.

The good news is that, after ten years of intensive work and overcoming several critical impasses at Basel meetings, we now have a new set of globally agreed regulatory standards. It is also good news that, contrary to some earlier speculations, the US financial regulators have continued to emphasize the important roles that multilateral regulatory cooperation plays.

The bad news is that the trust between authorities has not been lifted to the level needed to smoothly implement cross-border resolution of systemically important financial institutions. It is not uncommon that an authority, which adopts a single-point-of-entry strategy when acting as a home authority, flexes its muscle for ring-fencing when acting as a host authority. In addition, Brexit may inadvertently lead to a regulatory framework less tolerant of the cross-border provision of financial services by third-country firms.

WHAT SHOULD BE THE PRIORITIES TO ADDRESS THIS SITUATION?

Internationally agreed standards are minimum standards and would not prevent national authorities from doing more. What one can do is, when assessing the equivalence of other authorities' national regulation with one's own, to benchmark with internationally agreed standards, not with one's own gold plating or unique approaches, and to focus on the outcome of the regulation, not on specific articles or languages.

In addition, I wonder if countries could install a process to address conflicting national regulations and supervisory actions. We cannot eliminate differences between national regulations. Neither can we eliminate the extraterritorial effects of national regulations. But we should at least try to address outright conflicts.

There are many cases of conflicting requirements. Authority A may request a bank never to tell anyone about the forthcoming sanctions, but Authority B might impose another sanction on the bank for not having reported to Authority B about Authority A's action in advance. A host authority's demand to establish a single local holding company for all operations may conflict with the home authority's demand to separate corporate chains for different activities. A home authority might demand that the global KYC control has to be audited by the headquarters, while a host authority might not allow personal data to leave its territory.

What if countries agree on a simple process to address conflicts between national regulations? First, a financial institution operating in two countries and facing conflicting requests from two regulators submits a letter describing the conflict to the two regulators. Second, the bank and the two regulators will have a two-hour conference call within three weeks of the submission of the letter. Third, within six weeks, each regulator will write a short response and publish an outcome document, which comprises the bank's initial letter and the two responses, on their websites. Each of the initial letter and the two responses shall be no longer than three pages.

IS THAT ALL? CAN THIS ELIMINATE CROSS-BORDER INCONSISTENCIES?

No, it cannot. But the proposed process will at least make policy makers aware of the pain they create. The process can be agreed bilaterally or can be incorporated in a multilateral memorandum of understanding. We can also choose to task, say, the secretariat of the Financial Stability Board to act as a repository of bilateral and multilateral MOUs and of outcome documents on individual cases. It might also be useful if one of the FSB's Standing Committees could review the outcome periodically. A stronger process involving arbitrators can also be designed, but my preference is avoiding a burdensome, legalistic or binding process. I hope to use the Vienna Eurofi to try out this idea with my European and other colleagues.

WHAT ARE THE KEY NEW AREAS WHERE GLOBAL COORDINATION IS NECESSARY (CYBER RISKS, DIGITALIZATION/FINTECH, SUSTAINABLE/ GREEN FINANCE, MACRO PRUDENTIAL FRAMEWORKS…)?

Many key new areas do not fit well with the structure of the existing fora for global coordination. Let's take the example of crypto assets. The financial stability aspects of crypto assets are addressed by the FSB, the customer protection and market integrity aspects by IOSCO, banks' exposure to crypto asset businesses by the BCBS, the use of crypto assets for payments by CPMI, and the money laundering and terrorist financing issues by FATF. A process to integrate the various pieces of this mosaic into a package of coherent policies is needed.

The regulatory authorities have only four options to deal with crypto-asset businesses: i) prohibit, as China and India do, ii) regulate, as Japan does, iii) monitor, as the FSB has started to do, or iv) ignore. In practice, the various aspects mentioned above cannot be considered in isolation when a regulatory authority chooses one among the four options. There is a mismatch between the structure of the existing fora and the cross-sectoral and cross-border nature of the issue.

More widely, in a slower moving world, a three step approach to design regulation has worked reasonably well: i) regulators talk with the industry to find the status quo ii) they design regulations, and iii) the industry starts to think about how to implement them. In a faster moving world, however, this approach may make regulators lag behind and allow the damage to grow. On the other hand, if regulators aim to prevent every possible future problem, they may unduly stifle innovation. A more synchronized process may be needed, where regulators and the industry identify emerging issues and solutions together. There is a mismatch between the existing regulator-industry relationship and the speed and potential of innovation.

WHAT DO YOU THINK CAN BE A REMEDY FOR SUCH MISMATCHES?

There may be several useful things we can do. Compiling a crypto-regulators' directory which describes, for each jurisdiction, which regulator (central bank, capital market regulator, banking regulator, AML/CFT authority…) do what (prohibit, explicitly regulate, interpret and apply existing general framework, monitor…) for which policy objectives (financial stability, customer protection, market integrity, AML/CFT…) may lay the groundwork for cross-border knowledge sharing and cooperation.

A roundtable of representatives from the financial and information technology industries, academia and regulators may also be useful in mitigating the two mismatches. The Japan FSA plans to host a crypto asset roundtable inviting regulators, innovators and academia in September and I hope it may work as a testing of a prototype.

A more ambitious endeavor could be to come up with a to-do list a common list of issues to be addressed and key considerations and trade-offs in designing solutions. If regulators can produce a common set of principles for addressing crypto-asset businesses, such would also be valuable.

10 YEARS AFTER THE 2008 FINANCIAL CRISIS, THE LEVERAGE OF THE ECONOMIES HAS CONSIDERABLY INCREASED: WHAT ARE THE CONSEQUENCES AND THREATS FOR THE FINANCIAL SYSTEMS? TAKING INTO ACCOUNT THE G20 REGULATORY REFORMS, IS THE FINANCIAL SYSTEM UP TO THE VULNERABILITIES CREATED BY SUCH A LEVEL OF PUBLIC AND PRIVATE LEVERAGE?

This question is about the first of the two objectives I mentioned at the beginning; making the financial system more resilient. Banks now have much stronger capital and liquidity buffers. The derivatives markets are reformed and are now less likely to be a major channel of contagion. We have come a long way indeed, but, if we are to attain lasting financial stability, we should aim to build an economy which can attain full employment and avoid deflation without relying on the continuous build-up of leverage. Banking regulators alone cannot achieve this, but they may be able to make their own contributions.

After the banking crisis in the late 1990s and early 2000s, Japan attained financial stability but until recently the economy continued to stagnate. Learning from this experience, the JFSA has been trying to design a supervisory approach which rigorously pursues financial stability but at the same time is least constraining to growth and innovation. Our current thinking is summarized in JFSA's supervisory approaches – Replacing checklists with engagement, published in June. It is not easy, but we will keep trying. ●

Q&A

Claudio Borio

Head of the Monetary and Economic Department, Bank for International Settlements (BIS)

Global financial vulnerabilities: get ready for a bumpy ride

Ten years on after the Great Financial Crisis (GFC), and with a recovery that is quite mature, it is worth asking: what are the main global financial vulnerabilities that could risk derailing the expansion or amplifying any slowdown? The question is far from an idle one because the policy response to the GFC has been unbalanced, overburdening central banks – they have been "the only game in town" for far too long. Their unprecedented actions no doubt avoided a repeat of the Great Depression and helped lay the basis for the recovery. But the extraordinarily and persistently low interest rates, combined with bulging balance sheets, have also contributed to the financial vulnerabilities that we now see.

THE NEAR-TERM OUTLOOK LOOKS FAVOURABLE...

The near-term outlook – say, over the next 12 months or so – looks favourable. This is the message of the forecasts of the main international organisations and of the economists' consensus. The year 2017 was a truly vintage one: growth was back in line with long-term pre-crisis averages, unemployment at multi-year lows in many economies, including the largest, and inflation generally subdued. After a soft patch in the first quarter of 2018, notably in the euro area, global growth is projected to edge up this year, staying above potential, and to fall back slightly towards potential in 2019. Inflation is not seen as a threat.

....BUT NOT ALL IS WELL ON THE REAL SIDE....

At the same time, this picture is quite unusual. Strong, above-potential growth so late in the expansion is quite rare, especially with economies close to, if not beyond, full employment estimates. To be sure, standard practice is to increase measures of potential if inflation fails to rise. But this can be misleading. It clearly proved to be so pre-crisis. In fact, inflation has been a rather unreliable measure of sustainable output. And we know that, for purely technical reasons, should a recession occur at some point, all the current measures of economic slack ("output gaps") will be revised upwards, because of the way trends are calculated.

Indeed, as we document in the latest BIS Annual Economic Report, the behaviour of inflation has become an increasingly unreliable leading indicator of output turning points since the early 1980s. A typical postwar pattern until then was that recessions followed a rise in inflation and consequent monetary policy tightening, with credit showing no particular acceleration. Since then, inflation has done little around turning points, so that monetary policy has not had to tighten significantly, but recessions have been preceded by strong and protracted credit growth. Hence the greater relevance of financial vulnerabilities.

...AND FINANCIAL VULNERABILITIES HAVE BEEN BUILDING UP

And financial vulnerabilities have been building up, in their usual, gradual and cumulative way.

First observation. There are signs that financial markets are overstretched. Despite the equity market wobble in February and the recent tightening in emerging market economies (EMEs), financial conditions remain quite easy from a long-term perspective. G3 term premia are very compressed, equity markets elevated (except in relation to the unusually low bond yields themselves), volatilities rather low and, above all, credit spreads are hovering around pre-crisis levels.

Importantly, and rather puzzlingly, at least until recently, US financial conditions, and on balance global ones, actually eased during the Fed's tightening. This was so despite bond yields edging

up. EMEs were the main beneficiaries during this phase, as the US dollar depreciated. Given their large stock of US dollar debt, a dollar depreciation tends to strengthen borrowers' balance sheets there. That is why the more recent appreciation has coincided with wobbles and tensions, greatly exacerbated by idiosyncratic vulnerabilities in some countries, most notably Argentina and Turkey.

Such very easy financial conditions are one reason for being cautious about the optimistic outlook beyond the near term. Research at the IMF, consistent with our own analysis at the BIS, finds that easy financial conditions boost economic activity in the short run but increase downside risks further down the road.

Second observation. Leading indicators of banking distress are flashing amber or red in several countries less affected by the GFC. These are countries that have seen a further build-up of financial imbalances – essentially, prolonged strong private sector credit expansion and strong property price increases. This has been the case in advanced economies, such as Australia, Canada, some Nordic countries and Switzerland, but also in several EMEs, not least China, some others in Asia and also in Latin America. Moreover, a number of EMEs have seen rapid foreign currency credit growth post-crisis. The aggregate stock of such credit to non-bank EME borrowers has actually doubled since the turmoil. In contrast to pre-crisis, the funding has come mainly from capital markets.

There is some good news in all this. The list of countries does not include any of the large economies hit hard by the GFC. The post-crisis financial reforms have greatly strengthened the financial system's resilience. And EMEs have built up their defences since the serious strains in the mid-1990s – better macroeconomic policy frameworks, greater exchange rate flexibility and larger foreign currency reserve buffers. Thus, one should read the indicators not so much as pointing to banking distress ahead, but to the risk of strong financial headwinds at some point. Signs that financial cycles have actually turned in a number of countries underline this possibility.

ON TINDER, SPARKS AND FIRE

All of this suggests that there is plenty of tinder to fuel a fire. And, above all, the limited room for policy manoeuvre on the monetary and fiscal sides should give us cause for reflection. Post-crisis, not only have interest rates declined substantially to new depths and central bank balance sheets ballooned to unprecedented sizes, but public sector debt has reached peacetime highs.

There is no dearth of candidates to spark the fire.

One possibility could be inflation rising unexpectedly and financial markets perceiving that central banks are behind the curve. This would be the worst scenario. It would trigger the sharpest snapback in the yield curve, with greater global implications, not least for EMEs. Personally, I don't think this is very likely. As Japan highlights most clearly, there are still significant disinflationary tailwinds in the global economy, probably linked to globalisation and technological advances. Still, such a scenario cannot be ruled out. Moreover, given the way markets are positioned, it would not take much for them to overreact. We saw this, briefly, in February, when a slight upward surprise in US wage growth appeared to trigger a rise in yields and drop in the equity market.

A second possibility could be a general reversal in financial markets' risk appetite in response to self-reinforcing cyclical developments. Regardless of inflation, growth could disappoint as the mature expansion flags or financial cycles turn. This may well be what we started to see in EMEs as the US dollar appreciated and external conditions tightened. It might also occur as the Chinese authorities struggle to maintain growth while inducing the necessary deleveraging.

A third possibility could be a more exogenous trigger reflecting political developments. An escalation of protectionist pressures is especially worrisome: its global impact would be very significant. But the trigger could also be more country-specific: what we saw in Italy earlier in the year is an ominous sign.

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

WHAT END GAME?

And guess what: there is an elephant in the room. Debt (private plus public) has continued to rise globally in relation to GDP as interest rates have declined and remained unusually low, in both nominal and real (inflation-adjusted) terms. Indeed, real rates are negative even as countries look like they are approaching, or even exceeding, estimates of potential. Moreover, rates are expected to remain low for quite some time, which could encourage a further debt build-up.

If this continued, how far would central banks manage to raise rates without triggering the very problems they are trying to avoid? Empirical evidence that debt service burdens matter greatly for expenditures is clearly relevant here. The possibility of such a "debt trap" should not be dismissed out of hand.

WHAT POLICIES?

To conclude. The near-term prospects are good, but the risks ahead should not be underestimated. The path is narrow. Policymakers and market participants should brace themselves for a bumpy ride.

The main policy implication is the need to seize the moment to rebalance the policy mix and regain room for manoeuvre. This means reinvigorating the flagging structural policies, finalising the implementation of the financial reforms, activating macroprudential tools where vulnerabilities are building up, consolidating fiscal positions, and normalising monetary policy with a steady hand. All this should be seen as part of the establishment of more holistic macro-financial stability frameworks designed to ensure lasting macroeconomic and financial stability.

Such frameworks would be firmly anchored to a long-term focus. Financial vulnerabilities build up slowly. And the costs of high debt may emerge only after a long time. The incentive to kick the can down the road can prove irresistible. But, however distant it may appear, the future will eventually become today. At which point, it is too late. ●

I. EUROZONE AND EU INTEGRATION CHALLENGES

Issues at stake

The euro area economic expansion continues to be strong and broad-based across countries and sectors. With this economic recovery underway, now is a favourable time to deepen the Economic and Monetary Union, building on the proposals made by the Commission and certain Member States.

Several macro-economic challenges however need to be considered. A first issue is the necessary normalisation of monetary conditions. Public debt in Europe also remains high and rising interest rates may reignite government debt sustainability concerns in the absence of further structural reforms. Developing private risk-sharing remains challenging with the persistence of fragmented regulations in most financial sectors. Finally, an appropriate balance needs to be found between the pan-European and the local dimensions of the development of financial markets notably regarding the CESEE region.

Content

Deepening the EMU

Nadia Calviño

Minister of Economy and Business, Spain

We need to accelerate our efforts to create a fiscal capacity

Since the European leaders started dreaming of the project of a Monetary Union, back in the 20th century, much has been achieved in the EU: not only have we created the common currency, but we have also leaped forward in deepening our monetary, financial and economic system, improving its instruments and architecture, notably with the establishment of a Banking Union, as one of the elements of response to the harshest economic and financial crisis in the last 60 years.

Much has been achieved, but we must advance further. Europe is still facing major challenges and we must make sure that the euro area is well prepared for downturns. This compels us to further strengthen our common structures and to make them more efficient, more resilient and more beneficial to our citizens. For the project to work, there is a need to complete financial integration and to create a common fiscal capacity as an instrument for stabilization.

To achieve financial integration, it is fundamental to conclude the Banking Union and to boost the Capitals Market Union. The Banking Union is already well underway, with banking supervision and resolution carried out at the European level, but it will not be completed if deposit protection remains purely national. The Common Deposit Insurance Scheme is indispensable to break effectively the links between bank failures and sovereigns. To foster the Capital Markets Union, it is of the utmost importance to remove investment barriers along national borders. Creating a large and liquid capital market in Europe will contribute to achieving a more diversified and resilient financial system and reinforce financial stability. It will channel high levels of savings and resources towards productive uses in the economy, notably towards SMEs, to create wealth and employment for our citizens. This project is ever more compelling now that Brexit is around the corner.

On the top of this progress, we must not lose sight of the final objective of completing the Economic and Monetary Union: shared prosperity and economic and social convergence. For this purpose, we need a common fiscal capacity. We all agree that national fiscal stabilizers are the first line of defense in case of normal economic fluctuations. But as we have seen during the crisis, in case of a significant shock, national stabilizers need to be complemented by a stabilization function for the euro area as a whole. The common fiscal capacity can take many forms, such as, a euro area budget to support investment downturns or an Unemployment European Fund.

One of the worst legacies of the crisis is the increased inequality and poverty that has hit many Europeans, especially the young. Unemployment, but also poor salaries and unfair labour conditions, remain an issue that we must tackle before they become structural to our system. It is important not only for social reasons but also to ensure long term sustainability. These problems affect the Union as a whole and must, therefore, be faced together by all of us.

Protection against permanent fiscal transfers is of course very important. But it should not be used as an excuse to postpone the creation of the fiscal capacity forever. The restoration of national fiscal buffers and the creation of the central fiscal stabilization could advance in parallel. The move towards a common fiscal stabilization function could be subject to conditional criteria.

Let me conclude by underlining that the trend of divergence of the European economies during the crisis is now being reversed as a result of the determined response to strengthen the functioning of the euro. Once again, further integration has been the answer to our most recent problems, as when the founding members of the European Union decided to overcome our differences by creating a shared space of economic and social cooperation in Europe. There is an urgent need to accelerate the completion of financial integration and the creation of the common fiscal capacity. By December, Leaders should be presented with a comprehensive package for a financially stable and resilient Economic and Monetary Union. We need to ensure that when the next shock strikes, the Monetary Union will have sufficient mechanisms to counter it and that the European Union progresses towards economic and social long term sustainability. ●

Bruno Le Maire

Minister of Economy and Finance, France

Post Meseberg – next steps towards completing the EMU

The EMU's architecture was significantly reinforced as a response to the last economic and financial crisis. Those deep reforms were essential and ensured the crisis was overcome. But the lack of foresight in the pre-crisis period came at an important cost. The euro area is still suffering from the economic and social costs of the crisis, in particular levels of unemployment which remain far too high in many countries. And the EMU itself remains incomplete. Further important reforms are needed to ensure the EMU is strong enough to resist all future shocks and to be the right basis for sustainable growth and jobs in the euro area and EU as a whole. Completing the Eurozone – by finally transforming it into a genuine economic union - is essential for long term stability and prosperity.

We must not repeat past mistakes by waiting for the next crisis to take action. We should act now to complete the EMU: "the time to repair the roof is when the sun is shining" Christine Lagarde judiciously said last year, using JFK's words. We need to seize the current historic window of opportunity to move forward.

The Declaration by Emmanuel Macron and Angela Merkel in Meseberg on 19 June 2018, together with the more detailed French-German roadmap for strengthening the Euro Area, are our common contribution to strengthening the euro area and attempting to put forward a balanced approach on all the issues that are most important to ensure a well-functioning monetary union. The roadmap sets out the main steps needed to finalise the EMU: completing the Banking Union – notably by setting up a backstop to the Single Resolution Fund within the European Stability Mechanism (ESM) while further strengthening the banking sector –, further developing the Capital Markets Union, reforming the ESM by improving its instruments, and creating a genuine Eurozone budget.

It is the first time France and Germany have agreed on the concept of a Eurozone budget. The main objectives of the Eurozone budget are twofold: first, stimulating convergence in the Euro Area through the continued funding of productivity-enhancing public policies, even during times of recession, while also encouraging structural reforms which will improve competitiveness. Second, providing a macroeconomic stabilization function. These objectives address the clear weaknesses that have been identified in the euro area in recent years and are in line with agreed principles for an optimal monetary union.

Since the crisis, there has been growing economic divergence between Euro Area Member States. If this dynamic were to persist, the stability of the Euro Area could be severely threatened. In particular, citizens in some countries will feel left behind. They will feel that the benefits of the currency union are not being appropriately shared between Member States. This could lead to a lack of trust and acceptance of the currency union. It is therefore vital to once again ensure that Member States' economies are put back on a convergence path.

Moreover, in a currency union, countries give up their ability to adjust their national monetary policy. Market pressures can also deprive even fiscally disciplined countries of their national fiscal stabilizers in times of crisis. The ECB cannot be the sole responsible actor of macroeconomic stabilization within the euro zone. The policy mix during downturns should be better balanced between monetary and fiscal policy instruments. A Eurozone budget could provide a temporary relief in times of crisis, without permanent transfers.

The June Euro summit has given the Eurogroup a clear mandate to work further towards the completion of the EMU. Our ideas – which need further refining - are a contribution to that work. We will now discuss these issues with all euro area members and collectively report back in time for the December euro area summit. We will focus on the three work strands mentioned above: completing the Banking Union, reforming the ESM and creating a Eurozone budget. I hope the spirit of compromise shown in Meseberg will be a positive source of inspiration for all. We should seize the political momentum and make important steps towards the completion of the EMU, ahead of the next European elections. We cannot afford to fail. ●

Peter Kažimír

Deputy Prime Minister and Minister of Finance, Slovak Republic

Reality check: times are a-changin'

It has been more than a year since our discussions about deepening of the EMU finally intensified, driven by key election results across Europe. “Window of opportunity” has become the buzzword, which I myself am guilty of using repeatedly, to say the least. Today, three Euro Summits later, with that “window” about to close, it is time for a reality check - a sober look at where we are, what we have (and have not) achieved and, most importantly, how we move forward.

For a euro-enthusiast, like myself, the progress could be more substantial. Delivery requires a joint and coordinated effort of the entire European family. In the end, the chain is only as strong as its weakest link. Too often we were held back by domestic politics or other issues at the European and international level. Good economic times coupled with the ultra-loose policy of the European Central Bank allowed us to grow complacent when it comes to completion of the EMU architecture. We need to acknowledge, however, that the times are a-changin'. And, stealing from Bob Dylan: “We better start swimming or we'll sink like a stone”.

Sure, we have made a couple of strokes in recent months. We have advanced in our work on reducing risks in the banking sector, made some progress towards strengthening the role and functionality of the ESM and reached an important agreement on the common backstop to the SRF.

What is of the utmost importance now is for the public eye to spot improvements and the fruit of the work done. In the end, how can people even remotely appreciate an agreement scribbled in language barely understandable beyond Brussels' negotiating rooms? The urgency to deliver reforms Europeans can actually see and touch is further intensified by the rise of political populism on the continent. Europe needs to see that we care to address challenges ahead of us, no matter the political family.

One of the key messages of the June Euro Summit, although hidden in the fine print, is the Eurogroup's mandate to work on a stabilisation function for the euro area. Who would have thought it two years ago, when we, to irritation of many, decided to pursue the issue of fiscal capacity during the Slovak Presidency of the Council of the EU. Still, the task ahead is far from straight-forward, as some continue to question the economic rationale of a central stabilisation function. Yet, their arguments are mostly political – fear of moral hazard or creation of a transfer union. I agree, these fears must be mitigated by the function's design. Nevertheless, the economic case for a macroeconomic stabiliser in a monetary union holds firm. What's more, it offers a prime opportunity to deliver something that may directly impact people's lives. Something even your grandma will understand.

Thankfully, we are not starting our discussions from scratch. On the table already, we have the European Commission's proposal for a stabilisation function focused on investment as well as the more ambitious Franco-German proposition for a Eurozone budget. We must explore all of the options in order to find common ground and deliver. I am convinced that a credible stabilisation function, particularly in the form of unemployment (re)insurance, would not only make the EMU more resilient, but also finally provide a tangible result for the people.

All this will keep us afloat, both politically and economically, but we need to do more in order to swim smoothly. In the vein of concurrent risk reduction and risk sharing, our effort to establish a shared stabilisation mechanism should be complemented by reform of the fiscal rules. We need to fix existing flaws. Both the design and enforcement of the rules must be revamped and strengthened. We cannot afford to put this off for any longer. To use the words of the Nobel Laureate one last time: he that gets hurt will be he who has stalled.

We have all that is necessary to succeed, in Brussels, in Frankfurt, in all European capitals. I want to believe we will not need another crisis to show where our strengths lie.

The Eurofi Financial Forum 2018

Vienna | 5, 6 & 7 September

Enhancing cross-border risk sharing

Peter Praet

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

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

In recent years, the European Union has achieved major progress towards financial integration. We now have a single supervisor and a single resolution authority, and banks are subject to the same European rulebook. The Banking Union contributes to providing effective mechanisms for cross-border risk-sharing and broadening the sources of funding within a country, thereby promoting macroeconomic stability and growth. However, we still observe a number of obstacles that hinder the fungibility of capital and liquidity of banking groups. Very often, these obstacles relate to regulatory fragmentation and ring-fencing of national markets. Further harmonisation would help to address many of the issues, while appropriate prudential safeguards can be put in place to address possible financial stability concerns by national authorities.

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

Second, the proposal to have cross-border capital waivers within the EU was not taken forward in the on-going review of the CRR, which is a missed opportunity. Such waivers would be consistent with the establishment of the SSM and the Banking Union and help to support the free flow of capital across the Union. On the one hand, it is understandable that some national authorities are concerned about the possible financial stability implications of the proposal. On the other hand, such concerns could be addressed by making the waivers subject to additional prudential safeguards, and by putting in place appropriate transition arrangements that account for the planned further progress on the Banking Union.

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

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

Jean Lemierre

Chairman, BNP Paribas

Absence of cross-border consolidation is only one of the symptoms of the growing fragmentation of the Euro area financial system

In the midst of a sovereign debt crisis, Europe has embarked in an ambitious journey to create the much needed Banking Union. The set-up of the Single supervisory mechanism is a major achievement with a transfer of sovereignty and the aim of achieving convergence in supervisory practices. The Single resolution board has started to handle some distressed situations. The Single resolution fund is financed with hundreds of millions which are contributed every year by large banks, and will soon benefit from a backstop provided by the ESM, ultimately also relying on the banking sector.

As we are approaching the term of the European Commission and Parliament, it is time to take stock of those achievements, and to think about what should be the roadmap for the next five years. The key question is : what type of financial system do we want in Europe, and how to achieve it?

A large and diversified economy such as the Euro area needs a strong financial sector to support growth and job creation across the monetary union. This financial sector should be:

- Diversified, to provide the full range of financial services to a wide range of retail and corporate and institutional clients, supporting their domestic needs and able to accompany them in their international development.
- Safe, which requires high and harmonized regulatory and supervisory standards, as well as a better balance between bank and capital markets funding.
- Efficient, which implies a capacity to fund growth without piling on balance sheets risks, as well as allocation of savings to investments across the monetary union to adjust financial conditions.

Where do we stand on those dimensions? The European banking sector certainly enjoys diversity which should be preserved by a full range of business models. The European financial sector has become much safer, and this safety must be preserved by avoiding to relax regulatory and supervisory frameworks, continuing to harmonize practices toward the highest standards of risk management, consumer protection, and social expectations such as sustainability or data protection. >>>

>>> Going forward, two points should be the focus to strengthen the European banking sector.

First, in order to fund the economy without growing bank balance sheets, Europe needs a powerful securitization market, which would also foster private risk sharing across the Euro area and beyond. Not only securitization has not taken off in Europe since the financial crisis, but issuance has continued to drop. Accelerating the implementation of STS securitization needs ensuring the removal of regulatory obstacles for issuers and investors. This is a priority as no significant restructuring of the European financial sector will occur without such capacity to sell bank assets to investors in a smooth way. The development of capital markets is also essential to finance long-term assets such as infrastructure projects and energy transition.

Second, in order to efficiently allocate savings to investments across the Euro area, fighting against fragmentation is essential. Fragmentation reduces the efficiency of ECB's monetary policy transmission, and leads to a need for lower rates and higher liquidity provision for longer. Relocalization of liquidity pools generates divergences in the cost of money despite the unicity of monetary policy. Funding cost differences between corporates in different countries, irrespective of their intrinsic competitiveness, lead to uneven playing field and fuel inequalities. To soften the impact of such imbalances, the ECB can only maintain rates at a lower level for longer. This in turn hits bank profitability, and return for savers in cash-rich countries, in a lose-lose game with social and political consequences.

We continue to see ring-fencing within the Euro area, probably due to a lack of trust between the "home country" and the "host country". At the end, the whole Euro area is penalized. Rather than using a substitute such as transforming banks' subsidiaries into branches, it would be wiser to truly implement the project of the Governments, ie to create a real Banking Union, under the responsibilities of the SSM and the SRB. Retrenchment within national borders is not the solution, as home bias tends to make banks and market participants more vulnerable to domestic economic or fiscal shocks.

Removing these two obstacles is urgent to allow the ECB to regain dry powder sooner than later, and the Euro area banking system to be more resilient in the next crisis. ●

Ashok Bhatia

Deputy Division Chief, European Department, International Monetary Fund (IMF)

Mahmood Pradhan

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

Time to tackle the tough challenges

Euro area growth appears to be leveling off from the very high levels of last year, but is projected to remain broad-based and solid. Risks, however, are particularly serious at this juncture. Abroad, trade tensions have risen with the recent U.S. imposition of tariffs on steel and aluminum imports. At home, policy inaction >>>

>>> and political shocks are key risks, especially with limited fiscal buffers and waning appetite for structural reforms in many countries. And time is running out on the Brexit negotiations, with the lack of progress raising the risk of a disruptive exit. Against this backdrop, strong policies are needed to buttress the euro area's resilience.

Monetary policy needs to remain accommodative until there is convincing evidence that inflation is converging to target. Underlying inflation remains low, and is expected to climb only gradually. The commitment to keep policy rates at their current low levels at least through next summer is therefore vital. As quantitative easing ends, the importance of forward guidance on interest rates will grow even stronger.

Much of the policy heavy-lifting, however, will need to happen at the national level. Despite firm growth, public debt loads have barely fallen in the high-debt countries, leaving little space to respond to the next shock. High-debt countries should be reigning in deficits and reducing debt while conditions remain supportive, and should step up structural reforms to lift productivity and create job opportunities. Large net external creditor countries with persistently excessive current account surpluses and ample fiscal space need to increase public investment in well-targeted ways, encourage faster wage growth, and incentivize private investment. This will lift potential growth and contribute to a necessary external rebalancing. Reforms to the architecture of the currency union also need a new burst of energy. The three priorities are well known.

First, on the banking union front, the IMF's recently completed Financial Sector Assessment Program for the euro area notes important progress, yet reminds that more needs to be done. Too many rules remain fragmented along national lines, and the lack of a common deposit insurance scheme and a shared backstop for the Single Resolution Fund could put past achievements in jeopardy. While substantial risk reduction has been achieved, banks should complete their legacy asset clean-up. Banks can also use the current upswing to continue building capital and other loss absorbing liabilities. Completing the banking union will help encourage private cross border risk sharing, supporting growth and resilience.

Second, progress on the capital markets union has likewise been encouraging, but here too the agenda ahead remains substantial. Further reforms are needed to deliver a genuinely single and integrated capital market. In the near term, it is critical to ensure that regulatory and supervisory capacities are prepared for the likely influx of financial business to continental Europe in the shadow of Brexit. Over the medium term, there will need to be greater harmonization of national insolvency regimes, securities regulations, and more. Implementing all or even some of these proposals would help promote a better allocation of private capital across the region.

Finally, better public risk sharing is needed. The euro area relies too much on monetary policy for stabilization. A recent IMF Staff Discussion Note proposes a central fiscal capacity for macroeconomic stabilization. The mechanism would require countries to save in good times, by paying into a common fund, and allow them to receive transfers from the fund in a downturn to help offset budget shortfalls. The whole point of the IMF's central fiscal capacity proposal is to show that public risk sharing and public risk reduction are both necessary for a resilient currency union, with strong safeguards to ensure that countries maintain prudent fiscal policies and that there are no permanent transfers. It will take time to build political consensus in this area, but it is a goal well worth pursuing. ●

Vitas Vasiliauskas

Chairman of the Board, Bank of Lithuania

A fully fledged and EU-wide banking union is essential in overcoming national confines

National authorities "ring-fencing" cross-border banks in terms of capital and liquidity can indeed constitute an obstacle in developing a truly pan-European banking system. In my view, a complete and expanded EU-wide banking union would enable us to eventually relinquish such regulatory practices.

A complete banking union implies having its third pillar – the European Deposit Insurance Scheme (EDIS) – established and fully operational. Breaking the impasse on EDIS would be especially relevant should we expedite the process through which foreign subsidiaries are allowed to become branches. As long as the third pillar is missing, a home country in which the transnational bank is headquartered can be exposed to substantial losses, especially in the event of a symmetric, euro area-wide shock. In an extreme scenario, it might find itself unable to cover cross-border depositor claims, with negative spill-overs across the EU. A well-integrated EDIS scheme, however, could deepen the EU's single-banking market and improve its resilience.

Taking the issue a step further, an EU-wide banking union would allow for a centralised supervisory approach for all of the EU's largest systemically important banks, regardless of host-country membership in the monetary union. Currently, the SSM only operates in the euro area; other EU member states are yet to enter into "close cooperation" with the ECB.

Without such a unified banking supervision framework across the entire EU, we cannot ignore the realities in countries where the parent companies of the largest banks reside outside the euro area. Let us assume, for instance, that in one of the Baltic States a capital or liquidity waiver is applied to a subsidiary of a bank established in a non-SSM jurisdiction. In such a case, the host-country regulator simply has no means to ensure that the parent undertaking will allocate enough funds to its cross-border subsidiary in times of market distress, as it is unable to take part in overseeing such transfers. At the moment, there are no sufficiently reliable legal instruments that would guarantee unconditional intra-group transferability of own funds outside the context of the banking union.

In the presence of uncertainties regarding capital or liquidity repatriation, euro area-host jurisdictions would lose a great deal of control with the application >>>

>>> of a waiver while remaining exposed to the downside risk of bearing the financial burden. This is why I endorse the idea that our aim should be a complete and, ultimately, EU-wide banking union, thus removing from the equation concerns of "giving up control". We need to do a better job at convincing decision-makers in non-euro area countries to enter into the "close cooperation" regime. This would enable all EU member states to effectively become part of the banking union and, hence, to enjoy the widely recognized benefits of this membership.

If we are to observe only limited progress in strengthening the banking union, the suspension of ring-fencing practices may also negatively affect our ability to address the build-up of systemic risk. Turning subsidiaries into branches and exercising capital waivers may hamper the use of capital-based macroprudential instruments, subject to national discretion and applied on an institution-by-institution basis (e.g. the O-SII capital buffer).

Despite these concerns, I believe that it is less than optimal to confine the EU-banking markets to national boundaries. Creating more transnational banks could help overcome the dreadful "doom loops" by virtue of risk diversification. Cross-border banking would also bring scale, whereby fixed costs ratios are reduced and technological innovation can be diffused more easily. This, in turn, has the potential to deliver cheaper funding for EU citizens and companies.

Fostering cross-border banking is part of deepening the EU's single market, which in itself is part of an even larger end-goal, namely, economic convergence. Reduced transaction and compliance costs as well as increased capital mobility could have tangible effects on welfare across the less-affluent regions of the EU. Such convergence is also critical for the smooth functioning of our monetary union. ●

Casper von Koskull

President and Group Chief Executive Officer, Nordea Bank

The paradox of cross-border banking in the European Single Market

Nordea is the leading bank in the 10th largest economy in the World, the Nordics. We are active on four small, liberal market economies, each with its different characteristics. Finland is in the Banking Union, Denmark and Sweden are in the EU but outside of the Banking Union, and Norway is outside of the EU but a part of the EU Single Market.

From the beginning of the creation of Nordea almost twenty years ago, the vision is to create one Nordic bank, One Nordea. Despite the efforts to create a truly single market in Europe, operating as a cross border bank was difficult with the combination of an integrated cross-border operating model and national legal entities. Nordea therefore saw it necessary to simplify its legal structure by merging the main banking subsidiaries into one and this structural change was completed 1 January 2017, creating significant branches in other Nordic countries.

As mentioned, the goal was to enable a "One Bank" operating model and to reflect that in the bank's legal structure. The branch structure also helps Nordea strengthen corporate governance, reduce operational risks and simplify administration. Finally, a key driver behind the branchification was to simplify implementation of regulatory requirements to avoid negative consequences of future regulation.

Nordea is a systemically important bank on all four markets and the five supervisors – national supervisors and the SSM - in the Nordics are cooperating in a supervisory college for Nordea. At the point of branchification, a memorandum of understanding was put in place between the supervisors, elaborating on issues such as information sharing. It is indeed important to ensure that home and host supervisors are comfortable with the setup with regards to securing financial stability and proper risk mitigation. Nordea has also been keen to ensure that host supervisors receive the information they need to fulfil their supervisory tasks.

In a branch-setup, the distinction between prudential and conduct related regulations and supervision is highlighted, as banks will principally need to follow the prudential rules of the home member state and the conduct rules of the host member state.

However, the branch set-up is not without complexity either. Especially in local supervisory guidance this distinction is often not made very clear, with one FSA regulation sometimes including elements of both prudential and conduct regulation. This causes challenges for interpreting what is the applicable law and may cause overlapping of similar requirements at group and local level, increasing the regulatory burden.

"The goal was to enable a "One Bank" operating model and to reflect that in the bank's legal structure."

- CASPER VON KOSKULL

Similarly, the line between supervision, and reporting, for microprudential and financial stability purposes could be clarified, ensuring that the macroprudential information needs of the host supervisors are fulfilled in a uniform manner across the EU. The supervisor's need to ensure financial stability in their jurisdiction while being "deprived" of some of the tools of prudential regulation may result in the host supervisors inventing new – specific and/or duplicate - ways, which is suboptimal both for banks and supervisors.

Supervisory evolution continues, as well as the development of bank structures. Nordea has decided to move its headquarters to into the Banking Union, a move that is planned to be completed by 1 October 2018. Nordea's business presence stays unchanged in the four Nordic markets, but the legal domicile will be Finland. This is a further step in our efforts to achieve a stable, predictable environment for the bank and to ensure level playing field with our European peers. ●

Luděk Niedermayer

MEP, Committee on Economic and Monetary Affairs, European Parliament

Restoring capital mobility between the Eurozone countries

There are three essential conditions that lead to restoration of capital flows, if met all at once.

High and smooth capital flows within the monetary union are under normal circumstances a proof of its functionality and a sign of confidence. While there has been substantial progress since the economic crisis, it is hard to estimate to what extent the post-crisis mission is completed.

There are three essential conditions that lead to restoration of capital flows. They are inter-linked and need to be met together for the capital flows to be restored.

1. Sound and stable banking system

The EU has made great progress in reinstating soundness and stability of the banking system – an essential condition for the EU economy, where banks are the main facilitator of capital flows.

New regulation closing loopholes uncovered by the crisis has been introduced, oftentimes with security margin as well as the project of the Banking Union - reducing if not eliminating risk of failure of national supervision and enforcement. The ECB used available tools to avoid liquidity collapse of the financial sector when trust between banks disappeared.

As a result, banks are financially stronger, regulation is more robust and enforcement more efficient. It is therefore surprising that the current debate on further risk reduction postponed the completion of the Banking Union and reintroduced mistrust.

2. Sound economic policy in Member States

We have witnessed clear improvement across the EU supported by key economic data, positive signs have been coming from labour markets with their all-time high employment that will be or already is followed by wage growth with direct implication on domestic demand and living standard.

External conditions including robust growth in the USA and stable situation in other key markets are supportive for the EU economies and make space for both further growth and necessary structural reforms.

The situation is not equal across the Eurozone and the EU.

Different Member States are in different parts of the cycle, and although not all of them are progressing with their "homework", we have not seen such a balance in economic performance and absence of substantial risks for a long time.

But sound and stable financial sector, particularly banks, and macroeconomic stability together with good policy making are necessary but not sufficient conditions for restoration of capital flows.

"There are three essential conditions that lead to restoration of capital flows, if met all at once."

- LUDĚK NIEDERMAYER

3. Demand for investment, demand for capital

Capital will only flow when there is investment demand. Overall economic demand and confidence in future are key. Today, international developments, particularly disturbance in international trade, can be the main obstacle. While the EU takes part in the effort to reduce such risks, it is not fully in our hands.

The overall conditions for restoration of capital flows across the EU may look optimistic. It is now up to local and regional governments to compete for investors allocating their capital. It is not the task for macro-economic policy-making.

Improved capital accounts reduce the need for external funding in form of capital flows. While disturbances in flows are always bad, massive capital flows are not automatically good. If the three above conditions are met, it is more likely, that the financial sector will step in and facilitate necessary funding leading to more equally spread growth and prosperity across the EU. ●

Sylvie Goulard

Second Deputy Governor, Banque de France

Exploiting the full potential of the Banking Union through effective private risk sharing

The Banking union was a major step toward the enhancement of the framework for the supervision and the resolution of credit institutions in the euro area. Both the SSM and the SRM are fully operational and a number of successes have already been achieved. The euro area banking sector is obviously safer than before, even though more needs to be done to complete the Banking union, in particular the setting up of a robust backstop for resolution. However, the full success of the Banking union is not just a question of institutional settings and public intervention. Private risk sharing, in particular in the cross-border context, is also paramount. But in this area, further steps are needed. >>>

>>> **Why?**

If the persistent degree of fragmentation of the European banking sector has several explanatory factors, the uncertainty surrounding the capacity of local entities of cross-border groups to withstand shocks plays a prominent role. This uncertainty leads host supervisory authorities to take "ring fencing" measures, which can have various features (based either on pillar 1 or pillar 2 or even on macro-prudential instruments) and eventually act as traps for capital and liquidity at local level, which in turn undermines the efficient use of the latter at a group. The "raw material" needed to finance the economy, at European level, exists but is mobilized sub-optimally. Clarifying ex ante how would parent institutions intervene in case of difficulties faced by a foreign subsidiary – a typical form of private risk sharing – would certainly help deal with the root cause of host countries concerns and, at the end the day, would favor the emergence of a more integrated banking sector. Given the high degree of banking intermediation in Europe, compared to other jurisdictions around the world, striving for a smoother movement of capital and liquidity, across EU countries, is essential.

"The adjustments proposed above have to be carefully designed but remain within reach."

- SYLVIE GOULARD

Possible way-forward

There are different ways to consider the issue, legally and economically.

From a legal perspective, one has to work out concrete solutions that would give host authorities assurance on the robustness of the local entities they supervise, while fully taking into account their belonging to a group. Credible cross-border guarantees provided by EU parent banks to their subsidiaries, based on EU law and enforced by EU authorities, should in this regard be considered; they would by nature increase trust between authorities in the short term, giving more time to work on the completion of the Banking union. These guarantees should address the question of group support to subsidiaries during going-concern and not only during resolution, allowing to lower prudential constraints targeted at subsidiaries.

From an economic point of view, we should put the issue in the broader context of the private sector's role in the financing of the economy. Strengthening and enlarging the investor base, so that, beyond the banking sector, a better matching of savings and investment needs across the different markets is achieved, appears ultimately to be the best way to involve the private sector in the funding of the economy, in sharing the benefits but also the losses that may occur. This is the end goal of the Financing Union for Investment and Innovation.

All in all, looking backward, considerable progress has been made toward a genuine Banking union. The adjustments proposed above have to be carefully designed but remain within reach. ●

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Optimizing the Banking Union

Klaas Knot

President, De Nederlandsche Bank

Balancing liability and control in the Banking Union

A continuous discussion in the EU is the division of responsibilities between member states and the European level. One guiding principle is that competences tend to be allocated to the European level if economies of scale and spillovers between member states are large, and if differences in local circumstances and preferences are small. Another principle is balance between liability and control. The level that bears the consequences of decisions (financially or otherwise), will also want to have a say in them, for example via policy coordination. These principles are also central in the debate on the completion of the Banking Union.

Before the financial crisis, banking supervision and crisis management were national. Liability and control were aligned, because EU countries themselves faced the consequences of the failure of a bank under their supervision. Yet the crisis showed that this situation was unsustainable, as European banks had become much larger and much more international. The scale of banking problems increased: failures strongly affected national public finances and contributed to the so-called doom loop between banks and sovereigns. Spillovers also increased, as financial integration amplified contagion risk between member states. All this provided a case for more involvement of the EU level.

With the establishment of the Banking Union, the EU was given the responsibility for supervision (via the Single Supervisory Mechanism or SSM) and resolution (via the Single Resolution Mechanism or SRM) of large banks. Still, the Banking Union currently remains a mixture of European and national elements. In terms of control or policy coordination, the SSM and SRM are responsible for bank supervision and resolution, but bank liquidation will still be executed by member states under national law. In terms of liability, the European level now bears part of the cost of bank failures via the single resolution fund (SRF) and possibly the ESM-instruments for (in)direct bank recapitalization. It can also impose losses on the private sector via bail-in. Yet an important part of the costs still lies with member states, because the SRF's public backstop is still in development, because deposit guarantee schemes are national and because national central banks provide emergency liquidity assistance (ELA).

So the Banking Union is not finished yet. Because member states are still partly liable for bank failures while the decisions on supervision and resolution made under >>>

>>> European control, tensions and discussions may arise. More importantly, due to the incomplete banking union the doom loop between banks and sovereigns has not been fully broken yet. An important contributing factor here is that many European banks still hold large quantities of domestic sovereign bonds on their balance sheets, due to their favorable regulatory treatment. EMU countries now remain unnecessarily vulnerable to future crises.

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

After all, risk-sharing will only be fair ex ante if starting positions are sufficiently similar between countries. An effective further reduction non-performing loan stocks is one of the essential elements in this regard. It also requires a further reduction of the sovereign-bank nexus via risk-weights and concentration charges for sovereign exposures. The current favorable prudential treatment should be phased-out. In addition, it should be ensured that European banks are sufficiently resolvable, for instance via strict requirements for subordinated MREL. Finally, the outcome of liquidation procedures could become more similar with improvements (and possibly further harmonization) in legal systems and bankruptcy laws. ●

Olli Rehn

Governor, Bank of Finland

Completion of the Banking Union as a priority in reforming the EMU

Financial stability remained the neglected stepchild of the European family when monetary union was agreed on at Maastricht in 1991. A heavy price was paid for this neglect during the great financial crisis. Now, the completion of the Banking Union is crucial not only for the stability of the European banking system but the EU as a whole, and should therefore be the first priority of EMU reform.

Significant progress has already been made in building the Banking Union since it was agreed in 2012. The Single Supervisory Mechanism, established under the auspices of the ECB, has successfully unified and overhauled the supervision of euro area banks. The Single Resolution Mechanism has given the authorities improved powers to intervene in failing banks. However, further strengthening of the institutional basis of the banking union is still needed, particularly in the areas of banking resolution and deposit insurance.

The Single Resolution Fund still needs a proper fiscal backstop, ensuring the liquidity of the fund. Such a backstop would strengthen the credibility of the task of the SRM to resolve, wind up or reorganise failing banks quickly and effectively. The backstop should be seen as a reserve instrument, which would be activated only if the Single Resolution Fund becomes temporarily short of resources, even after the owners and eligible creditors of failing banks have borne the losses allocated to them. It >>>

>>> should be seen as fiscally neutral, so that, over time, the Single Resolution Fund and ultimately the banking industry itself would replenish any funds drawn from it.

The common deposit guarantee scheme is needed to prevent bank runs, especially those across national borders. Confidence in secured bank deposits should be uniform throughout the euro area. A common European deposit insurance scheme would ensure this, even in severe crises.

Risk-based insurance premia would make the common deposit insurance system fiscally neutral ex ante. Still, further reduction of risks in two areas would obviously facilitate its establishment. The amount of non-performing bank loans should be further reduced. Moreover, some reduction of banks' exposure to their home countries' sovereign bonds is called for.

Completing the Banking Union will contribute towards a stronger EMU in many ways. Together with the accompanying project of the Capital Markets Union, it will improve the efficient allocation of capital in Europe, where banks play a particularly important role in the financing of private investment. Furthermore, a safe and stable banking sector will support the monetary union by making the transmission of monetary policy more effective.

Ultimately, it should help create a more resilient and productive real economy, with high employment and better growth prospects. ●

José Manuel González-Páramo

Member of the Board of Directors, Chief Officer, Global Economics, Regulation & Public Affairs, Banco Bilbao Vizcaya Argentaria (BBVA)

Let´s address pending aspects for an optimal Banking Union

The Banking Union will be one of the most relevant tools to achieve financial integration in the Eurozone and break the doom loop between sovereigns and banks, but for this it needs to be completed. The project will remain unstable and fragile unless there are real steps towards achieving the two pending components: a credible common fiscal backstop for the Single Resolution Fund and a European Deposit Insurance Scheme (EDIS).

The June European summit could have been a milestone to adopt decisions in the right direction, but EU leaders made little progress on the completion of the Banking Union. The only substantial decision was that the European Stability Mechanism (ESM) would become the common backstop of the Single Resolution Fund, but leaders postponed the discussion on technical details for the second half of 2018 and their approval not before December, together with the reform of the ESM itself. With respect to EDIS, there was a reference to start political negotiations but without a specific calendar. >>>

>>> The lack of a single EDIS raises doubts on the compromise of European countries on the Banking Union and hampers the development of a cross-country deposits market. EDIS would improve confidence in the safety of retail bank deposits regardless of a bank's location in the Union, thus weakening the historical link between banks and their sovereigns. A European scheme would in turn enable more lending to the economy, and therefore higher growth and more jobs.

Although there are banks and digital platforms that already offer European cross-border deposits to the public, up to date their success has been limited proving that confidence in national deposit guarantee schemes has to be reinforced. This is why a single EDIS is crucial to avoid fragmentation in the markets and reversals to the progress achieved by the Banking Union. Much has been achieved so far with the measures for reducing risks. Despite this, we must continue to move ahead, especially on NPLs, in parallel with the measures aimed at mutualizing risks.

In addition, we must look back and analyze how the Banking Union is working in practice, because initiatives already implemented are not truly "Single", as it is the case of some elements of regulation, supervision or resolution. On the single rulebook, we need to harmonize bank liquidation regimes in the EU. On supervision, we need to phase out national discretions. On resolution, we have to totally align national insolvency regimes with the EU resolution framework avoiding a better treatment in liquidation than in resolution and to align the bail-in tool and the MREL requirement. Besides, we should clarify how liquidity works both before and after resolution. Finally, we should reflect on whether the resolution framework can accelerate bank runs. All these aspects will make the whole framework more credible and effective.

Progress on completing and strengthening the Banking Union with EDIS is paramount, but other complementary policies would be highly effective. For example, the streamlining of the supervisory merger review procedures is another measure that could reduce the costs of establishing pan-European financial institutions and thus promote their introduction.

In sum, a lot of work is still pending for the next semester before the Euro Summit addresses these issues in December 2018. Let´s hope that European policymakers take the opportunity and work together to complete the main features that will bolster the Banking Union. ●

Dr. Karl-Peter Schackmann-Fallis

Executive Member of the Board,
Deutscher Sparkassen- und Giroverband (DSGV)

EDIS: why the diversity of the EU banking system is at stake

In the history of European achievements, Banking Union has been a remarkable feat in that it is nothing short of the largest European reform project since the introduction of a single currency. Not untypical of endeavors of historic proportions, Banking Union is subject to hugely different interpretations. A widespread perception is that Banking Union needs to be "completed" and that its current state is only a partial solution. This view appears to be rarely checked for accuracy as Banking Union is indeed complete from a political and economic perspective. >>>

>>> Its third pillar is built upon the Deposit Guarantee Schemes Directive (DGSD), which ensures a common depositor protection in every Member State according to the very same, harmonized requirements.

To acknowledge its completion however should not stand in the way of considering extensions to Banking Union as long as they further enhance financial stability. At their Euro Summit in June, the European Heads of State and Government took decisions on two key policy issues. One was the creation of a common backstop to the Single Resolution Fund, provided by the ESM. The other was to start work on a roadmap for political negotiations on a European Deposit Insurance Scheme (EDIS).

While the added value of a common SRF backstop is fairly intuitive and warrants its own discussion, the question is how EDIS would impact depositor protection and the banking sector as we know today.

A defining quality of the EU banking sector is its profound diversity. Concerning thousands of regional banks, this diversity relies in huge part on Institutional Protection Schemes (IPS). An IPS is an arrangement amongst a group of credit institutions to safeguard their solvency and liquidity. There are currently a dozen IPSs in Europe, covering about 50% of all euro area credit institutions – in large parts savings banks and cooperative banks.

Proponents of the European Commission's EDIS proposal argue that IPS membership could be "rewarded" by a reduced DGS contribution, thus leaving funds available to voluntarily support an IPS. This however would only work for DGSs and IPSs that are separated. But a number of IPSs, such as the one of the German Sparkassen, are indeed recognized under current legislation as a DGS at the same time. Transferring their existing funds to a mutualized system would eliminate the funds necessary to maintain a functioning IPS. Therefore IPSs, and in particular IPSs recognized as DGS, would become economically unviable under the EDIS proposal.

Rendering IPSs economically unsustainable seriously impedes regional banking. In fact, with EDIS, the very diversity of the EU banking sector is at stake.

Another acknowledgment of diversity lies in the DGSD's target level being approximately 40% lower for highly concentrated banking markets. EDIS on the other hand would level out contributions regardless of national structures.

Apart from its irrevocably damaging effects on diversity, EDIS would have negative systemic impacts as well. An obvious one is the introduction of moral hazard for policymakers in ignoring the effects of national economic policy on banking stability by mutualizing the resulting consequences. But EDIS would also give rise to contagion risk as depositors become aware of the interconnectedness that is inherent to EDIS, ultimately leading to spillover effects.

Among the supposed benefits of EDIS are a harmonized deposit protection, a level playing field, prevention of regulatory arbitrage, and enhanced stability of the banking system.

Considering that all these objectives are already explicitly addressed by the DGSD, the question remains if there is any net benefit to be expected from EDIS. And indeed there is, but only in the case of a national DGS being depleted because of a local shock. But there are much less invasive ways to address this remaining use case. A number of alternative proposals have been developed that avoid the issue of full mutualization, including concepts that would permit a DGS in a stressed liquidity situation to borrow from all other schemes.

Most importantly, alternative proposals avoid the issue of full mutualization. And they preserve national DGSs and IPSs, with the latter having been crucial for promoting financial stability and for facilitating regional banking as successfully demonstrated by the German Sparkassen for five decades. ●

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Enhancing supervision in the Banking Union

Sabine Lautenschläger

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

Combination of data and judgement fosters consistent and reliable banking supervision

We hear so much these days about computers and robots replacing humans in the workplace. Might that happen in banking supervision too? After all, supervisors rely heavily on data to do their job. So could a computer replace them? No, of course not. Data are important, but data alone are not enough, for various reasons.

First, there are essential elements in banking supervision that just cannot be quantified. Think of a bank's governance structure, for instance, or its risk culture. Second, data alone do not tell the entire story: they need to be put into context, and they need to be interpreted. Supervisors have to exercise judgement, drawing on their experience, their skills and their knowledge.

Data therefore don't replace judgement; they are fundamental to it. Good supervisory judgement is grounded in good data.

This philosophy underlies our main tool of supervision, the Supervisory Review and Evaluation Process (SREP). While banks each have a specific risk profile, their banking activities are comparable. Using the data obtained from 119 banking groups, we can compare and benchmark these banks in order to identify trends and risks early on. And we use the data within our SREP to treat banks in a fair and equal manner, and enable them to operate on a level playing field. As a harmonised tool, the SREP helps us to achieve this by guiding supervisors to form their judgements along the same lines. The SREP features what we call "constrained judgement". When assessing risks to a bank's capital position, for instance, we process the data to automatically generate initial risk scores, benchmarks based on peer comparisons and supervisory risk estimates. This ensures consistent and objective anchor points. That is the data side. Next, we use our judgement to account for idiosyncrasies which cannot be captured by automated algorithms. In other words, we can adjust the automated score, within certain limits, to take the bank-specific situation into account. That is the judgement side.

Good judgement is based on experience. And supervisors constantly broaden their experience, not only by sharing their views and know-how. We also ensure that our supervisors regularly rotate. Having supervised one bank for a few years, they move on, join another team and supervise a different bank. This rotation ensures that our supervisory teams do not become isolated "islands" with separate and even divergent supervisory cultures. It gives supervisors a breadth of experience and prevents supervisory capture.

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>>> So, data and judgement together allow us to consistently and reliably supervise banks. While data serves as the basis, judgement adds experience and expertise.

We are well aware that our efforts to collect high-quality and granular data add to the reporting burden on banks. And we also know that national differences in reporting obligations increase that burden still further. The amount of data collected differs across countries as do the definitions of requirements. Moreover, some countries still need to fully reflect the reality of banking union and a single supervisor in their reporting requirements.

To ease the burden on banks, we thus need to continue to standardise, integrate and harmonise reporting.

We are also supporting reporting agents in other ways. Working with the banking industry, the European System of Central Banks (ESCB) has developed the Banks' Integrated Reporting Dictionary (BIRD). It describes exactly what data banks should extract in order to generate the required reports. Moreover, the BIRD lays down clear rules for definitions of data transformations. Currently, the project covers the reporting requirements for AnaCredit and securities holdings statistics, and work is under way for it to include financial reporting (FINREP). ●

Sylvie Goulard

Second Deputy Governor, Banque de France

Harmonizing liquidation and deposit protection rules: next challenges for the Banking Union

Less than one year is left before the elections of the new European Parliament and Banking Union (BU) is currently at a crossroad. Despite substantial and recent breakthroughs, additional steps forwards are still urgently needed. At this stage, the level of completion of the various BU pillars is asymmetric: a common framework is in place for supervision but the second pillar of the Banking Union, resolution, is still incomplete due to the lack of a credible common backstop to the Single Resolution Fund. Such level of harmonization is still pending regarding liquidation rules and the 3rd pillar related to the deposit protection (EDIS). Overcoming this mismatch is a new challenge for European legislators.

First, we must urgently complete the second pillar of the Banking Union and make it credible. The agreement reached during the 29 June Euro summit meeting to complete the BU through the implementation of a common backstop to the Single Resolution Fund (SRF) will allow it to act beyond its financial capacities. The European Stability Mechanism (ESM) will bridge the funding gap through a dedicated credit line assuming SRF's financial means collected by banking contributions are not sufficient. This announcement is already a milestone in order to make the resolution tools more credible. Mario DRAGHI recently declared: "It will provide an additional layer of safety for banks in resolution, ensuring that they can be resolved effectively and without endangering financial stability. All this, in turn, will enhance confidence in the banking sector as a whole and make it more stable"[1]. By comparison, the backstop provided by the US government is probably the main reason why the Federal Deposit Insurance >>>

>>> Corporation (FDIC) had succeeded in resolving 500 banks without troubles on financial stability. The operationalization of this agreement must now be a major priority by the end of 2018.

Beyond the backstop, a single liquidity provision scheme implemented by the Eurosystem and compliant with EU monetary policy rules could provide liquidity to the banks whose financial situation has been restored following the resolution process.

EDIS, the third pillar of the Banking Union, is another objective to keep in mind to achieve a fully-fledged BU. The debate on the draft proposal of the commission has been taking place in the EP and council since 2015. The new version without mutualization proposed by the commission on October 2017 could provide a basis for a compromise. Substantial risk reduction has already taken place and risk-sharing greatly helps risk reduction. EDIS would additionally avoid self-fulfilling prophecies and bank runs. For breaking the current political deadlock, a design focused on liquidity needs – as proposed by the EC within its 11 October communication – seems to be a pragmatic approach and should meet the main objective of EDIS, namely covering the potential financial gaps.

The treatment of bank failures outside the resolution scope could also be further harmonized. The liquidation regimes of credit institutions across the EU are not sufficiently harmonized, consistent and predictable. The directive 2001/24/EC on the reorganization and winding up of credit institutions is a beneficial legal basis for further progress. It exemplifies how facing the diversity of domestic laws regarding security and property without establishing a single EU banking insolvency regime. The current directive does not consider the situation of banking groups. Additional improvements could be put in place, for instance through a reinforced regime for the enforcement of intragroup support in case of liquidation. The new EU regulation could set the rules for more robust ex-ante group support financial arrangements to upstream losses, especially in the case where subsidiaries face difficulties but the group/parent does not, in order to bolster confidence of host Member States; in this regard the current revision of the CRR offers a good opportunity to upgrade the current framework accordingly. Credible cross-border guarantees provided by EU parent banks to their subsidiaries, based on EU law, and enforced by EU authorities, are in our view the most credible option to increase trust between home and host authorities in the EU. ●

1. Introductory Statement by Mario Draghi, President of the ECB, at the ECON committee of the European Parliament, Brussels, 9 July 2018.

Dr. Elke König

Chair, Single Resolution Board (SRB)

Gaps in the Banking Union regarding funding in resolution and how to close them

A key task of resolution authorities (RA) is to ensure financial stability and continuity of critical services of a failed bank so that it can meet all obligations due after resolution. To achieve this RA have been given a number of tools. However, while the bail-in of creditors and restructuring measures will restore and improve a bank's solvency and viability, it is reasonable to expect that a resolved bank will experience liquidity stress after the resolution weekend.

By definition a recapitalised bank that has absorbed losses will be solvent and have better access to funding. However, given that analysts and creditors will likely require time to re-assess the financial position, the return to market funding will be a process rather than a one-off fix. Addressing the risk of banks having insufficient liquidity following resolution action therefore presents a crucial task in resolution planning.

It is important that RA follow fundamental principles, but at the same time adopt a flexible approach to ensure an orderly transition to private funding. According to FSB guidance, the way is clear: first, the bank's own resources are expected to contribute. From a market discipline perspective it is important to rely on the bank's assets and secured financing. However, the availability >>>

>>> of collateral is not static. In fact, we expect limited and decreasing collateral approaching the point of non-viability. This situation is exacerbated if a failure is caused by a deteriorating liquidity position and recovery options are exhausted. Close monitoring of asset encumbrance and a timely FOLTF are a must, but will not solve all problems.

While private measures are expected to narrow gaps, the impact must be seen against the backdrop of potential sizes of liquidity needs. Looking at historic cases, support to individual banks in stress easily count triple billion figures. Precisely for this reason, FSB guidance recommends establishing temporary public backstop funding mechanisms. Such a tool currently does not exist in the Banking Union (BU), which is a missing piece in the overall framework. While the SRF can play a role in providing liquidity, the role can only be limited, given the SRF's size, even if secured by a common backstop. We should however be mindful that the SRF was primarily designed for capital restauration.

"FSB guidance recommends establishing temporary public backstop funding mechanisms."

- DR. ELKE KÖNIG

Other solutions therefore need to be explored, particularly with central banks. When designing a credible tool some fundamentals must be fulfilled: first, all pre-conditions must be clear and RA should have certainty they can rely on the tool for finalizing all features of the resolution scheme, including funding, i.e. liquidity on day 1. Second, the scale must be sizable and flexible enough to support the effective implementation of any resolution strategy. It goes without saying, that only viable and solvent institutions in resolution should be supported with funding. Finally, the creation of a new sovereign-bank nexus should be avoided. Provided these objectives are met, the tool would address open issues in the current system and put the BU framework at equal footing with other jurisdictions such as the US or UK. A credible temporary public solution will provide markets with the needed confidence and allow fast return to private funding. ●


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Felix Hufeld

President, Federal Financial Supervisory Authority, Germany (BaFin)

NPL management: success through perseverance

There is a German summer hit with the line "Zusammen ist man nicht allein", which means "together we're not alone". Perhaps that sounds trivial. But after a moment's thought, it is true that we have to act differently as part of a community than we would if we were alone. And, of course, this is just as true for Europe's Single Supervisory Mechanism (SSM).

Admittedly, there were perhaps a few sticking points shortly after it was established in 2014, but today we can justifiably say that the SSM has proven its worth. The condition of European banks is significantly better than it was just after the crisis, too. But it cannot be ignored that substantial risks remain. These risks are not recent, but, so to speak, chronic diseases that have been hampering our banks for quite some time: the large sovereign risks held by banks and non-performing loans (NPLs).

It is true that the average NPL ratio in Europe has already decreased significantly. At the end of 2014 it was 6.5%, and in the fourth quarter of 2017 just 4.0%. However, the distribution is uneven. A quick glance at the following figures demonstrates this: in Greece the NPL ratio in Q4 2017 was 44.9%, in Cyprus 38.9% and in Latvia 0.2%.

Various initiatives were taken at an European level with the aim of reducing the high proportion of non-performing loans. Just a few weeks ago, on 11 July, the SSM announced a new supervisory approach. It builds on the guidance[1] published in March 2017, which essentially kick-started work on NPL reduction. This guidance provides an effective toolkit for banks. It was expanded a year later by an addendum[2] explaining supervisory expectations for prudential provisioning of "new" NPLs.

The new supervisory approach brings NPL management to a new level of quality. Specifically, this means that in the medium term supervisors will define their demands for each bank based on the new addendum. The expectations are based on both the current NPL ratio and the most significant financial aspects of the individual banks. The key now is to define ambitious and risk adequate expectations and to ensure that each bank carefully follows this roadmap. I find it encouraging that the majority of banks have ambitious plans to reduce their NPL ratio. For other institutions, individual, intensive supervision remains a valid option.

"The new supervisory approach brings NPL management to a new level of quality."

- FELIX HUFELD

A hot topic at the moment is the question of how to deal with sovereign exposures. The Basel Committee on Banking Supervision (BCBS) took the decision to review the rules regarding such exposures. The responses that the BCBS received on this are multi-faceted and reflect the different situations across Europe and, in fact, globally. However, we need to be ambitious and move away from the 0% risk weighting; otherwise, concentrations will build up on banks' balance sheets that can no longer be considered healthy from a supervisory perspective. ●

1. ECB: Guidance to banks on non-performing loans, March 2017.
2. ECB: Addendum to the ECB Guidance to banks on non-performing loans: supervisory expectations for prudential provisioning of non-performing exposures, March 2018.

Diony Lebot

Deputy Chief Executive Officer, Société Générale

The SSM and banks: improved reporting for enhanced supervision

Among the objectives of the Single Supervisory Mechanism (SSM) created in November 2014 is the willingness to foster supervisory convergence and transparency at a supranational level. However, this came along with a complex architecture of institutions with consequences notably in terms of data reporting. On top of regulatory reporting required by the EBA, the SSM imposes additional data requests for its annual Supervisory Review and Evaluation Process (SREP), with a common methodology adopted to supervise about 120 significant banking groups and 3,500 smaller institutions.

Banks never have provided as much data as today to their supervisors, with a considerable intensification in the last 5 years and the result is that statistical reporting by banks is not integrated as it should be. While prudential reporting is essential to ensure harmonization of supervision and to benchmark institutions, increased supervisory requests along with regulatory reporting at group and entity level add complexity. Even though banks have made considerable efforts to improve their data architecture, any change or new requirement is resource-intensive, and ad hoc requests are especially demanding.

Beyond that, this raises the question, in light of the huge quantity of data, about supervisors' ability to process data, interpret and prioritize the possible outcomes for the SREP. Moreover, the SSM deals with the diverse application of its methods by National Competent Authorities (NCAs), for example in terms of controls and data quality expectations.

Work should be carried on for the achievement of a common culture of supervision, which is more than just an addition of different national supervision practices and cultures, and it is a challenge for both the SSM and the industry. At its inception, the SSM was not a single hierarchical supervisory organization. It was rather a network of supervisors with some key competencies being transferred to the ECB but still cooperating with the NCAs – each of them keeping their licensing power.

> *"A common supervision is more than an addition of national supervisory practices."*
>
> - DIONY LEBOT

Keeping in mind that the EBA remains the EU standards setter, the SSM has a central role to play to foster Integrated Reporting. A balance has to be found between harmonized and extensive prudential reporting on one hand, and on the other hand ad hoc requests, more and more including analytical data, in order to better apprehend risk trends and national specificities.

More generally, the SSM has to continue efforts towards more transparency and communication with banks about requirements, expectations and identification of the most appropriate contacts depending on topics and responsibilities (JSTs, horizontal functions, and DG Statistics).

With the progress of the Banking Union, the SSM has also a major role to promote the Euro Area as a single jurisdiction. This implies the harmonization of requirements, including homogeneous data-quality controls via more unified IT systems, as well as less NCA-specific reporting, and waivers for host entities. ●

Diederik van Wassenaer

Global Head Regulatory & International Affairs, ING Group

Further enhancing the common supervisory culture

Looking back on the past four years, it is clear that the European Central Bank (ECB) has made a huge effort and significant progress in fostering a common culture of supervision and converging supervisory judgments. The ECB is one of the strongest and most convincing proponents of the Banking Union. And there remains a strong case to take the next steps towards completing the Banking Union, which would strengthen the competitive resilience of banks as well as that of the European economy. The recent track record of the ECB should provide additional confidence that banks are and will be properly supervised.

Unfortunately there is still plenty to be done to create a genuine competitive European banking market.

So how can further progress be made? Two elements stand out. Firstly, EU regulators, the Member States and the European Parliament should not lose sight of the political objective to complete the Banking Union, including its third pillar EDIS. The continuous attempts to insert discretionary national deviations into EU

law should be considered critically. The current discussions around the risk >>>

>>> reduction package provide a clear window of opportunity. To strengthen the Banking Union, pools of funding and liquidity that are trapped due to regulatory constraints should be tackled to allow for an efficient cross-border use of solvency and liquidity buffers throughout banking groups in the Eurozone. Europe creates its own inefficiencies because each subsidiary maintains idle buffers to prevent a local regulatory breach. And even more concerning, in the area of resolution we run the risk of inefficient and costly requirements at solo entity level in the Banking Union.

Secondly, the ECB could step up its interaction with banks, individually and collectively, to identify and analyse the new developments and challenges that banks are facing. More interactions would also help to identify, discuss and foster best practices (plural!). This would be a logical sequel to the ECB's transparency initiatives in recent years. It would at the same time mobilise a vast pool of brainpower and intelligence. Such a joint and collaborative effort is probably most warranted in cases where the ECB and banks face the same challenge or threat e.g. cybercrime, cloud computing, but also the use of data.

"The ECB is one of the strongest and most convincing proponents of the Banking Union."

- DIEDERIK VAN WASSENAER

We strongly believe in the potential of big data, also when it comes to our supervisory dialogue. Banks are always exploring new opportunities: for better customer service delivery, but also for better managing bank operations including capital and liquidity. Reporting is certainly part of such explorations. However in our continuous dialogue with regulators two challenges stand out: we have to ensure that data has the required quality and that the definitions of specific data items are the same everywhere. And we have to keep in mind that to build and maintain systems to collect and process data requires significant and continuous investment. So it is important to ensure that investments in state-of-the-art data systems/processes deliver tangible financial benefits. ●

James Morsink

Deputy Director,
International Monetary Fund (IMF)

Europe needs a unified and transparent bank resolution framework

While the Single Resolution Mechanism (SRM) delivered a substantial upgrade, resolution and liquidation regimes across the euro area remain fragmented. In recent interventions of significant banks in the euro area, only one bank was resolved by the Single Resolution Board (SRB) under the SRM. The others were handled under national bank liquidation regimes, which vary significantly across member countries and are subject to the less stringent loss-sharing (bail-in) requirements. To resolve a bank using public support under the SRM requires 8 percent of liabilities to be written down first; whereas under liquidation, which is governed by national insolvency laws and state aid rules, creditors may benefit more from public support. In other words, some creditors may be better off (and taxpayers worse off) in liquidation than in resolution by the SRB. As a result, outcomes for bank creditors can vary considerably across the banking union, creating an uneven playing field and a loss of transparency.

To unify the resolution framework, the recent Euro Area Financial System Stability Assessment by IMF staff recommended that the loss-sharing requirements under the state aid rules and those under the SRM should be aligned, subject to introducing alternative flexibility. Flexibility is needed because the SRM was designed to deal with idiosyncratic and not systemic events. While the SRM allows some flexibility, notably through precautionary recapitalization for vulnerable banks that still have sufficient regulatory capital, this is may prove insufficient when flexibility is needed most, namely during a system-wide crisis.

The flexibility for resolution currently resides in the national liquidation regimes, but this undermines the unity of the resolution framework and is opaque. Transparent flexibility in the SRM should take the form of a financial stability exemption (to allow departure from the 8 percent bail-in requirement for public support), which would be used only in times of severe euro area or country-wide financial stability risk and subject to strict conditions and governance arrangements. In the few scenarios where this flexibility might be needed, loss absorption by shareholders and subordinated debtholders would still be required as a minimum.

"Resolution and liquidation regimes across the euro area remain fragmented."

- JAMES MORSINK

The SRM should also include an administrative bank liquidation tool, allowing the SRB to appoint a liquidator and commence proceedings. The SRB should be able to apply this tool to all banks within its remit—mainly the so-called significant institutions—as well as other euro area banks deemed systemic at the time of failure. This tool would be especially useful for ensuring that cases involving cross-border banks are dealt with at a euro area level, facilitating necessary coordination and a level playing field. The tool could be applied by itself or in combination with other resolution tools, including an effective sale-of-business tool, and should be underpinned by a harmonized creditor hierarchy.

The views expressed in this article are those of the author and do not necessarily represent the views of the IMF, its Executive Board, or IMF management. ●

Dr. Johannes-Jörg Riegler

President, Association of German Public Banks (VÖB) & Chief Executive Officer, BayernLB

The SSM as successful start-up with room for improvement

As an organisation representing the banking industry, it is not without risk to express an opinion on the quality of the SSM. A positive assessment of supervision might be judged by the public as being too lax. An assessment too negative would probably also be followed by a call for stricter supervision. In both cases, therefore, banks would be additionally burdened. But how is the quality of the SSM to be judged, actually? We focus on three aspects in particular: does the supervisory authority act appropriately, within the legal framework? Is the supervisory procedure transparent, and therefore comprehensible for the credit institution concerned? Are the supervision costs for banks proportional to the benefits for financial stability? In all three areas, SSM has developed further in recent years. Yet there is still room for improvement.

The SSM could be described as a start-up. It was - and still is - certainly not easy to harmonised the various supervisory practices of the member states within just a few years, and to ensure a level playing field in terms of competition. This primarily includes a common supervisory culture and, in particular, uniform criteria for assessing the same issues. This applies equally to significant and less significant institutions. The ECB has gradually been setting guidelines for various areas of regulation. It is important in this context that shortcomings in individual areas will not necessarily trigger further regulatory measures, which would affect all institutions. Individual failures should be dealt with individually for each bank concerned, as part of the Supervisory Review and Evaluation Process (SREP).

The ECB is currently working on internal capital adequacy (ICAAP) and liquidity (ILAAP) assessment processes, to set the same standards in these areas. In principle, we welcome these activities, because the quality of internal risk management will therefore play a greater role in determining capital surcharges under the SREP in future. This may also make the exact composition of capital surcharges more transparent. The German supervisory authority has established a welcome process in this area, creating very clear rules that could set standards throughout Europe.

"It is vital for international competitiveness that authorities become more closely interlinked."

- DR. JOHANNES-JÖRG RIEGLER

Regulatory stress tests and data queries involve enormous efforts for the banking industry. An easing of requirements in this area would be very welcome. In particular, it would be appropriate to strike an adequate balance between quantitative banking supervision, which is essentially based on the evaluation of huge amounts of data, and more qualitative supervisory practice, which focuses on the assessment of the individual risk situation. Even if digitalisation and rapid developments in the IT sector open up new possibilities for the monitoring process, largely automated processes seem less suitable for a qualitative supervisory practice.

It is vital for financial stability and international competitiveness that supervisory and regulatory authorities become more closely interlinked. Communicating at an early stage - and therefore improving cooperation - avoids administrative workload for banks and makes it easier to plan requirements. ●

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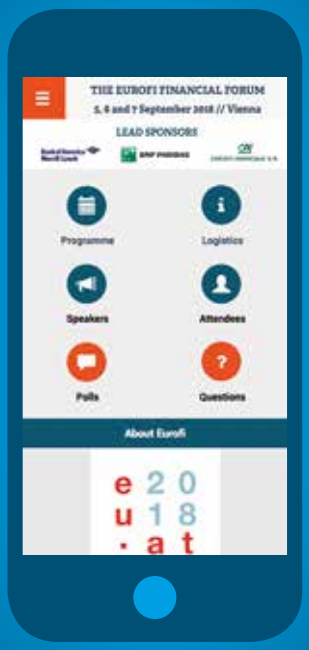

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Review of the operation of the ESAs

Robert Ophèle

President, Autorité des Marchés Financiers (AMF)

ESAs review: a unified European supervision is key for a true CMU

In an area where financial entities benefit from both the freedom of establishment and the freedom to provide services, and where they use these freedoms extensively, it is not sufficient to have common regulations; it is necessary to implement and enforce them coherently in all member states.

Achieving a common implementation of the rules is at the heart of the CMU project. Without effective supervisory convergence, there is no level playing field and a growing risk of diverging rules affecting the degree of investor protection and market integrity between member states. Consistent application of the rules is a prerequisite to ensure clarity for market participants, reduce the risk of a race to the bottom and mitigate the threat of market fragmentation. It should facilitate cross-border activities and economies of scale. Ultimately, it is a matter of credibility and competitiveness for the EU. Should the divergences become too significant, it is the European passport itself that could be put into question. Although the Lamfalussy report recommended using Level 1 regulation only for setting out general principles, one may believe that the more precise and detailed the single rulebook is, the easier supervisory convergence will be. This is actually not the case. On the contrary, the very granular Level 1 and Level 2 regulations often leave large possibilities to NCAs to adopt autonomous supervisory stances (even more so as some directives such as UCITS are considered minimum harmonization). This is due to the limited effectiveness of existing Level 3 regulatory instruments (guidelines, opinions, Q&As) to achieve supervisory convergence.

There are only two ways to make progress when it comes to convergence: either by transferring direct supervisory powers to a European Authority (the SSM way) - which would make sense for cross-border and wholesale market activities - or by reinforcing the convergence tools of the European Authority. Since there is little appetite for the first solution (despite the fact that it has been done for CRAs and TRs with no major opposition), all efforts should concentrate on the convergence powers.

Building on existing tools available to the ESAs, the following measures could be considered:

- Formalizing some European wide supervisory priorities, which could be supplemented domestically by national ones;
- Ensuring consistent understanding and implementation of Q&As, by introducing a comply or explain process for Q&As;

>>>

>>> • Setting regular reviews of the compliance of NCAs by the European Authority;
• Adopting common enforcement standards;
• Launching some European-wide stress testing exercises in addition to the existing CCP one (e.g., in the asset management domain).

Additionally, European authorities need the legal tools to avoid the deadlock which may occur when Level 1 or Level 2 texts are unenforceable or require international coordination; the ability to issue so-called no-action letters, with a European scope, similar to those used in the US for instance, would provide targeted and legally sound responses in those specific instances and offer EU players a level playing field with their competitors across the world. Finally, strengthened convergence powers should be supported by a more agile and independent organization of the European Authority's governance structure.

Having nearly finalized the single rule book and made every effort to promote supervisory convergence with existing tools, it is time to move towards a more unified supervision across the EU.

The limitations of the existing institutional European setting are a warning, both vis-à-vis any system of general mutual recognition with third countries (how could we monitor third countries' supervisory stances if we are not able to do so inside the EU?) and vis-à-vis the implementation of a strong location policy (which would exacerbate the divergence tendency between member states). The role of the ESAs should therefore be strengthened and become central in the relations with third countries. The current equivalence scheme needs to be revisited; in addition to the formal assessment of the equivalence of regulation, the effectiveness of supervision and enforcement, the promotion of the internal market for financial services and the protection of financial stability should become more and more relevant in the equivalence decision making process. ●

Jean-Paul Servais

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

Ensuring consistency of supervision and achieving the right balance between EU and national supervision

Harmonising financial regulation (single rulebook) and ensuring a convergent supervisory approach is a prerequisite to having a single European financial market. This allows consumers to invest with confidence outside their member state of residence and market participants to conduct business cross-border.

Having contributed extensively to developing a comprehensive and appropriate rulebook for the provision of financial services, the ESAs have rightly identified effective and consistent supervision, with comparable regulatory outcomes, as their main strategic priority for the coming years. In this respect, it is important to ensure not only a level playing field between the various member states, but also between comparable products. In our view, the single rulebook should guarantee consistency in the rules applicable to economically equivalent products, so as to avoid regulatory arbitrage between sectors. It is therefore essential that the ESAs cooperate closely and take a horizontal approach across various financial sectors.

A key challenge going forward is consistently to apply the same rules to the insurance-based investment products covered by the Insurance Distribution Directive (IDD) as those applicable to comparable MiFID products. >>>

>>> EIOPA will have to play a crucial role in enhancing convergence in the area of conduct of business supervision in the insurance sector. The new conduct supervision strategy of EIOPA is rightly ambitious in this regard and focuses on building supervisory capacity and convergence in practical conduct supervision. As part of its programme of conduct country visits to national competent authorities (NCAs), a first country visit took place in Belgium recently. In my view this visit has been successfully completed and will positively contribute to building a supervisory conduct handbook. EIOPA and its members will need to deliver quick and firm results, since IDD will be applied as from 1 October 2018.

While the ESAs should further prioritize cross-border and cross-sector convergence, there may be specific areas where the EU legislators could envisage centralised EU supervision in the interests of further integrating the single market and contributing to the CMU.

In this respect one needs always to consider which authority is best placed to supervise the harmonised and national rules. When reviewing the European System of Financial Supervision, it is essential to ensure the right level of supervision at the right level. In this respect, we believe that the main distinction to be made is between wholesale (B2B) and retail (B2C) markets.

Wholesale securities markets are more integrated and are regulated mainly at European level. As a result, a case can be made for a strengthened supervisory role for ESMA in some areas (e.g. data service providers under MiFID II). ESMA has already been granted supervisory powers for credit rating agencies and trade repositories and it has a natural role to play as regards select B2B activities of a similar nature.

By contrast, retail securities markets are by definition less integrated. NCAs are therefore best placed to supervise the compliance of retail products with the applicable legislation. NCAs have developed expertise in the applicable legislation, understand the language, and thanks to their proximity to the local market have a good view of the products sold there, are close to local investors and understand their preferences and vulnerabilities.

Transferring supervisory powers over retail products to the ESAs would ignore the existence of local ecosystems and risk leading to less efficient supervision. A division of supervisory responsibilities between the ESAs and the NCAs in some domains could also result in losing the overall picture needed to grasp all risks at local level. ●

Dr. Mario Nava

Chairman, Commissione Nazionale per le Società e la Borsa (CONSOB)

Data driven regulation and supervision - a European challenge

In the aftermath of the global financial crisis, large efforts have been made to close informational gaps by introducing new reporting obligations for a wide range of market participants (particularly for OTC derivatives, hedge funds and repo transactions) and trading venues.

In the EU much more information is now available to securities regulators and supervisors. More information may be used to strengthen the 'better regulation toolbox', supporting both the ex-ante assessment of new initiatives and proposals and the ex-post evaluation of existing legislation.

The availability of more information and data, combined with technological developments, may enhance the efficiency and efficacy of supervision, by allowing timely identification of emerging risks, vulnerabilities and priorities. >>>

>>> The Capital Markets Union (CMU) may also benefit from an evidence-based regulation and a data-driven supervision and surveillance, at least to avoid regulatory arbitrage and an unleveled playing field.

Regulators and supervisors, however, face many challenges. In the current European framework, an efficient data collection and consolidation needs still to be reached, since a lot of information remains dispersed. The consolidated tape already foreseen by MiFID I is not a reality yet. Information is mostly reported and used at national level, while sharing among ESMA and other EU institutions is still limited. Data coverage is uneven across sectors and institutions and information sharing among national competent authorities can be massively improved (for example the rules on cross border distribution of funds, where notifications for information sharing are still based on e-mails[1]).

A further challenge has to do with skills and tools. Regulators and supervisors should develop skills and approaches to extract fully the informational value from the available data. Building also on widespread market practices, surveillance need to be deeply innovated (applying, for instance, social-media/e-commerce-like algorithms to map the distribution and the demand for a financial product and to alert retail investors in case of mis-selling!). Leaving innovation to market participants only, at a time when they are already experimenting the applications of artificial intelligence (such as robo-advice and big data analysis), would leave regulators and supervisors truly behind and confined to point to point navigation, while people around are equipped with radar, sonar, and GPS!

ESMA could lead the shift to a consistent data-driven approach to supervision.

ESMA is already facilitating the collection, standardisation, consolidation and spreading of supervisory information. Centralising efforts at EU level is the most efficient and cost-effective way to handle information from the point of views of both market participants and national supervisors. It is the condition for a more streamlined approach to data management and a true EU perspective in supervision.

Data-driven supervision should be reinforced, shared and actively used, enhancing efficiencies of scale and productivity without increasing the bill for EU market participants. Inside ESMA, the Committee on Economic and Market Analysis CEMA could be the right place to promote this cultural change. Nevertheless, data-driven supervision is just one side of the current picture. Local factors may work as centrifugal forces raising negative externalities and weakening the EU project. A failure to shift to a more evidence-based oversight would then undermine the spirit of the post-crisis regulatory reforms and trigger a cost for EU citizens. ESMA and National Authorities should be willing to fully exploit these informational potentials in upholding their mandates. ●

1. On this, more details in Article "Cross border distribution of funds: new rules and challenges"


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Felix Hufeld

President, Federal Financial Supervisory Authority, Germany (BaFin)

Review of the ESAs – Don't fix what's not broken

On 15 September 2008, the US investment bank Lehman Brothers filed for bankruptcy. This was widely considered to be the height of the global financial crisis. Nearly ten years on, we now have a working system in the European Union (EU) for supervising the financial markets.

But given that the financial markets are changing dynamically, regularly evaluating the existing structures is the right thing to do. However, the current review of the European Supervisory Authorities (ESAs) poses a fundamental question: why >>>

>>> fix something that essentially already works? The members-driven approach of the ESAs has proven successful over the years.

Processes and governance structures that would harm this successful approach should be avoided. If we want to strengthen the ESAs, we should instead ensure that they are able to make more effective use of the powers they already have. And so the idea of giving them an even more active role in developing supervisory convergence and a common supervisory culture is the correct path.

This is the path we should continue to pursue in European financial market regulation and supervision. And we should do so carefully, without unnecessarily creating overlapping areas of competence and new, complicated processes. This is particularly applicable to the widely discussed matter of strengthening the areas of competence of the ESAs to the extent that they act as de facto supervisors for the national supervisory authorities. For example, the European Commission plans to give the ESAs a say when EU-based institutions outsource or delegate material activities and processes in non-EU countries, meaning that it would express its opinion on specific national authorisation procedures.

In a similar vein, the Commission is attempting to equip the European Securities and Markets Authority ESMA with even more direct supervisory powers. And that is despite the fact that the current supervisory system and architecture – in general – has been working well and ESMA's competences with respect to product intervention powers for example have only just been expanded by the Markets in Financial Instruments Regulation MiFIR (Art. 40).

Creating a kind of single supervisory mechanism for securities supervision and giving ESMA the responsibility for supervising, for example, central counterparties (CCPs) is something that I consider problematic, and not just in view of the principle of subsidiarity.

All the more reason to be careful that in equipping the ESAs with adequate powers we do not fall victim to regulatory overzealousness. Are the supervisory standards not already sufficiently harmonised by the EU regulations and the associated level 2 measures?

Not to forget the accompanying college systems, the passporting regime, the supplementary Q&As and peer reviews. A new Leviathan would help nobody. Instead, the European System of Financial Supervision (ESFS) should keep to its original brief: as a network of national and European authorities. ●

Helmut Ettl

Executive Director, Austrian Financial Market Authority (Finanzmarktaufsicht)

Living the single rule book – ESAs' important role in supervisory convergence

To fully appreciate the role that the ESAs already play, it is useful to briefly reflect on the motivation for establishing the ESAs.

The global financial crisis clearly demonstrated that financial supervision was in dire need of a stronger EU dimension. The ESA regulations therefore correctly stated that "The Union cannot remain in a situation where there is no mechanism to ensure that national supervisors arrive at the best possible supervisory >>>

>>> decisions for cross-border financial market participants; where there is insufficient cooperation and information exchange between national supervisors; [...]; where national solutions are most often the only feasible option in responding to problems at the level of the Union; and where different interpretations of the same legal text exist."[1]

The creation of the ESAs in 2011 brought significant supervisory convergence for market participants and National Competent Authorities (NCAs). The "to do list" mentioned above has nevertheless not yet been fully completed. There are still opportunities for improving the EU dimension of financial supervision in many areas. I believe that "living the single rule book" requires further strengthening of the ESAs' governance and improving instruments for convergence. Striking the right balance between strengthening the EU dimension of financial supervision and avoiding weakening the effectiveness of NCAs in their domestic financial markets will be essential for ensuring that such an approach is successful.

To enhance convergence, the ESAs should assume a stronger role in peer reviews. Such reviews should be made more transparent, accompanied by follow-ups and should feed into reviews of legal acts. Mediation procedures should be used for the efficient and timely resolution of disputes among NCAs. Commonly agreed European supervisory priorities could focus supervisory practice on cross-border market developments – ideally before risks emerge. Setting these supervisory priorities would require a common risk-assessment as well as efficient evaluation and follow-up measures.

Ultimately, breach of Union law proceedings should serve as the credible convergence measure of last resort. The ESAs' review must be used to strengthen these convergence mechanisms.

A convergent supervisory approach across sectors is crucial to preserve financial stability and to protect the collective interests of consumers and investors. Recent developments in the area of anti-money laundering and terrorist financing show that areas still exist where the level of cooperation and information exchange is still insufficient and where the role of the ESAs needs to be strengthened. It is therefore necessary to improve the interlinkages between the three ESAs. We need to join forces and take joint action whenever necessary, and national solutions to problems at EU level cannot be considered as a viable alternative. One way to achieve such an aim would be to improve the functioning of cross-border colleges, in particular regarding the sharing of information.

Enhancing the role of the ESAs' towards third countries is not only important, but also urgent. In light of Brexit, it is essential that the Members States speak in unison. I believe that the ESAs could play a pivotal rule in equivalence assessments of third countries. Such assessments could be reviewed periodically. Furthermore, authorisation and supervision of certain third country firms wishing to enter the single market and provide cross-border services could be centralised at ESA level. This could help to ensure a level playing field and avoid regulatory arbitrage as well as providing third country interlocutors with the notorious "direct line" to "call Europe".

While such thoughts on regulatory initiatives are important, we should not forget that the single market can only function seamlessly if ESAs and NCAs fully commit themselves to "living the single rule book" and the European dimension of financial supervision in practice.

We have already made considerable progress towards achieving this goal but need to continue to strive relentlessly to make the most of our common financial market for the benefit of all. ●

1. Recital (8) ESMA Regulation No 1095/2010.

Merel van Vroonhoven

Chair, Dutch Authority for the Financial Markets (AFM)

A well-integrated CMU needs a single capital markets supervisor

Supervisors worldwide are faced with the enormous challenge to get a grip on the fast-changing capital markets. We see the use of big data, huge quantities of data that are stored in systems and subsequently exchanged over the internet, we see potential efficiency gains of blockchain technology in market infrastructures. On top of this we see robots joggling with data and algorithms.

The role of stock exchanges has drastically changed due to globalization and technological developments. Electronic trading makes high demands on the robustness of the trading. The possibility of placing orders based on algorithms is becoming available on a much broader scale. Innovation also leads to new players operating across borders. New platforms create new – sometimes disruptive – opportunities. So, it's clear that the financial sector is changing radically. As the ecosystem is changing, the challenges and risks also become more overwhelming. Not just the traditional capital market risks, but also competition-related risks and data protection risks.

Individual supervisors will not be able to deal with the challenges just by themselves. Supervision on a national level is insufficient as violations and fraud often are taking place in multiple markets. Supervisors need to invest in data-driven supervision and strengthen their research methods. With this in mind, the Commission proposals on enhancing the ESA's role in the area of supervisory convergence is much needed. As are the proposals for centralization of tasks like direct supervision on certain wholesale prospectuses, Data Reporting Service Providers and benchmarks.

Market segments where business is principally European and of a cross border nature are most likely to benefit from more centralized European supervision. We should therefore also explore the benefits of centralizing supervision in other areas, such as clearing (CCPs), financial reporting and market abuse. A well-integrated CMU needs a Single Capital Markets Supervisor, and ESMA is best equipped to take up this role.

A stronger ESMA needs a different governance structure, in order to be able to deal with its tasks in a more independent way. It is important that ESMA has all the tools available to contribute to a joint supervisory culture. Introducing an Executive Board, as the Commission proposes, would be very helpful to support an independent role for ESMA. Of course, the devil is in the details of the regulation. The proposals so far have been received with mixed levels of enthusiasm, but it is important that we do not limit our policy-debates to all kinds of legal discussions, although I do acknowledge the importance of European principles such as subsidiarity and proportionality.

The current proposals could be seen as the bare minimum of what is needed to come to a central hub and spokes model with a pivotal role for ESMA. We need to take it a step further. My vision is that supervisors all have their specializations, based on their experiences and home markets. A network based on co-creation will enable us to jointly work on the desired supervisory outcomes. We need to support each other by sharing data, market intelligence, IT systems, creativity and knowledge. And >>>

>>> to really improve our outcomes, we also need to think beyond the current supervisory community.

I think we need to tap into the data and creativity of scholars, market participants, and investor organizations. ESMA can play a huge contribution in bringing together all the bits and pieces of what is needed to effectively supervise the capital markets. Financial markets are changing rapidly.

The only way to protect consumers and investors, is to be constantly able to adapt to a rapidly changing market. We therefore need to transform ourselves into a supervisor 2.0 or even 3.0, which is fast, alert, and can deal with today's and tomorrow's challenges. ●

Financing challenges in the CESEE region

Marinela Petrova

Deputy Minister of Finance, Republic of Bulgaria

Fostering economic growth by addressing the need for a more efficient capital structure

A common denominator of all national economies in the SEE region is that they lack versatility in terms of funding options available to the business. All of them being quite dependent on bank financing seem to be lagging behind in terms of finding optimal capital structure. Bank lending is by no means something bad for private business but when it is the only way to fund a company, even in the current low interest rates environment, it can only serve until some point, beyond which no other options are available. Furthermore, tightened prudential regulations increase banks reluctance to provide loans that could be qualified as riskier than average. This puts additional burden on firms that not so long ago faced no funding-related conundrums.

At the same time capital markets are barely able to bridge the financing gap. In each of the SEE countries the gap varies in relative terms but it is always considerably big. According to a 2017 IFC report on micro- and SME finance gap, for Bulgaria it is estimated to be around EUR 5.5 billion, EUR 40 billion for Romania and EUR 8.5 billion for Serbia, for example. And this comes at times when there is abundant liquidity at both banks and institutional investors. Yet, they are unable to fully utilise their cash thus lowering their profitability. This discrepancy is a result of many factors which affect both supply and demand side.

In terms of supply, low investor awareness is the major factor that prevents broader retail participation. The entire SEE region lacks traditions in stock exchange trading as these venues appeared after the countries set foot on the road to market economy in the early 80s as opposed to the banks that have been an important factor in the financial system for much longer. The cyclical development of regional stock exchanges over the last two decades ultimately led to misaligned expectations of retail investors. Instead of setting properly an investment horizon that matches their financial needs, most of them expect short term profits which is not in line with the principles of capital markets. The lack of equity culture cannot be easily and quickly compensated and it requires massive reforms in the educational system. So far this aspect of education has been neglected by most policymakers but in order to create a community of mindful retail investors with properly aligned goals, each country's efforts should be focused on developing a comprehensive training framework.

Propensity to save is also a driving factor for capital market development. With a few exceptions, in most of the countries the household savings rate is insufficient to >>>

>>> direct solid investment flows towards capital markets. In Bulgaria, for instance, more than 90% of household deposits are below the minimum threshold for sensible portfolio construction (considered to be around EUR 5,000). To a certain extent, this barrier could be overcome with the proliferation of retail-oriented investment products, such as PRIIPS, which combine low transaction costs and simplicity. That is why any EU regulatory initiative aiming at broader engagement of retail investors could play a very supportive role in capital markets development efforts. At the same time, however, regulators and policymakers usually combine any retail-focused measure or product with some very strong investor protection mechanisms which may result in excessively heavy burden on the institutions that offer such products to the public (e.g. credit institutions, insurers etc.) thus discouraging them to engage in that type of business.

Another factor affecting both sides, supply and demand, is corporate governance. In terms of supply of capital, Institutional investors always run to safety and would rather not invest at all than expose some of its investments to unreasonable risks which would affect their fiduciary duty. This is especially true for foreign institutions and is the primary argument for their prevailing risky perception of the entire region.

In terms of demand, most of the countries require a more systematic approach towards broader adoption of corporate governance practices among private companies. A qualitative change in corporate governance undoubtedly would be a really persuasive factor to invest in South East Europe coupled with country's efforts focused on developing a comprehensive and accessible training framework for increasing investor awareness. ●

Eugen Teodorovici

Minister of Public Finance, Romania

Further developing and growing the Romanian capital market

For most CEE/SEE countries the transition from centralised economies to functional market-oriented ones has been a challenge on multiple levels: political, social and even cultural. And although we have seen success come our way, there are still mountains to climb and rivers to cross until our citizens can reap all the benefits of economic growth. The CEE/SEE countries account for 20% of the EU's population, 8% of its GDP, but only 2.5% of capital markets activity. On average, capital markets in this region are about one third as developed as in the EU as a whole when measured for financial development.

Bearing in mind the lessons learnt from the financial crisis, we value highly our mission to prevent and to limit systemic risks in financial markets, but we also want to express our opinion that regulations should not be severed up further for the time being, given that it would come with unjustified increased costs and complexity. I want to mention that we noticed that some international banks have closed their equity trading operations in Romania over that last 5 years and I consider that increased regulation had a say in this.

The program of state-owned listing, started a few years ago, will be continued in the near future, which will add value to both new issuers (by increasing transparency and compliance with corporate governance rules), and the capital market (through >>>

>>> providing additional liquidity from which all market participants will benefit). We will also look into bond issuance by state-owned enterprises if the opportunity will arise, in order to kick start the Romanian corporate bond market and also to meet the existing substantial investors demand.

For Romania, we see issues on the supply side given the fact that the most successful companies are owned either by multinationals or by local entrepreneurs, in both cases with no intentions of taking this companies public. Creating tax incentives for issuers might help mitigate this. On the demand side, we see a limited number of individual investors given no cultural tradition of investing in the stock market, a limited public awareness and a general use of bank deposits for their savings by the households. Tax incentives for long term holdings (over 1 year) could increase the interest of the general public.

We have to find ways to further encourage local entrepreneurship, innovation and creativity. Microfinancing programs for startup companies are a good example, as "Start-Up Nation" worth 440 million EUR. Private equity and venture capital funds have had a beneficial but reduced presence on the Romanian economy so far and we will look for policies to encourage this, given the spirit of initiative and expertise added to the economy.

Despite loose credit standards driven by heavy competition among commercial banks, low interest rates and an improvement in economic conditions, as evidenced by declining bankruptcies and payment delays, the lending to SMEs often remains slow and with much higher interest rate costs compared to corporates. We plan to design regulation that supports a range of bank and non-bank financing instruments for SMEs and we will continue to support financing the SMEs through the capital market by either equity or bonds issuing. The companies need to develop a better understanding of the capital markets principles and advantages, as well as responsibilities, in order to understand the advantages provided by the stock exchange. We are committed to fully support this process, by working together with the industry participants.

Therefore, developing Romanian capital market in order to reduce the funding gap and to decrease the dependency on banking financing is a very important objective for us. The immediate goal of our strategy is to overcome the "frontier market" and obtain the "emerging market" status. This will increase the visibility of Romanian capital market especially to international investors, many of them subject to asset allocation constraints, who will be able to diversify their portfolios by investing in Romania. Competitive and sustainable financial markets, with adequate size in breadth and volumes, will provide support for the economic growth and it would also contribute to the development of Romanian economy. ●


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Andreas Treichl

Chief Executive Officer,
Erste Group Bank AG

Make banks less important!

Europe is a completely debt-oriented society. Therefore, when it comes to supporting companies, its banking system is significantly more important than it is in many other economies. This is even more the case for Central and Eastern Europe: Bank assets are on average equivalent to 81% of GDP – compared to 29% in the United States. On the other hand, CEE capital markets (bond and stock markets) are equivalent to only 78% of GDP – compared to 340% in the United Kingdom and even 350% in the United States. >>>

>>> So whatever we do in banking regulation in Europe has a substantially higher effect on our ability for the economy to grow than it has in the US, where companies can rely on a functioning capital market as an alternative funding source.

With that in mind, one would expect European politicians and regulators to consider the important role banks play for our economy and, as a consequence, for all employees. But I'm afraid that's not exactly the case.

Don't get me wrong – thanks to regulation, the European banking system in 2018 is substantially safer than it was in 2008. Banks are significantly better capitalized and less crisis prone than 10 years ago. Supervisory systems and tools as well as resolution mechanisms have improved tremendously. So can we say: "mission accomplished"? Maybe in the United States, where the threshold at which banks are considered systemically risky was just raised to 250 billion dollars; maybe in Asia – but definitely not in Europe. Here, anything above a balance sheet of 5 billion euros is systemically risky. The threshold for G-SIFIS is even going to be lowered to 100 billion dollars.

The US approach after the financial crisis was typical: We punish the banks, we repair them, the state makes a lot of money on it and then we regulate them such that they can help us make Amerika great again.

The European approach is: Taxpayers should never have to pay again. Therefore we need to control banks 24/7 on everything they do, irrespective of the impact on the growth perspective of the companies in Europe. I agree that taxpayers should not have to pay, but I don´t agree with the rest.

There are three reasons for this European approach:

1. The European political system is too complex to change direction quickly. The US and Asian countries are much better at that.
2. Europe is the most democratic, but also the most bureaucratic continent of all – regulators are bureaucrats and if nobody tells them otherwise, they will simply continue to regulate.
3. Recent regulation has made our banks safer, but it has also established a system that is so rigid that, in many cases, it can no longer supply companies with necessary funding – which is especially true for small and medium-sized companies.

What is the solution? Make banks less important! You might be surprised to read this from the CEO of a commercial bank, but we desperately need a functioning capital market in Europe and CEE especially. This would open for our entrepreneurs another way to finance their ideas, create prosperity by more innovation and make our economies more dynamic – and it would provide our citizens with the opportunity to participate in the success of our local economies in times of zero interest on deposits.

However, even if the right decisions are made today to advance the development of capital markets in Europe, it will take decades until we get there. In order not to lose the precious time until then, we should think about how European banks could replace some of the functions of a capital market until we have it developed. Such a bold plan could look like this: Banks with an NPL ratio of below 5% are allowed to level 1% of their RWA to start-ups and social business without guarantees and collateral. If the NPL ratio is below 3%, they should be allowed to double that to 2%.

It would not be so different from what some of the European Funds are doing, helping us to invest in SMEs in CEE and the Western Balkan region that need it so desperately.

Imagine the difference this kind of investment could make. It would be a sign of trust – not in the banks, but in the people in these regions, in the young entrepreneurs and social businesses. At the same time, it would plant the seed of a capital market culture, using the existing financial infrastructure to produce quick and positive results. ●

Pierre Heilbronn

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

Financial regulation in WB: all non-EU countries are equal, but some are more equal than others

In the aftermath of the financial crisis, a number of regulatory changes directed by the European Commission (and behind it the Basel Committee) were aimed at reducing risks in the EU banking sector. On the whole, we agree, these changes have achieved their aim in keeping underlying risks in the EU at bay. Some changes, however, appear to have unintended consequences on banking sectors of selected non-EU countries, especially those with a systemic presence of subsidiaries of Eurozone banking groups, as is the case in the Western Balkans (WB).

The treatment of sovereign exposures under the Capital Requirements Regulation and its impact on WB financial systems is particularly noteworthy[1]. Article 114 stipulates that risk weights on EU banking groups' exposures to EU governments and central banks, when in domestic currency, should be set at zero percent. However, risk weights on exposures to non-EU, 'third country' governments and central banks, even when that exposure is in domestic currency, should be in line with the credit assessment of an External Credit Assessment Institution, unless a "third country" is seen as applying "supervisory and regulatory regimes at least equivalent to those applied in the Union". In case of WB countries, which do not have an investment grade rating, nor a positive equivalence assessment, the risk weights applied on sovereign exposures are usually in the 75-150 percent range.

These risk weights on WB sovereign exposures do not only challenge the Parent companies of commercial Banks (affecting the profitability of their subsidiaries active in the region), but also WB central Banks and Governments. Namely, they affect their ability to conduct monetary policy – irrespective of the monetary policy regime; restrict fiscal policy making for Governments; and exert pressure on the local FX markets.

The impact on monetary policy stems from assigning risk-weights to mandatory reserve requirement deposited with central banks and central bank securities used in reverse repo operations. A mandatory reserve requirement is a monetary and macro-prudential instrument used widely in the WB. In countries with a currency board regime, this is virtually the only instrument of monetary policy. Assigning risk-weights to central bank exposures can severely limit the effectiveness of these instruments. Tightening of monetary policy, for example, based on higher mandatory reserve requirements might be completely offset by European banks acting in the opposite direction – reducing exposures to government bonds and thus injecting the very liquidity that the central bank is trying to mop up.

> *"The reduction of government exposures by subsidiaries of EU banks can exert pressures on FX markets."*
>
> - PIERRE HEILBRONN

Secondly, there is an impact on fiscal policy and public debt management. If, due to the introduction of risk-weights on sovereign exposures, the appetite of local banks is reduced, governments will turn to Eurobond markets and/or foreign investors. This can have negative repercussions for the financial stability of a country, as cross-border flows are inherently more volatile, the currency composition of public debt is adversely affected, and local capital market development is hampered.

Finally, the reduction of government exposures by subsidiaries of EU banks can exert pressures on FX markets. As banks choose to convert local currency stemming from sales of government bonds into FX deposits and/or invest in government bonds of EU countries, pressures on the FX market mount.

The banking sectors in the WB are currently experiencing significant liquidity surpluses, as evidenced by falling loan-to-deposit ratios and lackluster credit growth. Against the background of insufficient "bankable" demand, the inability of banks to invest these liquidity surpluses in local currency government securities has a negative impact on their profitability.

Although in some countries the impact may be currently muted, with any prospective tightening in monetary policy, and new regulation resulting in increasing capital requirements, negative effects may become more visible. On the margin, it could affect the decision of Eurozone banks whether or not to continue operating in these countries and any significant divestment decisions of a parent company could adversely impact the WB banking system stability, with potential political implications for those countries on the path of EU membership.

Having in mind the above, the WB countries should not just be "any third party" non-EU countries. They are: (i) official EU candidates, which sooner or later will become subject to EU regulatory bodies; (ii) they have a systemic presence of subsidiaries of Eurozone banks, whose share ranges from 60-90 percent of total banking assets; and (iii) thirdly, they have certain financial safety nets in place, including support and assurance that banking supervision policies are adequate[2].

Any changes to Article 114 are going to be very tricky, and it is likely that the interests of small countries, which do not have a seat at the table but whose banking systems are dependant on EU banks, will not be considered. I would nevertheless argue and leave you with the thought, that WB countries are "more equal" than other third countries, and should be treated as such. ●

1. The impact of the EU regulatory changes, including the Banking Union, has been focus of a dedicated work stream of the Vienna Initiative.
   The Vienna Initiative was launched at the height of the financial crisis in 2008/2009 to improve coordination between public and private stakeholders in preserving financial stability in Central, Eastern and South-Eastern Europe (CESEE). It successfully helped orderly deleveraging of Eurozone-based banks with subsidiaries in CESEE region.
   The Vienna Initiative 2 currently focuses on: (i) sustainable NPL resolution in CESEE; (ii) deepening and expanding Capital Markets Union to CESEE; (iii) raising the standard of WB bank regulatory regimes to levels equivalent with the EU; and (iv) identifying ways to improve financing innovation and innovative firms in CESEE.
2. As reflected in already signed Memorandum of Cooperation with EBA, and, for some countries, IMF programs.

Gertrude Tumpel-Gugerell

Supervisory Board Member, Commerzbank

Financing and investment are expanding - more needs to be done for sustainable growth

Financial markets in the CESEE region have recovered. But in the years after the crisis investment rates have been too low in view of the -on average- modest capital stock compared to the euro area. Only maintaining current capital to output levels would require the closure of a 4% of GDP investment gap.

While according to surveys firms do not necessarily see a quantitative gap in terms of capacity, they rather need to upgrade their machinery, equipment and ICT. Structural investment needs are especially perceived in R&D and innovation, human capital and skills.

The upgrading of the capital stock is important to boost productivity and thereby create sustainable growth rates for the future.

The EBRD finds a huge gap in physical infrastructure in the greater region including Turkey, Russia and countries in Central Asia of an estimated amount of 1,9tn €. The IMF sees a significant gap in the CESEE regional infrastructure.

A recent proposal to build a European Silk Road (WIIW 2018) assesses the considerable potential growth and employment impact of such a programme. Infrastructure improvement could lead to relocation of production sites to the region. Furthermore economic integration and political cooperation would be supported.

Bank financing is gaining dynamic in most countries of the region. Refinancing has shifted from foreign funding more towards domestic deposits.

Legacy issues like NPL have been reduced further to an average level of 5% with considerable differences between countries and –16% compared to a year ago.

Despite these positive developments the low level of equity capital remains a hurdle for future expansion and growth. Various policy initiatives in the context of CMU, Vienna Initiative and Structural Reform Support Service should be used to create a level and comparable playing field and make better use of technological investments by adopting similar.

"Demand for financing relies on confidence in the stability of trade relations and value chains across national borders."

- GERTRUDE TUMPEL-GUGERELL

What can policiy makers do to support further convergence?

- Make better use of structural and cohesion funds
- Put a focus on R&D and innovation capacity
- Invest in skills and education
- Invest in infrastructure and quality of projectmanagement
- Avoid public investment cuts during economic downturns
- Introduce regulation and standards as if being a member of the euro area or EU.

The recent innovation scoreboard published by the European Commission ranks CESEE countries among the moderate and modest innovators. It requires extra efforts and takes time to improve the position in this ranking.

Animals spirits' drive investment decisions, financing will follow. The supply should be available, demand relies on confidence in the stability of trade relations and value chains accross national borders. ●

Anita Angelovska Bezhoska, PhD.

Governor, National Bank of the Republic of Macedonia

Unbridling access to finance in Macedonia

Having proper access to finance is a main prerequisite for unleashing the growth potential and faster income convergence. In the past years, the financial depth measured as credit to GDP improved substantially, from 13% in 1997 to close to 60%, supported to a great extent by the entrance of foreign banks that increased competition and offered diversified financial products. At the same time, the economy went through financial integration process, in large part through FDIs that enhanced financing alternatives, by increasing access to finance from parent companies and to international financial markets.

Despite its rising availability, finance is bank-based and better access to it, for SMEs in particular is needed. The most recent data indicates that internal sources are important source of financing of companies, and the most important external ones are bank loans. Thus, banks account for about 90% of the total financial system and are mostly >>>

>>> foreign owned. Capital markets remain underdeveloped with market capitalization of around 23% of GDP. More diversified funding structures could increase resilience and help in filling financing gaps.

"Finance is bank-based and better access to it, for SMEs in particular is needed."

- ANITA ANGELOVSKA BEZHOSKA, PHD.

Various surveys note that access to finance is important constraint, for SMEs and start-ups in particular. The last wave of the SAFE survey in 2017 reveals that 13% of the surveyed SMEs perceive the access to finance as the most important problem in Macedonia, well above the EU average of 7%. While domestic banks do not face funding issues, they do pose loan requirements which not always can be met by SMEs. When specifying the obstacles, price of credit, complexity of procedures and collateral are stated as the main ones. The environment is even more challenging for start-ups, which in essence are un-bankable, but are forerunners of innovative growth. At the same time, the survey indicates absence of alternative financing, such as venture capital, crowdfunding or peer to peer lending. Given the importance of SMEs, which comprise 75% of the employment and 65% of the value added, it appears that improving SMEs financing options is of key importance for stronger growth.

In the local context, initiatives have already been taken to tackle the financing constraints. Certain programs are run by the state bank which facilitates credit to SMEs through external credit lines at more favorable terms, or by providing guarantee schemes for alleviating access to bank finance. A Fund for Innovation and Technology Development was established, aimed at improving access to finance for innovation and technological development through co-financing SMEs, or financing spin-offs. Financial regulatory framework has been reviewed for creating adequate environment for new financial services. To improve the infrastructure and stimulate capital markets, a regional SEE link project was implemented, supported by EBRD. Still, many challenges remain, related to corporate structures, quality and transparency of financial reporting, financial literacy of the companies and investors, including households that prefer holding savings in form of bank deposits. IFIs can play a pivotal role in helping the region to deal with similar obstacles, thus improving access to finance. ●

Jens Hagel

Managing Director,
BlackRock

Developing capital markets for the long term in Central and Eastern Europe

Developing Europe's capital markets has been central to efforts to return Europe to economic growth following the financial crisis. Central and Eastern Europe (CEE) still has plenty to gain from growing its relatively early stage capital markets, and harnessing the wider European political ambition to remove barriers to the flow of capital to investments throughout the Capital Markets Union (CMU). To put this take in perspective, the combined size of the asset management markets of all the EU Member States in CEE is still only at the level of Austria.

For CEE markets to become increasingly attractive to investors and issuers we make three recommendations:

1. Drive greater harmonisation. CEE capital markets would benefit from stitching together the patchwork of diverse legal frameworks in the region and achieving greater alignment on the interpretation of European rules and data standards.
2. Develop retirement solutions. The continued expansion of workplace and private retirement solutions should serve savers and contribute scale to capital markets.
3. Foster a long-term savings culture. The development of an investment culture should increase participation of savers with long-term patient capital to invest.

Drive greater harmonisation

For the small and medium size companies that typically underpin CEE economies, the greatest benefit of market-based finance is to increase access to, and to lower the cost of, capital. As capital markets grow and liquidity increases, the cost of finance can be expected to fall further. Capital market development can be largely attributed to the strength of the pension fund sector and how effectively it can attract investors. For savers, moving cash off the sidelines and into pooled, diversified investment solutions invested via the capital markets can bring the potential of additional returns, and puts capital to use in the economy.

However, diverse national rules can represent a significant operational barrier to the cross-border providers of pooled investment products. A greater degree of harmonisation of local market regulatory frameworks could attract a wider palette of appropriate products and services to CEE markets. In particular, alignment of interpretations of MiFID rules and data standards could make a material difference in reducing the costs of compliance with nationally specific requirements.

Develop retirement solutions

In many developed capital markets, occupational and private pension funds represent significant investors. The pooled contributions of hundreds or thousands of individuals give them scale capable of contributing meaningful liquidity and depth to capital markets. With populations aging in CEE, continuing the expansion of workplace and retirement solutions would serve the dual benefit of helping individuals meet future retirement income needs, and channelling capital >>>

>>> off the side-lines and into the economy. Cross-border initiatives such as the Pan-European Pension Product (PEPP) could also serve as a valuable complement to national retirement frameworks in this regard.

Foster a long-term savings culture

Both education and technology have important roles to play in developing an investment culture in CEE, and supporting individuals to invest for long-term goals, while contributing to the growth of capital markets. The benefit of risk reduction through diversification, long-term investment horizons, and the value of compounding of returns are not widely understood. Industry and governments must bring these key concepts to life.

Technology can be used to empower savers to take greater control over their savings and drive down the cost of giving advice and to enhance the saver's experience. Simple digital tools that aggregate an individual's future predicted retirement income from all sources, and provide a holistic view of what their future total retirement income is likely to be.

Putting the investor at the heart of future initiatives is key to realising the potential of the capital market in CEE over the long term.

The more coherent and investor centric the regulatory framework, the greater the potential flows of capital that savers will be willing to invest to both their own and the economy's benefit. ●

Peter Paluš

Head of Financial Unit,
Permanent Representation
of the Slovak Republic to EU

In search for the new financing means for micro, small and medium-sized companies

Given the structure of the Slovak economy, the removal of frictions in investment financing is one of the policy priorities.

From financing point of view, we can divide firms into three broad categories:

- First, firms not dependent on external financing. These are mostly large firms funded by foreign capital with direct credit line to the parent company – accounts for most of the private investments. This firms' category closes investment gap.
- Second, partially state-owned firms with large volumes of liquidity cushion on their balance sheets, i.e. energy corporations.
- Third, the most vulnerable group, micro, small and medium-sized enterprises (MSMEs). These are dependent mostly on bank style financing, which are costly and collateral demanding.

The banking sector in Slovakia has in recent years maintained relatively stable profitability. Their conservative business model oriented mainly on households does not motivate banks to develop products to satisfy the relatively more risky segment of MSMEs.

"One of the barriers why companies do not invest into innovations and development of capacities are frictions in funding projects, especially for MSMEs."

- PETER PALUŠ

Another possibility to finance MSMEs investment projects are European and International institutions such as the European Investment Bank (EIB) or the European Fund for Strategic Investments (EFSI). However, MSMEs are often unable to meet demanding administrative requirements and requirements on the size of the project.

Therefore, there is a thriving demand for alternative financing such as equity financing. Seed capital, Venture capital and Angel capital could fund those projects unattractive from the perspective of banks and others. To rump up alternative financing it is necessary to build functional infrastructure and develop marketable projects.

Slovak firms also belong to the category of low value-added and thus they occur at the bottom of productivity in eurozone. One of the barriers why companies do not invest into innovations and development of capacities are frictions in funding projects, especially for MSMEs. Therefore, we are working in Slovakia to create favorable financing conditions for this segment also with the policy aim to improve competitiveness. ●

II. FINANCIAL STABILITY CHALLENGES

Issues at stake

Much progress has been made since the financial crisis in mitigating systemic risks in the financial sector. However, some issues remain to be addressed notably in the capital markets area, while new threats are developing such as cyber-risk. In addition the measures needed to mitigate the systemic risks posed by banking and insurance activities still require some fine-tuning, so that they do not hinder long term investment.

Moreover, macro-economic risks stemming from protectionism, global indebtedness, monetary policy and climate-related developments could threaten the sustainability of the current global and EU economic expansion in the medium term.

Content

The safety of the financial system 10 years after Lehman

John Berrigan

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

More leveraged economies supported by more resilient financial systems? Time to stay vigilant

In the past ten years, most of the advanced and emerging economies have experienced a substantial rise in overall levels of indebtedness. This phenomenon is particularly remarkable, given that financial leverage lay at the root of the 2008/9 financial crisis.

Public-sector debt burdens have risen in the advanced economies, reflecting efforts to rescue their banking sectors to cushion the impact of the crisis on their economies with countercyclical measures. In the EU and the Euro Area, respectively, the average sovereign debt level is now at 82% and 87% of GDP respectively 87% (although with large cross-country differences), compared to 105% in the US and 253% in Japan. Public-sector debt burdens have also risen in the emerging economies, albeit from more moderate initial levels.

The private sector has also been accumulating debt in the advanced economies. After a temporary deleveraging in response to the crisis, corporate debt has been increasing, fuelled by sustained low interest rates. In some cases, corporate leverage is even higher than it was before the crisis. Household debt also remains high in the advanced economies. In the EU, household debt declined only slightly, and is currently at 50% (58% in the Euro Area), compared to 80% in the US and 75% in Japan. Again, a similar – albeit more moderate – trend is evident in the emerging economies.

These worrying trends in indebtedness reflect many years of benign financing conditions, including the exceptionally and sustained low interest rates which have restrained debt-servicing costs and incentivised borrowing. At the same time, these unusual financing conditions may be masking incipient vulnerabilities. As central banks are on their way to normalizing monetary policy, the expected rise in interest rates will imply higher debt (re)financing costs down the road, putting pressure >>>

>>> on governments and private-sector actors in meeting their obligations. This, in turn, may adversely affect bank asset quality and measures of capital adequacy.
How worried should we be? On the positive side, the regulatory response to the crisis has been reflected in a very substantial and broad-based deleveraging in the banking sector. Banks are also much better capitalised, with higher levels of liquidity than a decade ago. Other measures have been taken more broadly across the financial sector (e.g. Solvency II, MiFID II, BRRD, EMIR, AIFMD) to reinforce resilience. In the EU, public oversight has been reinforced through the creation of the ESRB, the ESA's, the Single Supervisory Mechanism and the Single Resolution Mechanism, while national authorities have improved their practices, including by increasingly implementing macroprudential policies. Furthermore, structures and mechanisms have been put in place to deal with severe financial distress, including the European Stability Mechanism and the Single Resolution Fund. Significant progress has been made towards a Capital Markets Union, which should help diversifying funding in Europe and contribute overall to more resilience in the system. On this basis, the global financial system has changed significantly and should be safer and better armed to weather potential shocks in the future. But, we cannot just rest on our laurels. The likely interaction of high levels of indebtedness and the normalisation of monetary policy is a potential source of macro-financial risk across the global economy and policymakers – in the EU and elsewhere – must remain vigilant. ●

José Viñals

Group Chairman,
Standard Chartered

Ensuring the safety and stability of the new financial ecosystem

Ten years ago, in Nice, EUROFI convened in the midst of the greatest financial crisis the world has seen. Since then, international standard setters, European and national authorities have taken steps to enhance the stability of the financial system, and in particular increase the strength of individual banks and reduce both the probability and impact of the failure of systemically important banks. Although work is still underway in terms of implementation of many regulations, today the financial system is overall safer and more stable. The question that remains is whether everything done so far will be enough to prevent the crises of the future, such as those that might arise from non-banks or even from the development of new technologies.

The shadow banking sector, whilst subject to ongoing regulatory scrutiny worldwide, continues to grow in importance. Policies introduced in recent years have dealt with the issues in this sector that are thought to have contributed to the last crisis, but, as acknowledged by the FSB, new forms of shadow banking are likely to emerge in the future, therefore demanding a forward-looking approach from the regulatory community. Further, the increasingly open nature of banking means financial firms face potential market disruption from multiple sources. Whilst regulators have so far focused much of their attention on the banking sector, the challenge for the future will be to ensure a stable financial ecosystem in which not just banks but also non-banks, including new players, are able to provide sound financial services to consumers while maintaining financial stability.

Some of the vulnerabilities of that new ecosystem are reflected in the increasing number of cyber-attacks. The emergence of new technologies affects industry >>>

>>> and infrastructure in every sector, but the systemic importance of banks and their fundamental role of being entrusted with customer and institutional assets makes them a primary target for cybercrime. Regulations, standards, technology development and the implementation of best practices all help mitigate cyber breaches, but they can never fully eliminate the risk.

This constantly evolving threat requires new thinking from boardrooms everywhere, and across whole organisations. The increasing costs of cyber-attacks, from USD3 trillion in 2015 to an estimated USD6 trillion by 2021, make substantial investment in a robust cyber security infrastructure essential, not optional. It is also essential that regulators take an internationally coordinated approach to dealing with cyber risk as this has a truly global dimension.

But as well as vulnerabilities, technology presents enormous opportunities and benefits for both financial firms and their customers. By embracing digital transformation, firms will be able to deal with the changing demands from customers for more seamless, timely and user-friendly access to banking services. This is why at Standard Chartered we have created a specialist entity known as the eXellerator, a global network of innovation labs which scan the market and seek out great ideas in the FinTech space.

Through numerous initiatives, and working in partnership with clients, tech firms, partners, and colleagues, we will be looking to develop solutions in a number of areas, including data science, artificial intelligence (AI), and cyber security.

The regulatory reforms that started in 2008, and continue to be implemented, have helped to make the financial system more stable and transparent. The fundamental role played by banks in terms of financing the economy reinforces the need to reduce the likelihood of another financial crisis. Disrupting technologies present both enormous opportunities for firms and customers, but also new challenges and risks.

There will need to be consideration of how technological developments might impact prudential rules, such as those dealing with liquidity and the linked assumptions about stickiness of deposits, and the related stress assumptions designed in and for a non-digital banking era. The new financial ecosystem demands that all market participants, both old and new, regulators and industry, ensure that the financial system remains sound and stable for the benefit of society today and in years to come. ●

Dr. Johann Strobl

Chief Executive Officer,
Raiffeisen Bank International (RBI)

Free banks from regulation and let them innovate!

Today, only 10 years after the outbreak of the financial crisis in the USA, the European Union is better prepared than ever to prevent and resolve future crises in the banking sector. We observed that the economic and financial crisis has been seized to fundamentally reform banking regulation, particularly in the Eurozone. When analyzing the sources of the crisis, we quickly understood that a diversified banking system is in fact a benefit for the European economy and enhances stability. All those banks, whether small, medium or large-sized, whether active locally >>>

>>> or cross-border or regardless of the business models they run, represent diversity. At the same time, such system reflects most the structure of the European economy which is composed of SMEs and large companies. Therefore, it is worth to undertake considerable efforts to preserve this "ecosystem". Consequently, we have to be aware that continuously adding additional rules and regulations create a systematic disadvantage for smaller banks.

Another aspect of the financial crisis was the alleged conflict of interest between the banking sector's home and host countries. Particularly the countries of Central, Eastern and Southeastern Europe (CESEE) - where often foreign banks' subsidiaries or branches are prominent - feared that financial stability and adequate credit supply for their economies was at risk.

Against this background, the banking sector together with the public sector launched the Vienna Initiative to avoid disorderly deleveraging and to ensure that potential cross-border financial stability issues are resolved. Various policy actions, notably in the supervisory area, were taken in the best joint interest of home and host countries. Tomorrow's regulatory framework should bear this in mind and abandon home-host gaps.

Today, Europe - and CESEE particularly - experiences continuously favorable economic conditions. The current situation isn't a coincidence, but it rather reflects the outcome of the manifold and determined reform efforts undertaken in the last years. In 2018 and 2019, the EU economy is expected to grow by over 2 % each year, with both internal demand as well as exports continuing to grow at a robust pace.

At the same time, labor markets will further improve and unemployment rates are set to decline. The current economic climate provides a window of opportunity for further strengthening of our region's resilience. The Austrian Presidency of the Council of the European Union stated that 'further measures are necessary, both at EU and at Member State level, to boost growth, employment and investment with a view to making Europe's economy more sustainable, more productive and more competitive'. Well defined measures with a specified timeline for execution are a prerequisite to successfully achieve that goal.

In spite of the regulatory efforts, reforms and achievements over the last years, European businesses, including banks, continue to face challenges. For example, compare price to book ratios of Eurozone banks' with those in America, Scandinavia or Australia.

Many of our banks struggle with lower profitability, certain legacy assets on balance sheets and low efficiency ratios given outdated network infrastructure in the midst of a technological revolution. It is no surprise that new agile competitors enter into the market. They operate with lighter structures, less regulation, third country financing and eye on income sources and customers that traditionally were served by European banks. To improve the situation, in my view protectionism or regulatory barriers would be unsustainable answers.

Rulemakers should rather focus their efforts on measures that remove obstacles for European businesses (eg, Gold-Plating) and let them innovate, compete and unfold their potential. We need to overcome home-host fears, have lagging regions on board (stop brain-drain) and foster investments in education, people and (IT) infrastructure. Many current proposals, including the Capital Markets Union, Sustainable Finance or the FinTech Action Plan, are important initiatives along that way.

We should be aware that the flood of new regulations as well as the build-up of the Resolution Fund and the Deposit Insurance Fund are limiting factors on investment and innovation.

Banks are much stronger now than 10 years ago. Free banks from regulation and let them innovate. ●

Isabelle Mateos y Lago

Chief Multi-Asset Strategist, BlackRock

More progress needed on Europe's Banking Union and Capital Markets Union

Europe remains dependent on bank finance to a large extent; the role of banks in the financing of economies has not changed dramatically since the period preceding the global financial crisis (GFC). According to BIS data as of end-2017, it has decreased from around 2/3 of the total stock of credit to the private sector to roughly 1/2 in the Eurozone, whereas it has been generally stable at a lower level in the US. Post-GFC regulatory reforms in G20 jurisdictions have also substantially reduced the amount of risk banks are allowed to take, and in many cases curtailed the scope for problems in one part of the bank to contaminate others. Banks now have substantially larger capital and liquidity buffers and, key central banks now subject the banks they supervise to rigorous periodic stress tests.

Investors in bank stocks and those hybrid securities now find themselves more directly on the hook in the event of a large economic shock, but arguably not more so than through exposure to other risky cyclical assets. The post-GFC changes imply that the banking sector should be significantly more resilient to future economic shocks, and should therefore cushion their impact instead of amplifying it through the financial system as in 2008 and, in Europe, in 2010 and 2012.

In Europe's case, the gradual move towards a greater role for non-bank sources of financing of the economy should further contribute to increased economic resilience. The development of market-based finance in Europe under the banner of Capital Markets Union (CMU), provides diversity of finance opportunities and thereby further improves financial resilience.

These improvements notwithstanding, it remains a serious weakness of the European financial system that both its banks and its capital markets operate on an overwhelmingly national basis instead of a pan-European one. This level of fragmentation makes it rather ineffective for risk sharing purposes. Unfortunately, the two initiatives intended to remedy this deficiency - the European Banking Union (EBU) and CMU - have not made the anticipated progress following the successful set up of the Single Supervisory Mechanism (SSM) and the Single Resolution Board (SRB).

Whilst progress on the EBU has been hostage to difficult to resolve questions around EU-solidarity and burden sharing, progress on the CMU has been limited. This is arguably due to poorly articulated goals and losing sight of core objectives. The need to break down barriers and promote more non-bank finance remains, whereas the controversial Review of the functioning of the European Supervisory Agencies (ESAs) and the broad-based sustainability package, whilst framed as CMU initiatives, have in fact distracted attention away from making real progress in this area.

Regrettably, game changing progress seem unlikely until after next year's European Parliament elections. This implies that real progress on the EBU and enabling

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>>> greater capital market finance in Europe by delivering the CMU, should be the next Commission's most pressing priorities.

Beyond the European level, the current context is one characterized by rising but substantially lower levels of aggregate private sector leverage than pre-GFC. Even in the US, where rising leverage has drawn the most attention, the private sector as a whole has a financial balance positive by 3% of GDP instead of negative 3.5% pre-crisis. Default rates are very low across advanced economies and asset quality in European banks has been improving steadily.

In this context, liquidity is a bigger risk than solvency. There is some evidence that post-GFC financial regulations and changes in technology have brought around changes in market structure, and as a result, potentially, liquidity in some markets. It's important to better understand financial institutions' incentive to provide liquidity, particularly in times of market stress.

In our view, investors are well advised at this point in the cycle to adopt an up-in-quality and up-in-liquidity bias in their portfolios. While current levels of leverage are made sustainable by a healthy earnings growth outlook (both for households and corporates) and still low interest rates, should growth falter or interest rates soar (perhaps in response to an inflation surprise or a higher risk premium), current levels of debt would quickly look more challenging. ●

Markus Ronner

Group Managing Director,
Head Group Regulatory and Governance,
UBS Group AG

Fragmentation risks undermining the value of the post-crisis reforms

The strong political and regulatory response to the 2008 financial crisis was key to regaining the confidence of consumers and investors in financial markets. Ten years after the crisis, Global Systemically Important Financial Institutions have significantly improved their resilience and resolvability by building strong capital positions and liquidity buffers, simplifying their legal structures, and enhancing their risk management and corporate governance. Moreover, new regulations and changes in market infrastructure have substantially added to the transparency and robustness of the derivatives markets.

The focus on TBTF and making the system more resilient also resulted in increased focus on local ring-fencing requirements by banking regulators. In an increasingly fragmented and regionally focused banking industry, however, a fine balance will need to be struck between self-sufficiency and unduly restricting the free flow of financial resources within global financial institutions. Constraining fungibility of a group's resources may, moreover, unduly restrict a firm's ability to manage a crisis effectively and cope with particular needs within its operations as a result of individual national regulators focusing on resolution rather than recovery. >>>

>>> The severe crisis required a very strong regulatory response in a short period of time. With hindsight, however, not all regulations proved effective and/or proportional with respect to cost and benefit. It is encouraging to see that some jurisdictions have started to refocus on the effectiveness and efficiency of regulation and its potential impact on the economy overall.

In this respect, it will be important to have a well-structured approach to reviewing – and possibly adjusting – current regulation, and prioritizing future regulation. The aim must be to achieve a good balance between continuity and targeted adjustment of an already highly developed regulatory regime.

Policymakers, regulators and the industry must have a common vision, a shared goal and transparency on further developing an efficient financial eco-system. Importantly, this includes also the unregulated industry, duly considering the substantial transfer of activity into shadow banking in recent years.

Whilst competition is welcomed, it should not go against the principle of transparent markets and equal treatment of participants, both to promote resilient financial markets and protect investors. The basic principle that should be followed is that similar activities and risks should be subject to the same regulation regardless of legal form or entity in which they occur.

Looking ahead, the – soon to end – decade of regulation will be followed by a new decade of digital transformation within the industry. Banks will need to free up resources to cope with these significant change requirements in business and operating models, and be able to rely on regulatory frameworks which will enable and indeed support a new way of doing business.

Thus, our combined focus shall increasingly turn to building the future rather than continuing to fix the past. A proportionate and stable regulatory regime will allow firms and their regulators to achieve the shared goal of a sound financial system that services clients fairly and supports the real economy. ●

NEXT EUROFI EVENT

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Supervision of EU and third-country CCPs

Steven Maijoor

Chair, European Securities and Markets Authority (ESMA)

CCP supervision: towards an improved governance and allocation of supervisory tasks

In the context of the review of EMIR, the Commission's proposal of June 2016, commonly referred to as EMIR 2.2, revisited the allocation of supervisory tasks and decision-making powers between ESMA, the National Competent Authorities (NCAs) and the Central Banks of issue (CBIs), for both EU-CCPs and Third Country CCPs (TC-CCPs). While the European Parliament has already voted on its proposal for amendments to the Commission's initial proposal, the Council has not yet finalised its own position. Given the upcoming UK's withdrawal from the EU by the end of March 2019, a timely completion of this legislative process is essential. It is especially important that the EU is ready on time for the recognition and supervision of Systemically Important TC-CCPs (i.e. Tier 2 CCPs).

The three EU Institutions views' are broadly aligned with respect to the review of the recognition regime for TC-CCPs, according to which ESMA would be tasked with the determination and recognition of Tier 2 CCPs and assigned some supervisory tasks on recognised Tier 2 CCPs. The amendments to the initial Commission's proposal improve the arrangements for the involvement of relevant CBIs in important decisions on Tier2 CCPs. The key change implies moving from consent to a consultation with a "comply or explain" approach. However, the regulatory role of CBIs could still be specified further and be adequately framed in the amendment proposal to the ECB Statute. Indeed, the regulatory requirements to be decided upon by CBIs should be consistent with the EMIR framework and any overlap should be limited to aspects that are relevant to the implementation of monetary policy. Parallel regulatory processes can result in inconsistencies and lack of clarity for all involved.

Concerning the review of the authorisation regime for EU-CCPs, there is a range of views on the most appropriate allocation of supervisory tasks and decision-making powers between ESMA, the NCAs and the CBIs. I believe that an enhanced role for ESMA as proposed initially by the Commission would help in achieving further supervisory convergence and overcoming some shortcomings of the current regime, without altering the current decentralised approach in day-to-day CCP supervision – which will remain with NCAs. I appreciate that there may be different levels of involvement of ESMA depending on the actual matter to be decided. Hence, a bucketing approach, as introduced in the European Parliament proposal, is a sensible way forward. However, the list of decisions on which an NCA should either seek consent by, consult or

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>>> simply inform ESMA, should reflect their impact on the resilience of EU financial markets and relevance for supervisory convergence across the EU.

Finally, with respect to governance arrangements, while understanding the aim of the Commission's initial proposal of a CCP Executive Session to strengthen the independence of ESMA decision-making, I find the alternative option involving a CCP Supervisory Committee as in the European Parliament's proposal a more effective arrangement. This proposal is consistent with the current institutional set up of ESMA and the ultimate decision-making powers of the Board of Supervisors. Such a Supervisory Committee would support cooperation with the relevant NCAs and CBIs and facilitate the consultation of CBIs when required. In terms of composition, I personally believe that the number of new ESMA directors should be commensurate to the new tasks of ESMA and its CCP Supervisory Committee. More importantly, considering the parallel legislative process on the ESAs review, the proposed governance arrangements in the two proposals should be integrated as much as possible, to keep ESMA's decision-making both efficient and agile. For example, this can be achieved by combining the responsibilities of ESMA's directors in both the CCP Supervisory Committee and the future Executive Board. ●

Danuta Hübner

MEP, Committee on Economic and Monetary Affairs, European Parliament

What future for the supervision of CCPs?

The review of the architecture for the supervision of CCPs has been keeping the co-legislators busy for over one year, since the Commission issued its proposal amending EMIR on 13 June 2017.

Over this year, progress has been made in the discussions taking place at the Council. The European Parliament has adopted its position, voted on 16 May 2018 in the Committee on Economic and Monetary affairs.

As regards the architecture for the supervision of CCPs authorised in the Union, we in the European Parliament are proposing to distinguish three types of supervisory decisions. There will be decisions taken by national competent authorities that will require the prior consent of ESMA, other decisions that will require the consultation of ESMA and finally decisions that will be taken solely by national competent authorities. The logic followed by the Parliament has been to require the consultation or the consent of ESMA in areas where experience has proven the existence of a lack of supervisory convergence or where there already exists some cross border coordination through the college structure. In parallel, new measures to strengthen current EMIR supervisory colleges have been introduced.

The aim of this system is to entrust ESMA with tasks where its involvement has a real added value and to allow it to progressively, starting from those tasks, develop itself as a central supervisor. In view of the rise in the importance of CCPs and also of the new challenges in the area of CCPs created by the withdrawal of the UK from the Union, convergence in the area of CCP supervision needs to be enhanced to the greatest extent possible. To achieve this goal, cooperation and exchange of experience and of best practices between ESMA and national competent authorities will be crucial, as will be adequate resources for ESMA.

As regards third country CCPs, we had intense debates on the proposal of the Commission to allow itself, acting on a recommendation from ESMA, to deny >>>

>>> recognition of a third country CCP based on its systemic significance for the Union. We supported the possibility of denying recognition of a third country CCP, but wished to make the procedure for taking such a decision less discretionary and more evidence-based. This is why, before the Commission decides to deny recognition, we propose ESMA to be asked to conduct a real cost-benefit analysis of this decision and of its impact. Also, in order for the Commission to be able to mitigate possible unwanted disruptions of any denial of recognition, it will be allowed to deny recognition only to some clearing services. It will also be able to set an adaptation period for clearing clients and members of the CCP being denied recognition.

Then, in order for ESMA to supervise CCPs in the most effective and efficient way, we in the European Parliament are proposing to create, within ESMA, a specific internal committee, which will be part of the current structure of ESMA. Crucially, this committee will deal with the supervision of both EU and third country CCPs.

Finally, a major topic of discussion in the European Parliament was the involvement in the supervision of EU and third country CCPs of the central banks of issue of the main currencies cleared. On this issue, we have tried to achieve a very delicate balance between legal certainty and flexibility. For instance, in order to create additional legal certainty, a list of requirements that central banks of issue would be able to impose on systemically important third country CCPs has been inserted in the regulation. However, in order to allow the subsequent addition of requirements that experience could possibly demonstrate to be necessary, the Commission on request of the central bank may extend this list.

We are now looking forward for the Council to adopt its position on the review of the supervision of CCPs.

Negotiations with the Council will be likely to focus on the two main points of the regulation: the role of the central bank of issue in the supervision of CCPs and the exact allocation of competences between ESMA and national competent authorities in the supervision of EU CCPs.

We stand ready for those discussions. ●

Paul Pitnik

Senior Legal Advisor, Legal Affairs of Banks and the Capital Market, Federal Ministry of Finance, Austria and Chair of the Council Working Group on EMIR CCP Supervision

Review of the supervision of EU and third country CCPs: state of play

On 13 June 2017, the European Commission published a legislative proposal with the aim to review the supervisory framework for EU and third country CCPs. This proposal was followed by a Recommendation of the ECB in July 2017 to amend the Statute of the ESCB and the ECB in order to grant regulatory competence over clearing systems, in particular CCPs, to the ECB. Since then, both proposals have been under scrutiny of the Council and negotiations between the Member States are to be continued under the Austrian Presidency.

"The chapter on recognition and supervision of third country CCPs is already highly advanced."

- PAUL PITNIK

During this time, considerable progress could be achieved within the Council Working Group regarding certain areas of the proposals (keeping in mind that these parts ultimately remain subject to a political agreement on the whole proposal within the Council, followed by trilogue negotiations with the European Parliament). The chapter on recognition and supervision of third country CCPs is already highly advanced; based on the Commission's initial proposal, it was further developed during Council's negotiations, now comprising inter alia the following key features:

- Classification of third country CCPs into "Tier 1" and "Tier 2" CCPs as part >>>

>>> of the recognition process, the latter category referring to CCPs which are systemically important to the financial stability of the European Union or one of the Member States.

- Application of additional prudential requirements to Tier 2 CCPs combined with comprehensive supervisory powers of ESMA.
- As a measure of last resort, denial of recognition of a third country CCP or of some of its clearing services in cases where they are of such substantial systemic importance that the application of and compliance with additional prudential requirements would not sufficiently address the financial stability risk for the European Union or one of the Member States.
- Establishment of an "ESMA third country CCP Supervisory Committee" which will – as a preparatory body – be in charge of all tasks and decisions assigned to ESMA in the context of third country CCPs.
- Establishment of an "ESMA third country CCP College" for information sharing purposes.
- Involvement of Central Banks of Issue in the recognition, supervision, review of recognition and withdrawal of recognition of third country CCPs, inter alia by means of consultation procedures in areas affecting their monetary policy responsibilities, such as margin or collateral requirements or liquidity risk controls of a third country CCP.

Notwithstanding the progress reached concerning the chapter on third country CCP supervision, the area of EU CCP supervision and the amendment to the Statute of the ESCB and the ECB require further preparatory and coordinating efforts within the Council during the Austrian Presidency in order to pave the way for the initiation of trilogue negotiations with the European Parliament. The main outstanding issues in this context which Member States will have to further reflect on are the future role of ESMA within the supervisory framework for EU CCPs as well as the final calibration of the involvement and powers of Central Banks of Issue with regard to CCPs. ●

Erik Tim Müller

Chief Executive Officer,
Eurex Clearing AG

CCP supervision: ensuring stability to protect EU taxpayers

Since Eurofi last spring, significant progress has been achieved on EMIR CCP Supervision, also known as EMIR 2.2. The efforts of the European Parliament and Member States have brought a number of valuable clarifications regarding the access of 3rd country CCPs to European markets – strengthening financial stability and the protection of EU taxpayers.

They have confirmed the central role of the equivalence decision framework and clarified the criteria and process to allow for an orderly de-recognition for substantially systemic CCPs, which clear key European products of direct relevance for the Union's financial stability.

Without doubt, and especially against the background of Brexit, a risk-based approach for 3rd country CCPs is essential to avoid financial stability risks and ensure the ECB's ability to fulfil its monetary policy mandate, a critical key element to retain the means to safely navigate the bloc also through stormy times.

We at Deutsche Börse Group take the legitimate political concerns very serious and contribute with our market-led solution that simultaneously caters for concerns by market participants, the Eurex Clearing Partnership Programme. Establishing a credible alternative liquidity pool will support market participants in their contingency planning but also help the market transition to a healthier market structure, thereby not only reducing concentration risk but also strengthening competition and choice for clients.

However, in order for the EU27 to ensure its Brexit readiness in the context of CCP supervision, the related questions around EU CCP supervision will have to be solved. From a Eurex Clearing perspective, we have had a very positive experience with the existing EU CCP supervisory system: interactions with our National Competent Authorities as well as the EMIR college run efficiently and prove effective.

Recent case studies support the view that the current EU CCP supervisory framework has delivered on expectations: on 24 June 2016, the day after the Brexit referendum, markets went through a similar shock compared to the default of Lehman Brothers. Yet, they remained stable and integer, thanks to significantly strengthened risk management and regulatory frameworks.

Against this background, it appears difficult to identify failure when it comes to existing EU CCP supervision. Nevertheless, we understand the push for a greater harmonisation of EU supervisory practices: the increasing size and cross-border nature of CCPs, their nodal position in financial markets, as well as their relevance for the proper conduct of monetary policy.

"A credible alternative liquidity pool will support market participants in their contingency planning."

- ERIK TIM MÜLLER

However, it remains critical to remind ourselves that a discussion about CCP supervision is by necessity a discussion about financial stability – as it concerns the neutral and independent risk managers of financial markets. Against the background of the crisis, we can safely agree that such stability should not be compromised – never, at any point.

Therefore, the ultimate answers to the questions around EU CCP supervision may likely be found in the right balance between theoretical views on how the system should look like and the practical reality of how the system works best to ensure stability and integrity in the interest of EU taxpayers. ●

Daniel Maguire

Chief Executive Officer, LCH Group

The need for globally integrated markets to support financial stability

The OTC derivatives reform provides a good illustration of regulators working together to achieve a framework that enhances international standards while avoiding liquidity fragmentation that would hurt the real economy - as OTC derivatives are predominantly used to hedge real economy activities. In imposing the clearing of OTC derivatives - thus reducing systemic risks in the system – G20 Leaders have ensured not to create fragmentation that would have reduced efficiencies and resulted in a lack of access to liquidity.

Before the 2008 crisis, OTC derivatives markets were mainly bilateral: in 2009 only 40% of OTC IRS were centrally cleared. As most exposures were bilateral, contagion risks increased due to the interconnectedness between market participants. This generated a lack of visibility and precipitated a loss of confidence and of liquidity. This has led regulators around the globe to review the functioning of OTC derivatives markets with the objectives to mitigate systemic risk and improve transparency.

Increasing central clearing is important to address these shortcomings - by 2017, 83% of OTC IRS were centrally cleared. When mandating central clearing, the G20 Leaders were mindful of the global nature of OTC derivatives markets and the benefits it brings in terms of systemic risk, efficiencies and reduced costs: they focussed on maintaining their global nature and avoiding market fragmentation that would create unintended risks affecting global financial stability.

OTC derivatives markets need internationally integrated clearing services to function efficiently. Access to a global liquidity is critical especially in times of market stress. LCH SwapClear clears IRS in 21 currencies for clients established in 60 jurisdictions. Internationally integrated clearing services support financial stability as they allow the diversification of risks and access to broader liquidity pools for market participants to hedge their risk – for e.g. 75% of euro-denominated OTC IRS is traded by non-EU entities. The fragmentation of efficient global liquidity pools would increase risk through the creation of smaller liquidity pools with reduced number of counterparties available.

It is an absolute imperative for EU customers to have direct access to global liquidity to efficiently hedge market risks arising from real economy activities. OTC derivatives markets need clearing services that reflect their international nature of markets in order to support their trade. Regulators need to be able to monitor the risks while avoiding market fragmentation, through deference, cooperation arrangements and the direct supervision of specific clearing services.

"OTC derivatives markets need clearing services that reflect their international nature of markets in order to support their trade."

- DANIEL MAGUIRE

In the EU, these solutions could be achieved through direct and proportionate supervision of third country CCPs without cutting off EU firms from international liquidity and diversified risks pools putting them at a competitive disadvantage as deep liquid markets allow customers' access to best execution pricing. A balanced approach supported by the application of EMIR, the direct supervision of ESMA and ex ante agreements would allow the market to continue to strike the right balance originally defined by the G20 Leaders a decade ago. We should not undo the work undertaken by the G20 since the financial crisis. ●

Jochen Metzger

Director General, Payments and Settlement Systems, Deutsche Bundesbank

It's the liquidity: why CBIs need to be involved in CCP supervision

The Eurosystem, as the central bank of issue (CBI) for the euro, is an integral part of the current European supervisory approach to central counterparties (CCPs). Its involvement is mainly based on concerns regarding CCPs' liquidity risks and how these are dealt with. From a CBI perspective, liquidity risk can heavily affect central bank tasks. For instance, the failure of a CCP to meet its own payment obligations could potentially lead to liquidity strains for its participants, thus impairing the smooth functioning of payment systems.

Moreover, in the event of a severe crisis at a CCP, which is most likely to occur under stressed market conditions, the national central banks of the Eurosystem might be asked to provide liquidity for collateral – albeit at their own discretion – to either the CCP itself or its participants. Consequently, the CBI needs to be actively and continuously involved in all liquidity issues. A rather limited involvement >>>

>>> at the onset of a crisis does not suffice. The European Commission (EC) has already acknowledged this point in its proposal to revise EMIR. The proposal calls, inter alia, for specific CBI competences related to liquidity risk for both EU and third-country CCPs.

"The CBI is ultimately responsible for all liquidity risk."

- JOCHEN METZGER

In addition, the EC proposal foresees that third-country CCPs be classified as either non-systemically important or systemically important (or, in certain cases, even substantially systemically important). From a CBI perspective, any such determination needs to consider liquidity risk metrics. In this regard, the EC proposal tasks ESMA with determining, on the basis of several criteria, whether a third-country CPP is systemically important. Generally, these criteria are rather openly worded, leaving ESMA some scope for interpreting how to ultimately determine systemic relevance. For instance, ESMA is supposed to consider the effect that the failure of or a disruption to the CCP would have on financial markets, financial institutions, and the broader financial system.

From a CBI perspective, such wording certainly encompasses the negative effects of failures in the CCP's liquidity risk management system. However, there is no guarantee that ESMA will take this into account. Therefore, it is even more important that the European Parliament's ECON committee go one step further in its report on the EC proposal and require the CBI to be consulted before the systemic importance of a third-country CCP is determined. This would help to ensure that liquidity issues are sufficiently covered.

Even though the original EC proposal does not differentiate between a CCP's different service offerings, it is apparent that some product categories entail greater inherent liquidity risk than others. For example, interest rate swaps, in particular, and repos are subject to high liquidity risk, whereas the liquidity risk of credit default swaps is less significant. For repo trades, liquidity risk is directly linked to the huge values outstanding, whereas for the clearing of interest rate swaps it stems from the extensive margining requirements. Regardless of the source, the CBI is ultimately responsible for all liquidity risk, particularly in crisis situations. ●

Laurence Caron-Habib

Head of Public Affairs, Strategy and CSR, BNP Paribas Securities Services

CCP supervision – securing the right success factors

In a context where CCPs have gained more and more importance in the stability of financial markets all over the world and in Europe in particular, it is of upmost importance that they are properly supervised, including those from third country jurisdictions, and that a true level playing field prevails for all stakeholders involved in clearing activities. The European Commission's proposal issued in June 2017 on supervision of EU and third country CCPs is intended to address these legitimate concerns and is fully aligned with the project to develop of a true Capital Market Union across the European Union. In addition, Brexit increases the necessity to rethink the current supervisory set up for non-EU CCPs whereas experience has revealed some deficiencies in the existing framework.

Over the last months, the European Commission's text has generated several debates on what should be the best approach to enhance the supervisory framework for both EU and third country CCPs. With regards to EU CCPs, BNP Paribas supports the initiatives designed to overcome the persisting fragmentation in supervisory practices. Such initiatives should benefit to the European financial market as a whole through a better assessment of global systemic risk and a level playing field among EU CCPs. However, this approach will be successful only if a minimum of pre-requisites are observed. Beyond the need to get further clarity on coordination between ESMA, national competent authorities and central banks of issues, it must be ensured that ESMA has on-boarded the right competences on CCP supervision and that simple, efficient and clear decision-making mechanisms are adopted in the end.

For non EU-CCPs, main hot topic is about the potential need to re-locate Euro-denominated clearing in Continental Europe in case of highly systemic CCPs and on the impact this could have in terms of costs and fragmentation of liquidity for the industry. We understand that the draft proposal as currently negotiated at European Parliament and Council level would create a situation of un-level playing field between EU27 and non-EU27 market participants as the latter would not be obliged to clear their Euro-denominated transactions concluded with non-EU27 clients on EU CCPs.

"It is key to safeguard a real level playing field between European and non-European players by ensuring that any change applies similarly to both."

- LAURENCE CARON-HABIB

It is key to safeguard a real level playing field between European and non-European players by ensuring that any change applies similarly to both. One situation where only European clearing members would have to comply with re-location constraints would be highly damaging in terms of competitiveness and costs for European players as it is likely that the liquidity in the EU-CCPs will be much lower than the liquidity remaining in the non EU-CCPs (75% vs 25%). Such an outcome would be also quite negative for end-investors as it would significantly reduce their options to select their clearing members in an environment where many players have already decided or been forced to exit this business.

Last but not least, and whatever the final decision will be on the specific case of Tier 2 third country CCPs, BNP Paribas as a global player in the clearing space will have the capacity to adapt accordingly, thanks to our presence in all major clearing places. It is however essential that a minimum of time is available for the effective implementation of a new framework. Transfer of contracts from one CCP to another cannot be performed immediately; transitional period and grandfathering clauses have to be part of the final deal. ●

Risk reduction in the EU banking sector

Pablo Hernández de Cos

Governor, Banco de España

It is time to move forward on risk sharing policies especially with regard to EDIS

For the banking union to work effectively, risk reduction and risk sharing measures should go hand in hand. Otherwise, while stress events in the banking sector are expected to be milder as result of the reforms undertaken, if risks materialise we may still face fragmentation and lack of policy coordination.

We have taken decisive steps in the EU to reduce risks stemming from banks. In particular, two key milestones were achieved: the full operationalisation of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). Moreover, the Risk Reduction Measures (RRM) Package proposed by the EU Commission is in its final round of negotiations. This is a very positive step and it would be important to finalise this regulation in the upcoming months.

The reduction of Non-Performing Loans (NPLs) is challenging since progress on this matter also depends on the existing macroeconomic conditions. However, we have been also observing important advances. The Spanish experience illustrates this. Spanish institutions have reduced the volume of NPLs to the resident private sector by 58% from its peak in December 2013, to €79 billion in April 2018. Besides, the gross book value of foreclosed assets by end-2017 was slightly above €58 billion, which represented a fall of 29% with respect to the maximum reached in December 2014.

Despite all these positive developments, this is an area where carefully design policy measures can help. The EU Commission package to tackle NPLs seems to be a step in the right direction. For instance, backstop measures for new NPLs will incentivise right credit and management policies looking forward.

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

The Banking Union will remain incomplete until a fully-fledged EDIS is in place. This has a number of benefits that are pivotal to ensure a truly banking union. First, it equalises the level of depositors' confidence across the single market. Second, it helps to delink the depositor protection from the depositor location, thus contributing to reduce the link between banks and sovereigns, and also strengthening the depositors' protection to local shocks. Finally, it reinforces the level-playing field.

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>>> Another outstanding initiative to complete the Banking Union is the common financial backstop for the Single Resolution Fund (SRF). We welcome the Commission´s recent proposal for a Regulation on this area. It is necessary to prioritise its operationalization while guarantying that the magnitude of this backstop is sufficient to ensure banks can be resolved effectively.

One matter that is hindering the completion of the Banking Union, and in particular the idea of a fully-fledged EDIS is the current regulatory treatment of sovereign exposures, where changes have been demanded as a pre-condition.

However, sovereign risk has very special characteristics, plays multiple roles in financial markets and the economy, and interacts with monetary and fiscal policy. For these reasons, standard prudential tools do not work effectively in the case of this risk. The best way to tackle this problem is to address its root causes. For the UE this means to continue strengthening banks' resilience in order to prevent that stress in the banking sector spreads to the sovereign. It also means to continue strengthening the economic governance of the EU. All this justifies a holistic and flexible approach for any policy assessment on this matter.

The Banking Union will remain incomplete until its third pillar, EDIS, is in place. There is a need to move forward on this crucial issue, as well as on the common backstop for the SRF, designing a clear and certain road map to EDIS and reaching an agreement for its implementation date. No doubt this requires high prioritisation of this issue in the European regulatory agenda, but the expected benefits of a truly Banking Union deserve the efforts. ●

Dr. Boris Vujčić

Governor, National Bank of Croatia

In praise of supervisory vigilance in dealing with non-performing claims

Following the fallout from the 2008 financial crises, the Croatian economy suffered the second deepest recession in the EU. Despite the continued good performance of the banking sector throughout the crisis in terms of capital adequacy and profitability, the prolonged recession left a heavy toll on the level of non-performing loans (NPLs), which peaked above 17% at the end of 2014, reaching a level three times higher than the pre-crisis level. While cyclical factors weakening the borrowers' financial conditions and their debt servicing capacity were the main causes of the rapid accumulation of NPLs, their persistence was underpinned by structural weaknesses, such as slow court procedures and the absence of an efficient secondary market for NPLs. Moreover, the inflow of new NPLs at the beginning of the crisis reduced their coverage by loan loss provisions to a level below 40%.

Faced with rising NPLs, falling coverage and reluctance on behalf of banks to acknowledge potentially large write-offs needed to repair their balance sheets, the central bank decided to take corrective action in 2014. The necessary stimulus for banks to deal with accumulated NPLs was provided by the decision to impose stricter provisioning requirements on the basis of the age of each non-performing exposure. Requirement to provision for at least 30% of NPLs that are two years past due, and add another 5 percentage points every six months, regardless of the collateral, was designed to tackle not only new NPLs, but also legacy stock. >>>

>>> As a result of the new regulation, already by the end of 2016, loan loss provisions gradually increased and NPL coverage exceeded 60%, a level well above the EU average. However, it has to be noted that the incremental rise in loan loss provisions was eased by the previous central bank policies requiring banks to build up their liquidity and capital buffers over the long period of growth prior to the financial crisis, bringing the capital adequacy ratio of the banking system above 21% on the eve of tightening provisioning requirements.

The rapid increase in NPL coverage following the change in central bank policy noticeably reduced the gap between the book value of non-performing loans and their market value, thus encouraging banks to start selling NPLs to investors. This process was eased by the emergence of enterprises specialized in the collection and management of non-performing claims as well as by wider effort across European banking groups to repair their balance sheets. Croatian banks sold about 2.5 billion euros of NPLs between 2014 and 2017, amounting to almost half of their NPL stock at the end of 2013. Accelerated sales of NPLs from 2014 onwards improved asset quality and the NPL ratio declined below 12% by the end of 2017. Even though the decrease in the NPL ratio was primarily driven by the sales process, return to economic growth also helped to some extent.

While the improvement of the quality of banks' loan portfolios has been encouraging so far, there is no room for complacency. The NPL resolution so far has mostly been driven by the sales process, while banks resolved only a smaller portion of their NPLs internally. Also, while removing NPLs from the banks' balance sheets has provided a welcome respite and an opportunity to refocus their businesses on new lending, the potential "growth dividend" of the NPL disposal process largely rests on the successful "digestion" of NPLs by the debt collection companies. This is particularly important as the effectiveness of the court enforcement of NPLs, a major structural impediment to NPL resolution, has improved only in a piecemeal fashion over the recent period. The arguments above speak in favor of supervisory vigilance, both in good times to ensure that new lending is underpinned by sufficient capital buffers, as well as in bad times to make banks acknowledge bad business decisions in a timely manner and move on. ●

Sharon Donnery

Deputy Governor, Central Banking, Central Bank of Ireland

The steps taken towards the reduction of non-performing loans in the euro area

A decade on from the start of the crisis, despite much progress, non-performing loans (NPLs) remain stubbornly high in the euro area, and well above international standards, with the scale of the problem differing significantly across member states. Elevated levels of NPLs affect banks in numerous ways, increasing capital and funding costs and reducing profitability. NPLs also affect the real economy as the supply of credit to households and businesses is inhibited and resources, which could be put to better use, are diverted to deal with NPLs. Due to these factors, the Single Supervisory Mechanism (SSM) has taken several steps to tackle the problem.

The journey to deal with NPLs began with the 'Comprehensive Assessment [1]' of 2014. Subsequently, it became evident that the approach to dealing with NPL workout and resolution varied across Member States and that a more proactive supervisory role was needed. To address this, ECB Banking Supervision established a High Level Group to develop a consistent approach to the supervision of NPLs. This led to comparative work on a 'Stocktake of national supervisory practices and legal frameworks related to NPLs[2]' in 2016. A key action which followed was the publication of the 'Guidance to banks on NPLs[3]' in March last year, which set the standard for NPL management, while allowing for the differing positions of individual banks and the varying contexts in which they operate. While it is necessary to consider heterogeneity, the SSM must also strive to address key vulnerabilities in banks in a consistent manner that ensures fair and equal treatment. To this end, banks are assessed against their peers and any deviations from the principles set out in the guidance must be justified. The supervisory expectations outlined in the guidance have been incorporated >>>

>>> into the Supervisory Review and Evaluation Process (SREP), thus becoming a consistent feature of the ECB's approach to banking supervision.

The ECB subsequently published an addendum to the Guidance in March this year, setting out supervisory expectations for the provisioning for new NPLs. The addendum supplements the qualitative NPL Guidance and is also complementary to the European Commission proposal, which would result in a binding pillar 1 requirement for newly originated loans that become non-performing. However, the addendum is still vital, as supervisors have to assess and address institutions-specific risks which are not already covered or which are insufficiently covered by the mandatory prudential requirements in the Capital Requirements Regulation. The elements of the Commission proposal aiming to further develop secondary markets for NPLs and to introduce greater harmonisation across national insolvency frameworks are also important, as there are several options to tackle the problem of NPLs, including sales or workout. Furthermore, in July this year, the ECB announced additional steps in the supervisory approach to the stock of NPLs. Bank-specific supervisory expectations will be set for the provisioning of the stock of NPLs. These will be guided by individual bank's current NPL ratio and main financial features in a consistent manner across comparable banks. The aim is to achieve the same coverage of the NPL stock and flow over time.

As a result of this, while progress has been made – the NPL ratio of Significant Institutions has decreased from 8 per cent in 2014 to 4.9 per cent in Q4 2017– this must be sustained. Taken together, the steps taken by ECB Banking Supervision and other stakeholders, have created an environment where banks are clearly expected to ensure a deliberate and determined reduction in NPLs. In addition, steady economic growth in the euro area has contributed to a window of opportunity to address NPLs and to create a healthier and more stable banking system. This opportunity should not be squandered. All stakeholders have taken difficult steps in this journey – we must continue to display patience and resolve moving forward. ●

1. https://www.bankingsupervision.europa.eu/ecb/pub/pdf/aggregatereportonthecomprehensiveassessment201410.en.pdf
2. https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.stock_taking2017.en.pdf
3. https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf

Andrei Magasiner

Corporate Treasurer, Bank of America

De-risking through capital markets

I would characterize the main challenges to improving the conditions for economic and financial stability in Europe as two-fold:

- Structural. Europe is much more "bank-centric" than US and Asia. Around 70% of corporate debt financing is provided by banks, compared to 30% in the US and 45% in Asia. And around 30% of EU's outstanding government debt is held by banks. Alternative funding sources are limited, due to less developed and fragmented capital markets, meaning a high dependency on banks for the transmission of monetary policy. The risk of contagion between banks, governments, and real economy – the so-called "negative feedback loop" – is structurally higher than peers.
- Functional. The European banking sector has not dealt with legacy bad debts as fast as other major economies. Non-performing loans (NPL), while down from its peak in 2012, still represent around 4% of total outstanding loans. In US and Japan that ratio is closer to 1%, likely due to significant write-offs and recapitalisations early on in the crisis, and then supervisory intensification, for example through stress testing, also hastened the repair.

In Europe, the "negative feedback loop" has been prolonged and the economic recovery slower. Without picking up the pace of reform, Europe is left more vulnerable to near term exogenous shocks – for example, the brewing geopolitical frictions on global trade together with limited fiscal and monetary capacity.

Initiatives are underway to address the structural "over-banked" problem through Capital Markets Union, but this will be will be complex, political and therefore take time to reap rewards. The Risk Reduction Measures initiative seeks to address the functional NPL problem – however, urgency is required while economic conditions remain benign. Deeper NPL secondary markets can contribute to accelerating the adjustment process. Currently, the volume of transactions is low, with €80bn in 2016 against €1tn of NPL. Most of this activity was in the form of portfolio sales and to a lesser extent as securitisations.

Unlocking the securitisation market provides a real opportunity for achieving risk transfer. Securitisations attract a wider pool of investors by tranching the risk into different notes and yields, and allow banks to manage their credit risk profiles more responsively.

Boosting NPL securitisations requires a regulatory environment that improves both market demand and supply:

- Demand: Reduce regulatory costs of buy-side investments, as current regulation imposes high capital charges for non-banks investing in securitisations relative to other funding instruments of similar credit risk.
- Supply: Firstly, aligning regulatory costs of holding NPLs by calibrating stress tests and RWA densities to match higher standards in other jurisdictions would incentivise banks to off-load NPL. Secondly, reducing regulatory cost by recognising risk transferred would stimulate the securitisation markets and align the risks with the economics. Finally, allowing genuine pan-European retail and commercial banks to develop improves bank profitability, resilience and potential to absorb write-downs.

In conclusion, developing deeper and more liquid capital markets is key to Europe's de-risking process, both structurally and functionally. ●

Resolution of banking groups at EU level

Andrea Enria

Chairperson, European Banking Authority (EBA)

Resolution factors impacting confidence in cross-border banking

The completion of the Financial Services Action Plan in the early 2000s and the introduction of the euro significantly improved cross-border banking in the EU and created the circumstances whereby the ideals of the Single Market could start to bear economic fruit. However, progress came to an abrupt halt with the onset of the financial crisis, leading to widespread ring-fencing and market fragmentation. The decade long process of institutional, banking and regulatory repair that followed has sought to restore the position by delivering a far safer, stronger and comprehensive regulatory regime.

The Bank Recovery and Resolution Directive (BRRD), one of the cornerstones of the reforms, introduces a standardised regime in the EU for dealing with failing banks. Because of this purpose, it is at the sharp end of financial supervision bringing into clear focus the issue of where the burden of dealing with failures rests. Consequently, it tests the boundaries of trust between national authorities probably more than any other area. However, delivering on its ultimate goals of confidence and assurance, the grounds for trust to flourish, remains somewhat out of reach.

Why is this and what can be done to reap the full benefits of the new framework? There are a number of factors currently affecting confidence:

- Notwithstanding the significant progress in resolution planning in the last 3 years, work remains to deliver executable plans in which key stakeholders have full confidence. Until we are closer to this point, caution and restraint will remain to the fore.
- One important element is the pace with which policy for minimum requirements for own funds and eligible liabilities (MREL) is implemented. Absent progress in this area, in particular internal MREL, highly conservative approaches will be taken to local loss absorption requirements, with potential knock-on impacts on the efficient use of economic resources.
- Defining and agreeing on what constitutes a 'critical function' is a third area of concern. While significant progress has been made in the collection and analysis of data, some important gaps exist between home and host authorities. Such divergence in understanding undermines cooperation and trust.
- The fourth issue stems from the differences that exist in national insolvency regimes. Recent cases have shown that idiosyncrasies in national liquidation rules give rise to unforeseen impacts on resolution execution. The scope and variety of these differences creates unwelcome uncertainty.
- Finally, while clearly a double-edged sword, developing a sound understanding and experience of how cross-border bank failures will turn out, can only occur

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>>> through practical experience. Fortunately, the number of failures in recent years has not been very high but those we have seen have not robustly tested bail-in and loss transfer mechanisms. Paradoxically, the absence of failure inhibits confidence building.

In moving forward, increased experience of bank failures is obviously not something that anyone will advocate. However, implementing MREL policy, agreeing on the critically of functions and determining the best resolution strategies for banking groups are issues that are well within the grasp of resolution authorities. Other issues, such as having a clear approach to funding in resolution, require the involvement of other authorities. However, what is important is that finalising work in these areas is not delayed unnecessarily.

Harmonisation of EU insolvency regimes is a longer-term project. However, as with other impediments, the importance of understanding local requirements and how they affect the resolution strategy, should be part of all resolution plans.

In conclusion, availing of the full benefits of the BRRD is within grasp. However, it does need decisive action to ensure delivery. We cannot wait until every 'i' is dotted and 't' is crossed. Trust is needed and as Ernest Hemingway said, "The best way to find out if you can trust someone is to trust them". ●

Klaus Kumpfmüller

Executive Director, Austrian Financial Market Authority (Finanzmarktaufsicht)

Making European banking resolution work

European banking resolution and regulation are two reinforcing pillars. Any framework that allows for market integration must also offer stability safeguards and effective burden sharing when integrated banking groups fail. The experience in Austria, past and present, is a case in point.

Since the early 1990s, large banking groups headquartered in Austria are well established in Central and South Eastern Europe, with substantial subsidiaries relative to both the size of the group and local markets. During the global financial crisis, these groups' integrated funding model turned into a vulnerability. While they relied heavily on parent-funding for liquidity, co-operation between their supervisors was lacking, and there were neither a legal nor an institutional basis for cross-border burden sharing. Through the funding-lines, local risks would have to be borne primarily in Austria as the groups' home country – an intolerable burden. It took an extraordinary measure – the Vienna Initiative – to ensure a minimum of stability. Market integration had outrun the regulatory safety net.

The crisis drove home an important lesson: "banks grow internationally, but die locally". Austrian authorities devised a sustainability package, requiring that business development be underpinned by local funding. It was a bold policy step, but it introduced more realistic assumptions and put the groups and their subsidiaries back on a stable footing.

The lesson of the crisis sticks to this day and still characterizes much of the dilemma of the EU resolution framework. The BRRD went a long way in establishing a European legal basis. The banking union, matching integrated markets with integrated decision making, has been a major improvement. Outside the banking union, however, resolution planning and decision-making must be done jointly between EU >>>

>>> national authorities. It can only work smoothly when all involved agree on strategies and instruments.

In terms of consistency between market integration and regulation, we are not yet quite where we need to be. Here are four suggestions how to get there:

Be realistic. Even with the BRRD, market integration and safeguards must not be out of step. A one-dimensional focus on centralised resolution plans of banking groups takes the current framework too far. EU home- and host countries each have legitimate stability concerns, therefore all levels – home and host – must be put in a position to absorb losses where they accrue.

Co-operate more. A simple reason for the current lack of confidence is, that resolution planning is still uncharted territory. With everyone busy getting to grips with the new resolution regime, co-operation between actors was not a top priority. The creation of the Single Resolution Mechanism arguably absorbed additional attention and energy. This must change. Co-operation must become our top priority. The banking union in particular should not lead to a rift between ins and outs, but facilitate cooperation throughout the EU.

Create common ground. The legal framework leaves significant room for interpretation. Policies and prudential instruments are still lacking in important areas. However, a common understanding and application of the legal framework is key for the credibility of EU cross-border resolution. Here, the European Banking Authority has a major role to play. Common views on MREL, requirements for Multiple- and Single Point of Entry approaches, Public Interest Assessment, Valuation – to name only some key areas – need to be elaborated to guide the practice of resolution authorities. Common policies will translate into a common understanding on strategies and practices and, eventually, a common resolution culture. Without this common ground, we lack the credibility and confidence that are indispensable for cross-border resolution – even within the SRM.

Integrate more. Ultimately, the surest way to ensure smooth cross-border resolution, as the basis for market integration, is an integrated institutional framework. For those states that are not euro area members, we should make the instrument of close co-operation an attractive and sensible option. It has fallen into neglect somewhat during the build-up phase of the banking union. We must put it back on the agenda and improve it as much as possible. With Bulgaria, the first test case is at hand. We have to make it work. ●

Dr. Elke König

Chair, Single Resolution Board (SRB)

Why we need an EU liquidation regime for banks

The resolution of banks is a specific insolvency procedure, introduced as an alternative to liquidation under national laws. Under the EU regulatory framework, resolution only applies where resolving a failing bank is in the public interest – be it out of financial stability concerns or because of the critical functions performed by the bank. Resolution is for the few, not the many: insolvency remains the primary route for failing banks, even for those that are under SSM and SRB remit. However, while the legal framework for resolution has been harmonised and developed to be suitable for the specific challenges of banking failures at EU level, insolvency regimes remain national.

The lack of an EU liquidation regime is a major obstacle towards a fully-fledged Banking Union. The SRB's assessment of the no-creditor-worse-off principle seeks to ensure that the treatment of creditors in resolution is not worse than the one they would have received under normal insolvency proceedings. Currently, with nineteen different insolvency frameworks in the Banking Union, the analysis of the insolvency counterfactual for a cross-border bank in resolution is a challenge, and results in diverging outcomes depending on the home country >>>

>>> of the institution. Moreover, the 'failing or likely to fail' assessment is not always aligned to the criteria for liquidation at national level and may similarly lead to different conclusions.

"The lack of an EU liquidation regime is a major obstacle towards a fully-fledged Banking Union."

- DR. ELKE KÖNIG

Bank insolvency procedures should be subject to common standards and practices at EU level. The ideal solution would be EU-wide rules on insolvency proceedings for the banking sector. This harmonisation would have a number of advantages: it would facilitate resolution planning for cross-border banking groups; level the playing field and eliminate wrong incentives; and provide the industry and investors with the same level of certainty in liquidation as in resolution. An efficient and effective insolvency framework also contributes to addressing legacy assets and avoiding the build-up of new non-performing loans. Furthermore, a harmonised system would also benefit the Capital Markets Union, by providing investors with greater clarity.

These ideas are not new. Already in 2010, the European Commission's Communication on an EU Framework for Crisis Management called in the medium term for "further harmonisation of bank insolvency regimes, with the aim of resolving and liquidating banks under the same procedural and substantive insolvency rules."

The SRB is currently working within the Single Resolution Mechanism on National Handbooks to define how to implement resolution schemes in each country, as well as national implementation steps for a decision not to adopt resolution. This is a step in the right direction, but is only a 'second best' option and not comparable to a harmonisation of bank insolvency procedures – something only legislators can deliver.

Proposals for harmonisation across the board will inevitably be fraught with political perils and resistance. An incremental approach – such as the one exemplified by the recent harmonisation of the ranking of unsecured debt instruments in insolvency – may be a more palatable solution. The ultimate goal, however, must be to have in place an EU liquidation regime alongside an EU resolution regime. ●

Mark Venus

Head of Recovery and Resolution Planning, BNP Paribas

The Banking Union and Murphy's law

At first sight, Resolution Authorities and indeed Heads of Resolution in banks, must pass for fairly pessimistic characters. Their job obliges them to start from the assumption that the worst has occurred, that a bank is in dire straits, that recovery actions taken as the crisis unfolded have been insufficient, and that resolution is the only possible course of action. Against this negative back-drop, Resolution Authorities are to some extent arch proponents of Murphy's Law "Anything that can go wrong, will go wrong". Resilient resolution planning imposes the discipline of planning for the worst.

If we look back at the 2008/2009 crisis, the worst was pretty awful. Previously unimagined imbalances emerged rapidly, resolution planning was non-existent, resolution powers were not available, resolution funds were inexistent, and states had to step in with public funds.

But times have changed. In the EU, legislation has created the obligation to plan for resolution, has created resolution authorities with extensive resolution powers, and built resolution funds with considerable pre-funded capacity. In the Eurozone, the Banking Union has deepened these powers by creating a Single Supervisory Mechanism to better identify and control emerging risks, MREL as a growing and clearly identified loss-absorbing capacity, a Single Resolution Board to plan for resolution, and a pre-funded Single Resolution Fund to assist resolution financing if bail-inable debt proves insufficient.

What this means is that home and host resolution authorities alike are in a very much improved situation. They may, and probably should, work on the assumption that Murphy's law still holds true, but with an additional clause: 'Anything that can go wrong, will go wrong, but not everything that could go wrong still can'.

It is only by recognizing the progress made in removing negative externalities that we can collectively reap the benefits of these EU and Eurozone resolution-related initiatives.

"Anything that can go wrong, will go wrong, but not everything that could go wrong still can."

- MARK VENUS

There are still potential problems in resolution for host authorities, and Eurofi's discussion papers explain them openly, and provide potential solutions. Group support mechanisms in which host authorities have confidence are one path forward, as is the creation of a 'group insolvency regime' giving legal assurance of equitable treatment of creditors whatever their country of domicile. Failing this, an alternative is greater use of branch structures in order to bring consistent application of a single insolvency and resolution framework, that of the home country, across an entire Banking Union group, overseen by the Single Resolution Mechanism.

These are challenging projects, but so were the creation of the >>>

>>> SSM and SRM, and these were achieved. If these projects can lead us to a position where host authorities are able to recognise with confidence that the potential problems for which they need to plan now form a far shorter list than before the last financial crisis, then value will have been created over the last 10 years of reform. But if that confidence between host and home is not solidly anchored in resolution planning for EU banks, then we will not have moved forward despite the intense reform efforts, and Murphy's law will remain in full and pessimistic force. ●

Edouard Fernandez-Bollo

Secretary General, Autorité de Contrôle Prudentiel et de Résolution (ACPR)

How to foster trust between home and host authorities in the EU?

To ensure an effective resolution regime in Europe, one should consider possible solutions to tackle the lack of trust between host and home authorities. It is necessary, in particular, to tackle the root cause of ring-fencing practices which, in general, lie in the perception that, should a banking group face difficulties, the parent company will repatriate liquidity and capital, at the detriment of subsidiaries in other jurisdictions.

When resolution is triggered, the resolution entities of a banking group are subject to resolution tools in accordance with a preferred resolution strategy. Under a resolution strategy based on the "single point of entry" (SPE) principle, subsidiaries, including 'material subsidiaries', stay out of resolution and losses at material subsidiaries level need to be up-streamed to the resolution entity, i.e. the parent bank/company. This raises two questions. First, how can we ensure that the "single point of entry" strategy addresses both the concerns at group level (i.e. home) and the concerns at subsidiary level (i.e.host)? Second, on financial terms, how can we ensure the appropriate allocation of loss-absorbing and recapitalization capacity within the groups outside of their resolution entity's home jurisdiction? My answer will be: we need credible guarantees, provided by EU parent banks, based on EU law, and enforced by EU authorities.

On the first question, the Banking Union has strengthened the European cooperation (SSMR/CRDIV/CRR for supervision, BRRD/SRMR for resolution). This framework should now fully deliver to make Member States feel more confident that, in times of crisis, there will be no national/home bias. Both in the SRM and the SSM, there is a centralized power. This centralized power allows to better manage crises, at group and at BU subsidiary level. Ring-fencing should no longer be an issue in the BU as there is now a single supervisory/resolution authority.

"My answer will be: we need credible guarantees, provided by EU parent banks, based on EU law, and enforced by EU authorities."

- EDOUARD FERNANDEZ-BOLLO

Looking beyond the BU, at EU level, relevant host authorities participate in a decision-making body for cross-border groups (Supervisory and Resolution Colleges). On the resolution side, those decision-making bodies adopt joint decisions on the adoption of resolution plans and of MREL requirements. These procedures create binding obligations on Member States and force resolution authorities to not only share their concerns and needs at group and local level, but also to find a common approach to ensure the resolvability of the groups and their subsidiaries. In case of dispute, dispute settlement procedures exist: a common mediation mechanism (EBA) and a common court (European Court of Justice). These mechanisms exist and they are effective. Recently, the EBA mediation procedure has been used to settle a dispute between the National Bank of Romania (NBR) and the Single Resolution Board (SRB) in the context of resolution planning of several cross-border groups.

Secondly, confidence of host Member States can be ensured by more robust ex-ante arrangements to upstream losses, especially in the case where subsidiaries face difficulties but the group/parent does not. Intra-group arrangements could be requested by supervisory/resolution authority to reinforce the protection given by parent banks to their subsidiaries in other Member States. They should address the question of group support to subsidiaries not only at the final point of resolution but before, during going concern, and in particular to support recovery measures. Resolution and supervisory authorities should then take into account these arrangements by lowering prudential constraints applied to those subsidiaries benefiting from such formal financial support. The revision of the CRR underway forms in this regard an opportunity to frame these arrangements in law so that waivers can be more widely used while fully taking into account host's legitimate concerns.

On the resolution side, inter-jurisdiction agreements should be reached soon on the setting of an "internal" MREL for EU banking groups. Set by the group's Resolution College, this iMREL will be required from material subsidiaries within the EU. To avoid ring-fencing and to reassure the host authorities, the internal loss absorbing capacity (iMREL) should be set at a low level because a reduction of the resources at the top increases the risk that the top parent company might not have enough resources to recapitalize material subgroups in other (host) jurisdictions. If the parent company has direct control over an 'iMREL surplus', it will allocate it to any subsidiary that may require financial support, in any host Member State. Contrary to the opinion of some host authorities, the iMREL requirement should be set at a low level as this will triggers earlier the obligation of the parent to support its (host) subsidiary in need.

Finally, a crucial element to foster trust is the urgent need to complete the BU through the implementation of a common backstop to the Single Resolution Fund and to clarify the issue of liquidity in resolution. ●

Wilson Ervin

Vice Chairman,
Group Executive Office,
Credit Suisse

A plan for a resilient Banking Union

This task is big. In May, Mario Draghi noted major problems from fragmentation:

1) A major threat to Eurozone economic policy: Fragmented banking markets mean that local shocks hit local banks. This intensifies regional downturns, exacerbating the problems in the periphery. Inside the Eurozone, member states don't have other good monetary tools. Fragmentation hurts the ability to stimulate weak regions and can lead to overshoot in strong regions.
2) Resolution becomes more difficult: Acquisition by a strong bank is an important resolution option, especially for mid-sized banks. Europe has struggled to find a deep pool of acquirers, in part because of the challenges of operating across borders. Last year's bank failure in Spain was solved by a Spanish acquisition. Italian failures were handled in Italy. In contrast, the US FDIC has bidders from many states to buy a failed bank. What if Santander had declined to bid?
3) It weakens European banks: EU banks are less diversified, and have lower economies of scale. The big 4 US banks each have roughly 2x the capital of the biggest EU bank. Diversification makes the big US banks less exposed to local problems, helping them recover quicker. Their scale also means more resources for new digital technologies; will the smaller EU banks be able to match the level of investment required?

A 4th point: fragmentation means more risk: Our research was summarized in Risk Magazine: a ring-fenced bank can be 5x to 15x more likely to fail than an integrated bank. If each country sequesters "their" capital, a resilient group can balkanize into a collection of risky, less diverse entities supported by small pockets of local capital. Even the ring-fencers eventually lose out when others retaliate - a classic "prisoner's dilemma".

"A better plan can protect hosts and enhance resilience, without relying on naïve trust."

- WILSON ERVIN

The obstacles are now modest:

1) Awareness of the issue: Ring-fencing leads to poor, risky outcomes.
2) Effective resolution: Member States need to know they're not on the hook. TBTF has been solved at many banks, but others need to finish their MREL build. That also provides deep protection for deposits. ECB Liquidity capability is also key.
3) Designing a better plan.

A Better Plan can protect hosts and enhance resilience, without relying on naïve trust. We build on the post-crisis resolution framework, which provide big pools of subordinated resources:

1) Modest capital preplacement to protect hosts. The home should have 'skin in the game' - to enforce cooperation and deter 'walkaway risk' (esp. for NCWOL).
2) Maintain host safety with top-up rules. (Perhaps binding contracts to support needy subs, as per US living wills).
3) Preplacement should mostly be in subordinated gone-concern MREL.
4) Keep equity buffers in a central /mobile reserve, for resilience.

Short Term Steps:

1. Capital and MREL waivers; expand branching where possible.
2. SRB must be able to scale internal MREL to a range (75% - 90%, per FSB).

Europe can escape the quagmire of fragmentation and move to a more diversified, resilient system. Building effective resolution was the hard part, but it provides a strong foundation for a better plan: let's start putting that to good use. ●

Alain Laurin

Associate Managing Director,
Financial Institutions,
Moody's Investors Service

EU bank resolution will be strengthened yet gaps remain

Four years after the creation of the EU's resolution regime via the Bank Recovery and Resolution Directive and the Single Resolution Mechanism Regulation, the EU toolkit is under review. Based on the proposals that are currently negotiated in the trilogue, Moody's expects that the revised legislation will lead to improvements yet important gaps will remain.

First, the resolution framework aims to address a capital shortfall yet provides no viable solution for a shortage in liquidity. The SRB recognises that resolution funds, including the "backstop", might not be sufficient for the resolution of a large bank. The Emergency Liquidity Assistance is limited by the ban on mutualising risk between national central banks hence the need for a "Euro-system Resolution Liquidity" instrument, the creation of which >>>

>>> is not yet in sight. Moreover a pan-European deposit insurance mechanism is still missing. Moody's therefore continues to incorporate into its ratings of the most systemically important banks some benefit, albeit moderate, from the potential for public authorities to provide support.

Further, as most large banks operate across international borders, resolution will involve complex legal issues in the absence of a common framework on insolvency. The SRB has admitted that it may be difficult to apply the "No Creditor Worse Off" rule in practice, given different interpretations across jurisdictions. At Moody's, our central expectation is therefore that resolution will be conducted along national boundaries.

"The decision-making process on resolution still lacks clarity and predictability."

- ALAIN LAURIN

Finally, the decision-making process on resolution still lacks clarity and predictability. This was illustrated by the de facto partial bail-out of Banca Monte dei Paschi di Siena in December 2016, which called into question the European authorities' resolve to use the BRRD to end "too-big-to-fail" and to protect taxpayers' money. It is hard to understand how the bank's large losses post recapitalisation can be reconciled with the "precautionary" nature of its public recapitalisation, officially prompted by a stress test.

Similarly, the use of special liquidation tools in conjunction with public funds to protect some creditors of the two Venetian banks which were deemed failing by the ECB, on the grounds that they failed to meet capital requirements, appears at odds with the BRRD's principles.

These examples of state aid supporting senior creditors highlight our view that BRRD has not so far precluded state aid, and underpin our inclusion of modest government support – typically one notch - in some bank senior debt and deposit ratings.

Such ambiguity is likely to persist. Article 32 of the BRRD, which sets out the conditions for resolution, is not part of the current review of the Directive, perhaps reflecting a lack of consensus amongst EU authorities on how best to address the resolution framework's shortcomings revealed by the cases mentioned above. While we believe that government support for EU bank creditors is less likely now than in the past, public authorities may on occasion take advantage of the flexibility of the current framework to deal with different scenarios, albeit at the expense of its predictability. ●

Eurofi would like to thank very warmly
the Austrian EU Council Presidency
for their support to the organization of this event

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Profitability challenges of EU banks

Burkhard Balz

MEP, EPP Coordinator, Economic and Monetary Affairs Committee, European Parliament
(* as of 1 September 2018 Member of the Executive Board, Deutsche Bundesbank)

Banking profitability - challenges in a post-crisis setting

In the last 15 to 20 years, the banking system in the European Union has passed a remarkable transition: a rapid expansion, a deep crisis, and a tepid recovery. Regarding the overall economic situation in the European Union, we experience signs of recovery with an average GDP growth rate above two percentage points. This creates a positive economic setting, also for Europe's banking sector. However, other factors cloud this setting.

The low interest rate environment affects the net interest margins. Due to maturity transformation, this effect might even persist once interest rates rise, as funding costs are going to increase in parallel. Compared with the international level, net interest margins are typically lower in the EU than elsewhere. This is a consequence of a more competitive and more diversified banking sector in Europe.

Another challenge is the cost efficiency where European banks are outcompeted by many international peers; EU banks show a high cost-to-income ratio. On the income side, banks have faced difficulties in increasing non-interest income under weak economic conditions, whereas on the costs side, the need for technology and IT investments, new regulatory demands, new competitors and the restoration of public trust have led to an upward pressure.

Furthermore, as a consequence of the financial crisis, the ratio of non-performing loans in the banking books has increased significantly and it is still way above the pre-crisis level in some Member States, though banking supervisors have successfully put pressure on banks to reduce their NPL portfolios. It will need further ambitiousness to clear this legacy from European banking books.

The most noticeable consequence of the financial crisis is a tougher regulation, both globally as well as in Europe. On the international level, the FSB was granted with a broadened mandate to promote financial stability. The BCBS has started to revise existing standards. On the European level, we have established several new supervisory authorities that support the overall objective of fostering financial

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>>> stability and the Banking Union in particular, consisting of the SSM, the SRB and harmonised rules on deposit guarantee schemes. Not only the different levels of regulation and supervision have increased noticeably, also have its comprehensiveness and its detail, leading to high compliance needs in the banks.

With regard to the future of banking, two connected keywords occur inevitably: digitalisation and fintechs. Fintechs are already transforming capital markets and hereby increase the level of competition for European banks. We must ensure that they do not act in a regulatory vacuum; however, they also should not part for third countries either, because it is easier to grow their business there. The EU legislators are working on initial steps to improve their business conditions in Europe, showing a positive attitude towards fintechs, but also for the use of financial technologies within established (banking) structures.

The following conclusions might be drawn with regard to the actual situation of the banking sector. First, European banks have to increase their cost efficiency. A possibility is to reduce overbanking and deepen financial integration by promoting cross-border mergers. European legislators support a deeper financial integration, in particular by pointing to the implementation of the Banking and the Capital Markets Union. Nevertheless, one should not leave aside that consolidation of systemically important institutions may also impede competition and might increase systemic risks.

Second, banks need to adapt their business models, especially in current times, when there are divergences in the performance of different banking activities. Efforts are already visible. In this regard, banks should also consider new technologies as an opportunity to adapt their business models to the digital age.

Third, we need to continue to speak with one European voice to promote our view on banking regulation and safeguarding financial stability in the current political context, on the one hand internationally, on the other hand internally. It is our task to help fostering sustainable business models, to safeguard the diversity of the European banking sector and thus to cater for proportionality in regulation also allowing small and medium-sized banks to remain profitable in a challenging environment. ●

Philippe Bordenave

Chief Operating Officer, BNP Paribas

Weak profitability of European banks: the hidden face of regulation

In the years since the crisis, the profitability of European banks has recovered more slowly than that of US banks. Aside from the different economic factors, this gap is largely due to the way financial regulation has been implemented in the US and Europe. Across the Atlantic the emphasis has been to tailor international rules to better fit the American economy and its financing model, while in Europe the thrust has been financial stability without considering the potential cost to economic growth.

Financial regulation in Europe has been gold-plated compared to the international Basel Committee standards without any visible improvements in terms of >>>

>>> financial stability, but with a clear impact on European banks' profitability. European banks have to comply with MREL requirements which will reach levels in 2022 well beyond TLAC, despite the fact that several factual surveys have shown that even during the worst of the crisis none of the largest banks would have needed an MREL buffer as defined today.

Moreover, the Single Resolution Fund, which last year alone cost French banks more than € 2 billion, has been set up, and in addition systemic taxes have to be paid every year in several Member states. Also, at a time when the industry is transforming into the digital age, the current European prudential rules on software investments continue to require their deduction from capital. This is a key issue that further accentuates the competitive disadvantage of European banks versus US banks, which are able to record software investments as tangible assets with an assigned RWA of 100%.

The way regulations are applied by national supervisors has also led to a retreat of the Single Market and to higher fragmentation in the European banking sector. There has been a race to the bottom as national regulators and supervisors have pushed for maximum local financial stability, applying the solo approach for the main ratios (capital, liquidity, MREL...) and refusing to allow waivers to pan-European groups. The last example of this is the requirement of an internal MREL at 100 % for subsidiaries, when the FSB recommended a range between 75 and 90 %. The consequence for European banks and their clients is that, unlike their US peers, they do not enjoy the benefits of a single market and the economies of scale that it brings.

To achieve a true single market, measures must be taken to enhance cooperation and trust among national supervisors so as to ensure proportionate requirements at national level. A full Banking Union is needed and would also allow the greater sector consolidation that a Single Market needs.

Moreover: no significant improvement has been introduced in the regulation to allow European banks, which finance the economy mainly through banking intermediation, to reduce their balance sheets assets through true-sale securitization. In fact, the activity has collapsed in Europe, as the figures on the issuance of European securitization demonstrate: from € 819 bn in 2008 to € 235 bn in 2017. Meanwhile American issuance has climbed sharply, from € 967 bn in 2008 to € 1713 bn in 2017[1].

Europe doesn't even try to adapt to the US inspired regulation it imposes to its banks: the upcoming "finalization of Basel 3" with its multiple input and output floors is going to penalize low risks assets on banks' balance sheets without any practical possibility to securitize those assets.

Therefore, it is not surprising that the profitability of European banks is weaker than that of American ones[2]. The industry has repeatedly pointed out that when supervisors in the Basel Committee decided to reduce banking intermediation, they consequently obliged the European banks to change their business models, but without providing the tools to facilitate this transformation quickly and smoothly in order for them to shift towards capital market placement capacities.

As recognized by the SSM, the low profitability of European banks may become a financial stability risk as it prevents banks from increasing their capital through retained earnings, to invest in new technologies and to grow their financing of the economy. It is now time to turn to the second goal set by the G20 and focus on growth, as the US has done. This is definitely the way ahead and it is essential now for Europe to adopt a more balanced approach where sustainable growth and profitability become part of the equation of financial stability. ●

1. AFME Securitization Data Report Q4 2017
2. In 2006 the profitability of banks in the EU and the US was comparable, hovering around an ROE of 14 – 16%. By 2016, EU banks' ROE had dropped to 3.5% while that of American banks had recovered back to pre-crisis levels. Sources: Federal Reserve Bulletin, vol. 94 2008; EBF Facts and Figures 2016; ECB; Bloomberg

Leena Mörttinen

Director General,
Financial Markets Department,
Ministry of Finance, Finland

Banking in the midst of a perfect storm

Banks are the oldest information platforms in the world. They have been crunching our numbers hundreds of years before the new techno giants. They have access to central bank money – a special privilege that other companies do not have. How can an industry with a special access to our data and a unique advantage given to it by governments be suffering?

This is a particularly burning question in the EU. Banks show a poor bottom line in many parts of the economic area. The average ROE has been improving but was still only 6% in 2017. Even banks in some of the strongest economies are struggling with low profitability. The answer lies in the perfect storm that is battering banks' business model: low long-term yields, tougher regulation and new competition from payment services deregulation and information technology advances.

The crisis forced central banks into exceptional monetary policy. To fight the deflationary specter central banks started using unconventional policy tools including quantitative easing (QE). This brought down interest rates, particularly the long-term yields that drive banks' net interest income. However, the alternative of a full-blown euro crisis would have been even more devastating. Furthermore, it is important to note that the long yields have been on a decreasing path since 1980s. Consequently, the downward pressure on banks' interest margins has grown steadily over the years.

Tightening regulation has also been an unavoidable consequence of the crisis. Banks failed the one job they were given: the pricing of risk. Actually, they increased risks through their connectivity to each other and to their governments. As regulators attempt to de-risk banks the funding costs are likely to increase – consistent with risks being carried by the investor rather than the taxpayer. Retained earnings have been used for building up capital buffers in profitable banks. But the weakest banks are suffering. Writing down non-performing loans (NPL) will slow the build-up of capital buffers, which will reduce their ability to improve their business models.

All this happens at the same time as information technology enables tougher competition for customer data than ever before. Our deepest thoughts are now probed by social media platforms, internet stores and search engines instead of a bank clerk. Furthermore, Payment Services Directive (PSD) 2 enables competition for customer data on a completely different level than what was possible under PSD 1, thanks also to the advances in information technology. New emerging techno giants have light balance sheets and very little regulation to slow them down.

So what now for banks? It is safe to say the EU banking system needs a substantial overhaul. Consolidations have to continue. Banking union, particularly a successful recovery and resolution regime with credible bail-in, can act as a healthy catalyst. A more active push from the authorities may be required in the case of those banks that cannot fulfil NPL, capital adequacy or MREL requirements.

Strong profitability is necessary for banks' survival. Otherwise, they will not be able to invest in new information technology and renew their business models to catch up with the competition pushing from outside the sector and from outside the EU. Those banks left standing will most likely specialize, smaller ones in retail services or even in more narrow niches. The choice for each bank is likely to be different depending on whether the change is driven by a need for cost reduction or increasing the scale of information business.

For the protected and uncompetitive banking sector stronger competition is a healthy change. However, competition is also needed to curb the increasing market power of the techno giants from US and China.

After the storm passes, banking sector and perhaps also the information market will look quite different from what we know now. The objectives should be a stable financial system providing greater transparency and consequently better risk pricing. Customers should also receive their fair share of the gains. This requires vigilance and resolve on the side of the regulators and politicians. The EU cannot afford anything else amidst of toughening global competition on financial services and our information. ●

Jordi Gual

Chairman, CaixaBank

Banks beyond banking

Ten years after the global financial crisis, profitability remains one of the main challenges for European banks. Low interest rates, weak growth in business volumes, higher capital and other regulatory requirements and, in some cases, the persistent high level of legacy assets continue to be strong headwinds on banks' profits.

The banking sector has gone a long way towards adjusting to this new financial and regulatory environment. There has been a large reduction in excess capacity, which has been instrumental in reducing the industry's cost structure. Consolidation has also increased the scale of the remaining players, which has allowed banks to reap the benefits of scale economies, including better access to capital markets. Banks have been cleaning up their balance sheets. Business models have evolved, decreasing their reliance on interest income and advancing business lines capable of raising fee income. And corporate governance –a crucial factor in explaining the performance of different banks during the crisis- has been strengthened.

At the same time, however, new technologies are changing the rules of the game for retail banking. Smartphones, big data, machine learning and other applications of artificial intelligence offer new ways to interact with customers who demand easy, instant and often free access to all the products and services that they need.

In this digital environment, where marginal costs tend to zero, the foundations upon which the banking industry has been built have changed substantially. Banks unable to adapt run the risk of becoming, at best, mere utilities providing services to third parties. Banks that embrace technology-driven change will have a chance to thrive.

New enabling technologies offer many possibilities to provide customers with better and more customised experiences. Some customers may prefer to interact exclusively through digital channels, some still prefer the nearby branch but most want both. Incumbent banks can meet this demand for multiple channel interaction. Thanks to data science, we are also now able to differentiate our products and provide more value to our clients, who benefit from the knowledge that we have of their preferences and from the network effects of a large customer base. As a result, we can help them in their decision making process, improving their experience, and thus reinforcing the long standing trust built over the years with them.

Moreover, these technologies allow us to broaden the range of products and services provided to our customers, going beyond traditional banking. Being at the center of these new ecosystems will benefit from partnerships with fintechs, bigtechs and other businesses. Following a multiproduct and multichannel strategy, new products and services can be developed aiming to offer the best service to our clients.

To that end, investing in technology is crucial. Some of these investments may contribute to cost savings down the road but, initially, the challenge is to make room for them within a tight cost envelope. Establishing the right priorities is key. Security and data protection, for instance, is surely one of them. Transforming legacy IT systems into a more flexible, cloud-enhanced architecture, another.

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

Banks that embrace this transformation will be well positioned to face the technological challenge, provide the best possible customer experience and create value for customers, employees and shareholders. As has been the case for the entire history of banking, the trick will be combining people and technology in the right way to nurture our most precious asset: the trust of the customer. ●

Paolo Angelini

Deputy Director General
for Financial Supervision
and Regulation, Banca d'Italia

Profitability of EU banks: challenges and possible solutions

Differences in GDP growth are likely the single most important determinant of the differences in profitability between US and European banks.

Banks' profitability has been under stress in the years of the global crisis, both in Europe and the US. However, for US banks ROE has returned on average to around 9 percent since 2013 (against 15 percent in the pre-crisis period); for European banks it has been around 6 percent since 2015, below the estimated cost of capital (currently in the range 8 - 9 percent). What drives banks' profitability, and differences between the US and Europe?

There is strong empirical evidence that real GDP growth is an important determinant of banks' profits, >>>

>>> mainly through its effect on loan loss provisions and credit dynamics. Some studies have found that the effect of GDP growth is asymmetric over the business cycle – it is larger during deep recessions. Also, it is relatively large for traditional, credit-oriented commercial banks. These results help explain differences in profitability between European and US banks: the US economy recovered earlier and faster from the global recession, whereas Europe experienced a double dip recession; bank profits fell more in the countries more affected by the sovereign debt crisis; furthermore, in Europe credit-oriented commercial banks represent a larger share of the banking sector than in the US.

The evidence about other possible drivers of bank profits is somewhat less solid. A role is played by other macro variables, notably inflation, central bank interest rates, taxation, as well as micro factors such as a bank's equity, efficiency, size (although typically only below a certain threshold), business model, use of the internal model approach. Cross-country comparisons are complicated by differences in accounting standards, fiscal rules, insolvency frameworks, and by methodological choices (e.g., some studies focus on ROA, others on ROE).

The available studies recognize that in Europe profitability is also affected by structural problems. There is evidence of overbanking, although with significant cross-country heterogeneity. This problem is due to a host of root causes, and is enhanced by the ongoing digital revolution, which is reshaping banks' business models and opening financial markets to new competitors. Stronger competition is also promoted by the Banking Union. Furthermore, regulation increases compliance costs and, at least in the transition to the new equilibrium, funding and capital-related costs, to the detriment of bank profits. While these developments are at least partly in common with the US, their impact on banks' profitability has probably been larger in Europe, due to the combination with weaker cyclical conditions.

Structural problems require structural solutions, and indeed, in several European countries adjustment has been going on for some years – in the form of both deleveraging and reduction in the number of banks, branches and workforce. M&As operations have helped, and can play an important role in the future if properly designed, as higher efficiency is clearly the main solution to the profitability problem. Since in equilibrium tough regulatory and supervisory standards enhance banks' resilience, the solution may partly come from lower profit expectations, rather than higher profits. Also, in my view regulators should double their efforts to curb banks' compliance costs, e.g. via stronger proportionality in regulation.

"Differences in GDP growth are likely the single most important determinant of the differences in profitability between US and European banks."

- PAOLO ANGELINI

The road ahead is still long and might be in some cases bumpy. The digital revolution, a key variable, can be friend or foe, depending on banks' ability to exploit new technologies. Banks that do not quickly respond to the new environment may face an existential threat in the not-so-distant future. Substantial investment in new technology, then, is a necessity. At the same time, however, it is also a risky business, as betting on the losing horse is a concrete possibility. Banks need to find ways to diversify these risks. ●

Bernard de Longevialle

Head of Financial Services & Sovereign International Public Finance Ratings, S&P Global

European banks' long road to solid profitability

More than 10 years after the 2008 financial market crisis broke out, the banking sector in Europe has still not resolved the issue of low profitability, which is essential if the sector is to build its resilience. Many of Europe's largest banking groups still struggle to earn their cost of capital, and some must be casting a jealous eye at the higher returns across the Atlantic. What can European banks learn from their U.S.-based rivals?

Domestic U.S. banks reported a systemwide average return on equity of 11% in the first quarter of 2018, well above the meagre 6.6% that S&P Global Ratings projects for Europe's largest 50 banking groups in 2018. A return of 11% probably covers U.S. banks' cost of capital taking into account greater exposure to legal risk than in Europe and the higher risk appetite at some U.S. banks. Returns were boosted, to an extent, by the recent U.S. tax reform.

That said, Europe is a heterogeneous place. Bank profitability in some regions, like Scandinavia, already outpaces that of U.S. banks, while other regions lag even further behind. We consider that banks in those lagging regions will have much to do if they are to catch up. European banks face structural revenue and cost disadvantages. We consider that they will outweigh cyclical elements, and even the uplift as the cycle turns will be gradual, at best.

"European banks face structural revenue and cost disadvantages."

- BERNARD DE LONGEVIALLE

Large U.S. banks typically generate a higher interest spread on loans and deposits than many European banks, reflecting the higher interest rates in the U.S. and high levels of nonperforming, nonaccrual loans in several European countries. U.S. banks also tend to sell lower-risk residential mortgages into the securitization market and have >>>

>>> deeper nonmortgage consumer finance and more-attractive midsize corporate lending businesses. European banks' focus on low-risk mortgage loans, where industry overcapacity affects pricing, also erodes profitability.

U.S. banks benefit from being home to the world's most important capital market and largest private wealth management businesses. Recent and upcoming regulatory changes will make it harder for banks globally to earn their cost of capital in investment banking. Unsurprisingly, European banks that formerly had strong investment banking activities have faced some of the region's most costly restructuring projects. U.S. banks' large, homogenous home market has made it easier for them to adapt. For the best players, the business of wealth management churns out strong risk-adjusted earnings. However, in Europe, it is a fragmented market and wealth levels are growing less strongly than in other regions globally.

European banks also face a bigger cost challenge. U.S. banks can operate seamlessly across a large home market and exercise very dynamic expense management, partly supported by a highly flexible labor market. Even with progress in the European Banking Union project, banks' ability to gain scale benefits from operating across various countries is limited by the different products and legal systems in play. The lack of "branchification" and waivers on stand-alone capital and liquidity requirements for foreign subsidiaries also impedes the efficient, seamless use of resources across the eurozone. ●

Korbinian Ibel

Director General
Microprudential Supervision IV,
European Central Bank (ECB)

Supervision and business model analysis for Euro area banks

Banks are in the business of earning profit on services they offer and loans they grant. They put this money back into their business or return it to their shareholders. Supervisors closely monitor banks to ensure the risks they

take are prudent ones. They also monitor how profitable banks are, how well they deal with costs that affect them or cope with challenging developments.

As euro area (EA) banks' profitability has on aggregate been under pressure in recent years, assessing banks' business models and profitability has been a priority since the creation of the Single Supervisory Mechanism.

EA banks' profitability improved in 2017, in part supported by the economic expansion. The average return on equity (RoE) of EA significant institutions stood at 6.0% in 2017 compared to 3.2% a year earlier: core banking revenues improved in 2017 compared to 2016, thanks to fee income growth accompanied by a roughly stable net interest income while net impairment flows from financial assets continue to improve.

However, EA banks are still lagging behind US banks and some have still not fully absorbed the impact of the crisis. The aggregate Cost-to-Income Ratio was relatively stable over the last year. Some banks do not expect their RoE to cover their Cost of Equity by 2020: the fact that many publicly listed banks still trade at price-to-book ratios below one indicates investors' appetite for further improvements.

Behind these averages, there is diversity: some banks – across various countries and business models – manage to consistently outperform their peers and to be profitable. These banks with the highest RoE follow different strategies with regards to costs and income but have overall better than average strategic steering capacity, i.e. their management has a better ability to set a course towards long-term objectives. Strategic steering capabilities cover for example the understanding of the detailed drivers of income across business lines or geographies, granular views of their cost, or a comprehensive pricing framework.

Banks' responses to profitability challenges vary. There is no one-size-fits-all approach to profitability as even strategies among best performing banks have largely differed. Banks' overall strategies going forward strongly reflect their current state of profitability – weaker banks are trying to reduce their costs and non-performing loans while better performers tend to focus on growth.

"Some banks – across various countries and business models – manage to consistently outperform their peers and to be profitable."

- KORBINIAN IBEL

In practice, this includes a number of different approaches: from increasing lending volumes to focusing on fee and commission-generating businesses and/or cost optimisation. Finally, digitalisation is a stated strategic priority for most banks. They not only need to react to the new environment to satisfy customers' needs but should also adequately address the transition towards digitalisation.

Deficiencies identified in banks' internal set-up, as well as issues related to the business plans, such as excessive risk-taking, are brought to the banks' attention as part of the supervisory dialogue. This could result in risk mitigation plans being drawn up or could trigger on-site inspections as well as deep dives into areas where blind spots have been identified. ●

EUROFI MEMBERS

Insurance comprehensive risk framework

Gabriel Bernardino

Chairman, European Insurance and Occupational Pensions Authority (EIOPA)

Insurance and macro-prudential policy responses

To date most of the discussions concerning macro-prudential policy have focused on the banking sector, for good reasons. Nevertheless, in insurance, understanding the sources of systemic risk, the tools already available and the potential need for additional tools is essential both for policyholder protection and financial stability. EIOPA has been examining these issues following a sequential, three-step approach.

The first step has been to set the conceptual framework for the potential sources of systemic risk. In EIOPA's view, which broadly coincides with other approaches developed at international level, systemic risk in insurance can materialise through 'direct' and 'indirect' effects. The 'direct' effect results from the failure of a systemically relevant insurer or the collective failure of several insurers generating a cascade effect, i.e. the 'entity-based' source. The 'indirect' effect occurs when possible externalities are enhanced by engaging in potentially systemically relevant activities (activity-based sources) or the widespread common reactions of insurers to exogenous shocks (behaviour-based sources).

Once the potential sources of system risk have been identified, as a next step the focus should be on the existing measures and instruments that contribute to mitigating the sources of systemic risk. EIOPA has therefore assessed existing tools that can be used to mitigate such risks. Indeed, although Solvency II is in essence a micro-prudential framework, it contains relevant features that help mitigate the potential sources of systemic risk identified in insurance. For example, tools such as the symmetric adjustment in the equity risk module, the volatility adjustment, the matching adjustment, the extension of the recovery period or the transitional measure on technical provisions can mitigate one of the potential sources of system risk and thus contribute positively to limiting procyclicality.

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>>> Finally, there are potential additional tools or measures to be explored to address risks for which no tools currently exist. To enhance the existing framework with additional, macroprudential elements and in light of the review of Solvency II, as a third step, EIOPA is further identifying possible additional tools and measures that could be effective in mitigating sources of systemic risk. It goes without saying that any policy responses developed to address systemic risk should consider the insurance-specific features and be proportionate.

In terms of potential additional tools, EIOPA's preliminary analysis has focused on four categories of macro-prudential tools: a) capital and reserving-based tools; b) liquidity-based tools; c) exposure-based tools; and d) pre-emptive planning. EIOPA is also considering whether the tools should be used for enhanced reporting and monitoring, or as an intervention power.

The complete list of additional tools under consideration includes several measures, of which the majority are designed for reporting and monitoring purposes, i.e. as preventive measures. This includes, for instance, the leverage ratio as a monitoring tool in order to detect potential for threats to the solvency position of the market. Additional reporting on liquidity risk or the enhanced monitoring against market-wide under-reserving are also under consideration.

Another potential tool is preventive planning for macro and micro purposes by means of requesting insurers' recovery plans, resolution plans, liquidity risk management plans and systemic risk management plans. Additionally, some measures under consideration are viewed as intervention and policy tools: These are the capital surcharge for systemic risk, the temporary freeze on redemption rights, and the possibility to establish soft concentration thresholds.

EIOPA will continue its work in this area, focusing on both the micro-prudential and the macro-prudential aspects. In the medium-term, both for consumer protection and financial stability, it is fundamental to build a proportionate and insurance specific minimum harmonised approach to recovery and resolution on the micro-prudential side, as well as an effective framework to tackle the potential sources of systemic risk on the macro-prudential side. ●

Victoria Saporta

Chair of the Executive Committee, International Association of Insurance Supervisors (IAIS)

IAIS - finishing the post-crisis job and looking ahead

The primary components of the IAIS (International Association of Insurance Supervisors) mission are to promote effective and globally consistent supervision for the benefit of policyholders and to contribute to global financial stability.

On both areas, the IAIS is making good progress in developing a common language among supervisors that enhances supervisory cooperation and builds trust.

On global standards, last November in Kuala Lumpur, the IAIS announced a path forward for its insurance capital standard (ICS v2.0) – the quantitative component of ComFrame (the common regulatory framework for internationally active insurance groups).

Implementation of ICS v2.0 will be conducted in two phases: (i) a five-year monitoring period starting in 2020, during which internationally active insurance groups (IAIGs) will be reporting to their group-wide supervisor (GWS) for discussions in global supervisory colleges a common capital metric – the "reference ICS" and other additional information, followed by (ii) the implementation of a ICS as group-wide Prescribed Capital Requirement (PCR). The "reference ICS" will be based on a common valuation approach, a common definition of capital resources and a standard way of measuring capital requirements. The reporting of additional information, at the option of the GWS, may include other methods of the calculation of the ICS capital requirement (e.g. internal models) and an ICS based on GAAP Plus valuation method. The IAIS also agreed to assess by the end >>>

>>> of the monitoring period whether the aggregation approach being developed by the US authorities and on which the IAIS is collecting data provides comparable outcomes to the ICS. Following this agreement, we have been making good progress and meeting all our project milestones, with a view of launching ICS v2.0 in our annual conference in 2019 ahead of its implementation the following year.

On systemic risk, good progress is being made to put together a sound framework that achieves broad intellectual consensus. Early last year, we charted a path forward, through the launch of a workplan that aspires to develop a holistic framework for systemic risk in the insurance sector. The framework focusses on the sources, transmission channels and impacts of systemic activities. It recognises that some of the risks originating from these activities are already being addressed by existing prudential measures and sets out the steps for identifying gaps. By doing so, the framework seeks to address risks posed to the financial system through the activities of individual entities and the activities of many entities operating in tandem.

"It's becoming clear that our members are interested in pivoting towards policy implementation and evaluation of agreed standards and to focus our activities on identifying and mitigating emerging issues relevant to our mission."

- VICTORIA SAPORTA

At the end of last year, the IAIS published a discussion paper on the framework which was broadly welcomed by stakeholders. We are now taking on comments received during the consultation period and developing a consultation paper for launch by the end of the year. The aim is to finalise the holistic approach to systemic risk in the sector by 2019. Once again we are on track for delivery, with all project milestones being met.

Although these two examples have tended to dominate many of our debates with stakeholders, they are in practice only one part of what the IAIS does, let alone what it needs to do in the future.

We are currently focussing on precisely what the IAIS's strategy should be post-2019 and we intend to present our recommendations to our members at our Annual Conference in Luxembourg in November this year. It's becoming clear that our members are interested in pivoting towards policy implementation and evaluation of agreed standards and to focus our activities on identifying and mitigating emerging issues relevant to our mission, such as those arising from digitalisation and the increasing protection gaps in many regions of the word (due to changing demographics and heightened climate risks). ●

Martin Merlin

Director, Regulation and Prudential Supervision of Financial Institutions, Directorate General for Financial Stability, Financial Services and Capital Markets Union, European Commission

Activity-based approach to systemic risk: finding all balances

Most of the new financial regulation initiated since the 2008-9 financial crisis focus on strengthening the resilience of financial institution, either by fine-tuning capital requirements, or by complementing the supervisors' toolbox to improve the risk assessment of those institutions.

Current regulatory developments focus on micro-supervision, but reforms have also started to address systemic risks by aiming at preventing the disorderly failure of large institutions. Looking beyond individual institutions, it would be short-sighted to ignore the interlinkages among global financial activity. Even if we believe that systemic risk cannot materialise when all financial firms are solvent or resolvable, there is still a case for policymakers' interest in the financial system as a whole, since we cannot ignore:

- The worldwide expansion of the insurance companies activities,
- The potential for regulatory arbitrage between highly regulated banking activities and non-banking activities, and
- The interlinkage between insurance activities, the real economy and financial markets.

In this context, a macro-supervision focusing only on individual institutions is not sufficient to allow for early identification and anticipation of risks and vulnerabilities which could propagate to the wider financial system in case of failure of an entire activity (known as "tsunami effect"). This requires a move to a holistic approach to macro-supervision, going further than a "domino approach".

"A minimum set of additional mandatory measures would need to apply at global level."

- MARTIN MERLIN

The new approach under development by the IAIS, focusing on activity-based regulation, lays more emphasis on the need for policymakers to have timely information on market trends. A certain activity is not necessarily systemic per se. However, based on the identification of potentially vulnerable activities, the objective is to focus on how collective and/or common behaviour of insurance groups, internationally active or not, could generate systemic risks when collective behaviour may exacerbate market movements and disturb the global financial system. >>>

>>> As an example, using derivatives for pure risk-mitigation purposes may be considered as a good practice from the perspective of the prudent person principle. The actual exposure/vulnerability depends on how such an activity is managed. Hence, the exposure could become a systemic concern only under certain circumstances, for instance depending on the overall state of the financial markets.

It would be suboptimal to set an absolute threshold for every single activity of insurance undertakings. Therefore a minimum set of additional mandatory measures would need to apply at global level, guaranteeing the level playing field, while supervisory expert judgement could modulate their intensity depending on the complexity of the insurer.

However any activity-based approach requiring an ongoing monitoring of risks and trends with measures being applied at global level faces a number of challenges.

Firstly the difficulty to develop, at international level, a common set of reliable data to be used, built on existing reporting for micro-supervision. Indeed for extending data collection requests, one would need to assess to what extent the existing information provided to group-wide supervisors does not properly cover all drivers of systemic risks. Any extension of the scope of the data collected would have to be duly justified in order to avoid unnecessary additional reporting burden for groups.

A second key challenge is to find the right articulation between macro-monitoring and micro-supervision. Supervisors are ultimately responsible for the risk assessment of insurance groups and the determination of the appropriate levels of capital adequacy.

Therefore, any activity-based regulation would require clarifying how supervisors could include the outcome of global risk monitoring to their micro assessment. For this to be made possible, design of new macro-monitoring instruments should be assessed in the perspective of avoiding conflicts between macro and micro supervision.

The IAIS continues to work on these challenges with the aim of finalising an activity-based approach to macro supervision in the coming years. ●

Jad Ariss

Group Head of Public Affairs
& Corporate Responsibility,
AXA

Insurance comprehensive risk framework

Macroprudential thinking is probably one of the main legacies of the 2008 global financial crisis. The then existing microprudential regimes proved inadequate to cope with a global crisis, in particular due to the lack of a consolidated risk based approach. Regulatory frameworks (notably Solvency II) have evolved since then, becoming much more risk based and addressing both microprudential and macroprudential concerns.

Macroprudential thinking points to a major cultural shift away from rational behaviours and efficient and self-equilibrating markets. This shift reinforces financial institutions' concerns that the availability of market liquidity in times of market stress should not be taken for granted. International standard setters have been intensifying their attention on this area. Liquidity risk is one of the two main risk exposures proposed in the IAIS November 2017 draft consultation paper on "Activities Based Approach to Systemic Risk" (together with macroeconomic risk exposure).

Many insurers have been strengthening their internal liquidity management since the crisis by further developing their governance around liquidity risk management (including both quantitative, mainly stress tests, and qualitative measures). These measures are already included in supervisory reporting in some jurisdictions, as part of ORSAs in Europe for instance, and in Liquidity Risk Management Plans for Global Systemically Important Insurers.

Regarding stress tests, it should be highlighted that they must take into account the much higher illiquidity of insurance companies' liabilities compared to those of banks. This fundamental difference allows insurance companies significantly more time for various remedial actions during a crisis. Slow materialisation of losses during such a crisis is positive for investors and financial stability. In any case, qualitative measures should remain the building block of supervision.

"Macroprudential thinking points to a major cultural shift away from rational behaviours and efficient and self-equilibrating markets."

- JAD ARISS

One should not underestimate the challenges to create a detailed liquidity and, more generally, macroprudential framework at international level. Starting points vary substantially per jurisdiction, reflecting significantly different microprudential frameworks. These frameworks (in particular Solvency II) already include tools with some macroprudential impact to various extents. As a result a principled-based, overarching approach would make more sense than a rule-based approach. The implementation of such a principled-based approach would have to strike the right balance between addressing potential gaps in microprudential frameworks, fulfilling the principles and ensuring level playing field.

In light of such evolution, the question as to whether the individual designation of some insurers continues to make sense should be raised. ●

Joseph L. Engelhard

Senior Vice President,
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MetLife, Inc.

ABA best addresses tsunami and domino propagation of systemic risk

Even with the most comprehensive and sophisticated monitoring systems, forecasting the actual probability and magnitude of potential "tsunami" and "domino" systemic events is impossible. What we can do, based on past experience and good forward looking market intelligence, is understand where vulnerabilities are building, and ensure we have the structures and tools to assess and manage the risk. Therefore, we must have the means to monitor potential macroeconomic risk across the financial sector along with the microprudential tools to mitigate any undue buildup of risk and its potential transmission to the system.

Macroeconomic risks or shocks may lead to systemic risk transmission through the channels of asset liquidation (liquidity) and interconnectedness (counterparty exposure). Therefore, macro-prudential measures should be focused on asset liquidation and interconnectedness. The asset liquidation channel should be measured via cash flow analysis and an appropriate liquidity framework. Counterparty risk should be measured via a balance sheet perspective and credit risk management of asset concentrations.

We believe an appropriately implemented ABA (activities-based approach) would be the most effective framework to address these risks. In other words, we believe an appropriately implemented ABA would address tsunami and domino risk effects.

While work needs to be done to develop an activities-based framework, the main challenge we face is convincing the FSB and IAIS that the entity based approach is flawed and that an ABA would be the most comprehensive and effective means to manage potential systemic risk in the insurance sector.

"An appropriately implemented ABA would address tsunami and domino risk effects."

- JOSEPH L. ENGELHARD

An ABA would rely on transmission channels as the primary lens to evaluate the potential of an activity to create systemic risk.

It would enable data collection, based on plausible thresholds, for regulators to conduct surveillance of emerging and accumulating systemic risk concerns. Any identified systemic concerns would be addressed as necessary by domestic, supervisory frameworks.

While IAIS policy measures are comprehensive, residual gaps do exist with respect to the tools available to address both liquidity and counterparty risk. An ABA can address these gaps through changes to IAIS policy measures, including strengthening ORSA requirements.

The ORSA provides a tool for insurance supervisors to collect the data necessary to identify and monitor potential systemic risk concerns. Together, the IAIS Core Principles, ComFrame, Liquidity Risk Management and Recovery and Resolution Planning standards provide robust guidance on how to manage identified risks. ●

Edite Ligere

Barrister, Global Government Relations,
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An activities-based approach to systemic risk across financial services: the way forward

An activities-based approach ("ABA") to identifying and addressing systemic risk in the insurance sector, currently being developed by the International Association of Insurance Supervisors ("IAIS"), is a promising construct for a more effective approach to defining the nature and scope of potential systemic risks in the insurance sector. The IAIS is rightly anchoring its methodology around the core attributes of systemically-risky activities: (i) an event or exposure that is demonstrably correlated with financial risk factors; (ii) manifestation of risks as a shock, as distinct from a more gradual "slow bleed"; and (iii) a mechanism for the transmission of risks across the broader financial services sector or macro-economy.

An ABA can be constructed in a manner that obviates, and therefore should replace, the current entity-based approach ("EBA"), which suffers from a number of practical and technical shortcomings, including limited transparency into the global systemically important insurer ("G-SII") designation process. >>>

>>> The EBA, as a regulatory construct initially developed for banks, is a flawed approach when it comes to insurance. In particular, it does not sufficiently acknowledge that unlike banks, which by the very nature of their business model regularly engage in liquidity and maturity transformation, insurers do not pose the same risks to the broader financial system and economy.

An ABA for insurance provides numerous public policy advantages, including: (i) recognition that the potential contribution of the insurance sector to global systemic risk is limited; (ii) differentiation of the activities in which insurers are a customer (similar to other corporate customers) of financial services rather than a contributor to systemic risk; and (iii) a coherent treatment of analogous risks across financial services, rather than a fragmented approach such as the current EBA regime, which only covers a select group of companies within the insurance sector.

"A clear focus on specific activities rather than on a small number of large insurers will enable more effective identification and management of potential systemic risk in the insurance sector."

- EDITE LIGERE

There are promising efforts underway to build a credible ABA. Alongside the IAIS's initiative, the U.S. National Association of Insurance Commissioners' ("NAIC") has launched the Macro-Prudential Initiative ("MPI"), a multi-pronged endeavour anchored in liquidity assessment (including stress analysis), targeted recovery and resolution planning, capital stress testing and counterparty exposure management. The MPI is a leading example of the type of policy construct which would make an ABA credible, effective and implementable. An effective ABA should provide a framework of tangible principles to serve as the parameters for locally developed policy constructs, for example, the NAIC's MPI, rather than prescribe detailed requirements across jurisdictions.

A properly designed ABA will complement local regulatory initiatives and promote alignment between local and international efforts. The definition and refinement of the scope of an implementable ABA will take time and effort. That said, the development of a cross-sectoral ABA to identify and address systemic risk in the insurance sector represents a unique opportunity not only to improve the way systemic risk is addressed in insurance but also to ensure a cohesive framework across the financial services sector to support global financial stability. ●

Market-based finance and ETFs

Francesco Mazzaferro

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European Systemic Risk Board (ESRB)

ESRB recommendations and continued monitoring of shadow banking: a focus on ETFs

The European Systemic Risk Board (ESRB) published a Recommendation on liquidity and leverage risks in investment funds in February 2018. The Recommendation is addressed to ESMA and the European Commission and focuses on five areas including liquidity management tools, liquidity mismatches, liquidity stress testing, reporting requirements and a framework to assess leverage risks. ESMA and the European Commission are due to address the recommendations by end-2020.

In the meantime, the ESRB's risk monitoring work continues. This includes the annual Shadow Banking Monitor which is due to be published in September 2018. It defines the size of the shadow banking system by using a broad approach including all entities of the financial sector except banks, insurance corporations, pension funds and CCPs. Besides liquidity and leverage risks, the ESRB also considers other risks and vulnerabilities that are relevant for entities in the shadow banking system.

These include risks associated with the engagement of financial entities in credit intermediation, maturity transformation and interconnectedness with the banking sector. A wide range of entities are covered in the monitoring universe including investment funds such as bond funds, money market funds and exchange traded funds (ETFs) as well as other financial institutions such as special-purpose entities or security and derivative dealers.

ETFs are one type of investment fund that has attracted attention among public authorities, academia and in the media in recent years. The use of ETFs by investors to gain market exposure, including to less liquid instruments, has grown rapidly. The high demand for ETFs is driven by several benefits to investors which other types of funds cannot easily replicate. They are low-cost products that deliver diversification benefits as they typically track market-wide indices, while offering intraday liquidity to investors.

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>>> ETFs combine features of investment funds with those of exchange-traded securities which involves trading on a primary and a secondary market. To participate in the primary market, an authorised participant (AP) first purchases a basket of shares as specified by the ETF issuer. The AP then exchanges this basket with the ETF issuer for a set number of ETF shares. This gives the AP an inventory of ETF shares which can then be sold to investors and traded on the secondary market.

Following these steps in reverse also allows APs to reduce the number of ETF shares in the market. ETFs are reliant on this creation and redemption mechanism to ensure that the price of the ETF accurately reflects the price of the underlying assets. Primary market trades are carried out where this is more economically beneficial than trading in the secondary market.

Financial stability considerations regarding ETFs largely revolve around the resilience of this arbitrage process in primary and secondary markets. When markets are functioning well, the arbitrage opportunities encourage APs to remain active in the primary market. However, APs have no legal obligation to create or redeem shares and thereby to provide liquidity to end-investors. Reduced risk bearing and hedging capacity among APs and market makers can lead to a temporary exit of these participants from the arbitrage process.

Regulators are considering rules to address structural vulnerabilities from asset management activities at the global level, including from underlying liquidity risks of ETFs. Several national authorities in the EU have already launched consultations with the industry in 2017. To date, the European ETF sector and any incremental financial stability risks stemming from ETFs in the EU remain small. However, given the strong growth in assets under management in recent years, the ETF market warrants a closer assessment of trends, benefits and potential risks. ●

Noel Archard

Global Head of SPDR Product, State Street Global Advisors

Unlocking the benefits of ETFs for retail investors in Europe

Global markets for exchange-traded products (ETP), particularly exchange-traded funds (ETF), continue to demonstrate remarkable growth, with global AUM exceeding $5 trillion in January 2018. While this reflects the strong performance in various jurisdictions, significant differences exist across 'local' markets. One example is the role of retail investors. Retail investors are estimated to account for less than 15% of the European market, whereas it is three times higher in the US. As several forecasts indicate the European ETF market could double by 2020, could retail investors in Europe be missing out?

There is a strong case for developing the ETF retail market, given the many benefits that are relevant to these investors' needs. The most notable benefit is the simple access to diversified asset allocation tools, through their brokerage accounts. The ability to trade on the secondary market enables investors to adjust their exposures more quickly and efficiently, with greater price transparency during periods of market volatility. Additionally, ETFs are often passively-managed funds, and therefore may have lower operational expenses and management fees. Furthermore, ETFs are typically characterised by a high degree of transparency, with investors benefitting from insight into fund holdings and the underlying investments of the fund.

"The characteristics of ETFs will help meet the diverse needs of retail investors."

- NOEL ARCHARD

However, the growth of ETFs, and the index fund industry more widely, continues to attract the attention of regulators. In that context, we welcome analysis currently being undertaken by IOSCO and are confident this >>>

>>> will help address some of the outstanding questions.

More specifically, there is concern that the easy accessibility of ETFs can be problematic for retail investors, as some ETF strategies are more complex or better suited for institutional investors. However, this does not necessarily apply to all types of ETFs. Moreover, in the EU, these funds operate within the regulatory framework established by UCITS and MiFID II, affording a number of safeguards to investors, such as disclosure, cost transparency and investor protection provisions.

To facilitate growth of the European retail market, several challenges will need to be addressed. Distribution is one such challenge, with market practices being markedly different between Europe and the US. In the US, ETF utilization spans the largest institutions, wealth managers and individual investors, with the majority of trading happening on national exchanges. In Europe, distribution remains influenced by banks, and trading is fragmented across different national exchanges and OTC markets. It would be beneficial to consider ways to increase retail investors' access to ETFs, especially at the point of sale, where changes introduced by MiFID II can be built upon.

To conclude, the further development of the retail market for ETFs in Europe should be encouraged.

The characteristics of ETFs, including their constant innovation, will help meet the diverse needs of retail investors. There may also be broader benefits, including for the objectives of CMU.

If calibrated appropriately, a more advanced and vibrant ETF market could help address concerns pertaining to the disparity between debt vs equity financing and the perceived overreliance on bank-lending in Europe. ●

Frédéric Bompaire

Head of Public Affairs, Finance and Strategy, Amundi Asset Management

The rapid growth of ETFs in the EU: a success story

Europe has been late in discovering the advantages of ETFs: if ETF in the EU reach about € 700 billion in AuM today, it was less than 100 billion a decade ago. It appears as a success story and it is easy to understand why. Indeed, the vast majority of EU based ETFs:

- refer to well-known indices and, hence, facilitate asset allocation and offer a clear and largely publicized reference that reduces disappointment when markets drop;
- do not incorporate fancy devices like leverage or negative exposure;
- show a very fine tracking of the index performance (in particular when using synthetic replication);
- are UCITS and must comply with the very protective constraints of the EU funds as well as market regulations (MIF2 and EMIR notably);
- are actively traded with market makers that contractually maintain a narrow spread and do not deviate from the instant NAV;
- are listed on exchanges which have circuit breakers in place in case of market disruption;
- have shown resilience in stressed market conditions.

And they are cheap!

Conversely ETFs are regularly suspected to carry some kind of specific risk for financial stability. In most cases these fears vanish when considering the best practices that apply to ETFS in the EU.

In terms of price discovery main concerns do not come from ETFs. We should more worry about HFT or the share of transactions that are conducted outside the lit markets and on the systematic internalisers (SI); ETFs tend to trade on the exchanges, at close, in order to have a price aligned with the valuation of their benchmark.

The role of Authorized Participants (AP) on liquidity is not always well understood. They are the only actors able to subscribe or redeem directly with the fund but they are not the only providers of liquidity on ETFs. Why would it be necessary to impose several APs, when what is relevant for investors is the number and of active market makers that offer fair bid/ask conditions? Who can contest that the current practice in Europe for asset managers to pay market makers for their work sharply reduces costs to access ETFs for end investors?

The role of these intermediaries, MM and AP, is strictly defined within the contracts that they sign with the asset management company and within the rulebook of the Exchange where ETFs are listed. They commit to bring liquidity both ways and continuously.

"Fears vanish when considering the best practices that apply to ETFs in the EU."

- FRÉDÉRIC BOMPAIRE

The return delivered to investors is the cornerstone of ETFs success. So called passive management requires a high level of expertise in many different fields. If fees are very low, it is not a low cost /low service industry. The capacity to industrialise processes produces economies of scales, provided that funds are seeded with a large amount and rapidly reach a sufficient size. What matters for investors is the capacity to deliver the performance of the benchmark with the lowest tracking error and cost. EU based ETFs have proved they could satisfy investors' expectations in the severely constrained EU regulatory environment.

Yes, the rapid growth of ETFs deserves a proper in depth analysis to get rid of fears that their novelty creates. Then, after clearance on the robustness of the strict European regulatory and operational framework for ETFs, we expect the development of innovations that will meet the wishes of investors to have simple, safe and diversified investment opportunities. ●

Natasha Cazenave

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

In a robust EU framework, focus should be on data and identifying emerging risks

Significant progress has been achieved in building an understanding of the activities, specificities and potential risks of the non-bank sector both at international level and in Europe. It's time to take a step back and assess the effects of the multiple reforms put in place. The focus should now be on identifying potential residual gaps and emerging risks.

"It's time to take a step back and assess the effects of the multiple reforms put in place."

- NATASHA CAZENAVE

The resilience of the financial system has been significantly strengthened through the implementation of stringent banking regulations but also through ambitious reforms affecting the non-bank sector, e.g., the OTC derivatives reform or the money market funds reform. In addition, authorities now collect detailed reportings covering non-bank entities and activities. In Europe, data is collected on individual transactions via the MIFIR trade reporting, on derivative transactions via EMIR, and on fund exposures and leverage levels. Reportings on securities financing and repos and money market funds will soon be in place. Such information should help authorities monitor market trends and their impact in terms of risks, at national and European level, and foster their understanding of interconnectedness in the system. Here, ESMA could gradually play a stronger role.

Going forward, the assessment of the potential build up of risks in the system and the decision of whether a particular measure or a new policy should be further supported or challenged by data. It is thus critical to ensure the data collected is relevant, its quality checked and, in some areas, improved in order to enable authorities to fully make use of it.

In recent years, the international debate has very much focused on the asset management sector and the risk of investment funds becoming a contagion channel of risk in the financial system through the materialization of liquidity mismatch between a fund's assets and liabilities and the potential impact of highly leverage funds on their counterparties or investors. Similar discussions took place in the ESRB and have led to the publication of recommendations to complement the European framework.

The results of these efforts is an increased awareness of the potential risks investment funds may pose to the system. The regulatory framework has in many cases been enhanced. That is the case in France, where a number of liquidity management tools have been introduced including gates and notice periods to give asset managers more means to contain risk in different situations. Guidance was also published on investment fund stress testing.

Importantly, beyond the market participants own risk management processes, European authorities also have powers to intervene should they believe there is a risk for the financial system as a whole. They have the ability to suspend redemptions of one or more funds or to cap leverage should it be deemed excessive. None of these should be considered lightly as they could themselves present risks in the system.

While there should be no complacency, Europe can proud itself with the fact that it has a robust and comprehensive framework to monitor and regulate the so-called shadow banking sector. It should now build on the very significant amount of data collected to strengthen the monitoring of the European financial system and identify potential emerging risks. ●

Alexandra Richers

Managing Director, DekaBank Deutsche Girozentrale

Regulation in the triangle of risk reduction, return on investment and reputation

In the current monetary environment asset management has become an ever more growing business, due to attractive returns. The critical role played by the asset management industry in funding real economies beyond bank funding has also been recognised in the EU and in particular in the US.

It is evident that there is a need for greater economies of scale and more market consolidation to face up to investment needs such as those in digitalisation and financial technology. Recently, there has been a large shift from core products given their performance towards more specialised ones. In particular, ETFs have grown significantly both in tactical and strategic asset allocation. There has also been strong growth in AIFs and in quant products. Asset managers are also operating increasingly in international markets. There is notably a great deal of investment from outside the EU into European high-yield asset classes.

The increasing importance of the asset management sector leads also >>>

>>> to higher potential systemic risks, like leverage and liquidity risk and also the herding effect. The market participant most interested to know these is the asset manager himself. If he fails, - his reputation and standing with investors - his most important assets - are at stake.

"Liquidity management should predominantly be the responsibility of fund managers, while recognising that regulators have a role to play in handling crisis situations."

- ALEXANDRA RICHERS

That's why asset managers are keen on identifying and limiting risks. Therefore the implementation of sound investment processes is key. A lot of the already existing EU fund legislation like AIFMD and UCITS tackles the main risks, addressing liquidity and leverage risks in particular.

So, many pre-emptive measures are already in place and are part of the day-to-day liquidity risk management.

A principles-based approach is desired for mutual fund regulation focused on activities, investment strategies and asset owners rather than on the legal entity (i.e. the management company). This creates a level playing field in a compatible way with domestic regulatory environments.

Currently there are already many macro-prudential instruments in place that take into account the investor's profile and behaviour, explicitly considering prospective redemption rates as well as the liquidity profile of fund assets. Instead of searching for ever more instruments it would be preferable to analyse the impact of the existing ones and make an effort to recalibrate if needed.

Liquidity management should predominantly be the responsibility of fund managers, while recognising that regulators have a role to play in handling crisis situations. Liquidity stress tests are very specific to the asset class and to the product category in question. In order to avoid herding all the fund managers in the same direction, the stress tests should be performed at the fund level. Stress tests should not be too prescriptive because of the different types of strategies pursued by funds.

Moreover, policy makers have to be aware that we might reach a point when ever tighter regulation prevents banks and asset managers from carrying out economically valuable functions. Furthermore, a global level playing field with consistent guidelines across the world is a prerequisite for risk reduction. However, an increasing gap to the US is looming. Apparently, the US administration believes the raft of post-crisis regulation has encumbered its asset management industry. They intend to deregulate and take a path that forks from that of other regions, especially Europe, which continue with the implementation of new rules. ●

Martin Moloney

Special Advisor,
Regulatory Policy,
Central Bank of Ireland

Vulnerabilities in market-based financing

Traditionally, banks have been the main providers of third party finance to the economy in Europe. They have generally intermediated the financing risk, taking this on themselves rather than leaving that risk with those who ultimately provide the funds. Consequently, banking regulators focus on preventing regulated entity insolvency and reducing the risks involved in direct connectedness.

The risks generated by market-based financing are different. They tend to require activity-focused regulation rather than entity-focused. The key concerns are disclosure, short-termism and conflicts of interest. The goal is an orderly, trustworthy market and minimising indirect contagion. This is because market-based finance no longer involves intermediating the financing risk. The financing risk is kept by the investor.

Most investors delegate the management of their investments to investment managers. These investment managers will try to tailor their offerings to investor segments. The temptation is to take a short term view. Investment managers can be tempted to have insufficient regard to the fragility of the various techniques used to enhance yield or liquidity, because it is the investor and not the investment manager who is exposed.

Our regulatory ambition should be to place limits on investment managers so they do not create illusions of high yields or liquid investments that are unsustainable or which are achieved only by intensifying market fragility disproportionately.

In addition to investors and investment managers, market-based finance relies on a vast range of intermediaries to facilitate trading and risk management. Concentration among these, herding, pro-cyclical behaviours or collusive behaviour with investment manager can all harm the ultimate investors.

Furthermore, all these risks are constantly shifting as innovation makes market-based financing evolve. These risks are also made more complex by the involvement of investment banks not only in bank-mediated financing, but also in this market-based financing, an involvement which can facilitate avoidance of their own banking regulatory requirements.

As market-based financing becomes more important, effective disclosure, cross-cyclically sustainable investment management strategies and the prevention and control of conflicts of interest all need to be familiar themes for all regulatory policy makers. The macro-prudential focus must refocus from direct to indirect connectedness and to the risk of contagion, i.e. the risk that the complexity of markets drives market participants, who come to doubt the pricing mechanism, to suddenly withdraw in the face of risks.

Only when this risk of contagion and market exit is limited and controlled could we rely comfortably on a financial sector dominated by market-based financing. ●

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3, 4 & 5 April 2019
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11, 12 & 13 September 2019
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April 2020
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III. BREXIT IMPACTS AND GLOBAL REGULATORY COORDINATION

Issues at stake

The financial system is global in many areas and requires global regulatory and supervisory coordination to ensure an appropriate financing of growth, preserve a global level playing field and mitigate the risks associated with highly interconnected players and activities. One challenge however is the wish of some jurisdictions to act more independently in order to ensure that regulation takes into account their own specificities and does not affect inappropriately their domestic financing mechanisms.

Brexit is a further concern. At this point in time it is still not clear what the future EU-UK trade relationship will be. Financial institutions are preparing for a possible no-deal situation but this uncertainty creates anxiety in terms of contract continuity and will in any case add costs and complexity and may increase market fragmentation at least in the short term.

Content

Addressing global financial fragmentation

Andrew Bailey

Chief Executive, Financial Conduct Authority (FCA)

The benefits of global financial markets

In July 2017, I gave a speech entitled "Why free trade and open markets in financial services matter". That speech was in response to some of the commentary on Brexit at the time that suggested that it must inevitably lead to restrictions on trade, on the location of activity in financial services and on open markets. In answer to the question of whether restricting trade is an inevitable or necessary consequence, my answer was an unsurprising 'No'.

My views on this have not changed, but I could not have imagined how the arguments of those like me would, a year on, have acquired such renewed urgency. Global markets and multi-lateral models seem under greater challenge than for a long time from a range of developments – while ironically market forces and technological innovations are underlining the potential of open, global markets more strongly than ever.

I also continue to believe that open markets in financial services, freedom of location and free trade are important to the functioning of the global economy, and that well integrated financial markets support economic growth and employment.

The G20 response to the financial crisis was intended to address the issues while avoiding fragmentation of markets, protectionism and regulatory arbitrage. These ambitions are still valid in respect of ongoing regulatory action. Regulators of global financial markets should always base our rules on prevailing international standards. And continued alignment with such standards should be a clear intended outcome of all financial centres. This also means that where rules implement international standards, there should be a strong presumption of equivalence. Consistent outcomes of regulation are what matters, reinforced by strong regulatory co-ordination which is essential to preserve the strength of the system. I have argued that there are four key elements of such co-ordination: comparability of rules, but not exact mirroring; supervisory co-ordination; exchange of information; and a mechanism to deal with differences. It is crucial for the continued success of efficient global markets and their effective regulation that we uphold these principles.

In the current climate, financial stability is of course one of the main current regulatory imperatives. And I and my FCA colleagues have also repeatedly stressed the importance of financial stability as a global public good. This means that regulatory structures that support open financial markets and free trade should, as they do now, represent the global as well as domestic interest.

>>>

>>> For as long as London and the UK remains a significant global financial centre, the FCA will ensure that it plays its full role as a global regulator, working closely with our fellow regulators across the world and inputting to the development of international standards and effective co-ordinated supervision.

The FCA's objective is to ensure that financial markets work well. This should be the shared goal of all regulators. ●

Sandie O'Connor

Chief Regulatory Affairs Officer, JPMorgan Chase & Co.

Emerging regulatory issues: a continued need for globally consistent standards

The framework for financial regulation has been transformed following the 2008 financial crisis. An increased emphasis on globally consistent standards and international coordination, applied to both new and revised regulatory initiatives, has been essential to increasing the resilience and effectiveness of the financial system. Currently, and in part due to the evolving financial services landscape, we are witnessing an increased focus on emerging regulatory issues such as cybersecurity, data use, and innovation in financial technology. Globally, jurisdictions are at varying stages in developing their own frameworks and implementation plans for these issues, with some more advanced and sophisticated than others. However, the benefits, challenges, and risks presented by these issues are interrelated and often borderless in nature. Regulators and policymakers, therefore, should maintain and strengthen their commitment to a global approach with consistent standards.

Consider cybersecurity and the fact that cyber threats are unrestricted by geographical boundaries – an attack may come at any time, from any location. Thus the cybersecurity frameworks put in place to assess the resiliency of organisations must be consistently designed and appropriately applied to all financial institutions, financial market infrastructures, and central banks. A fragmented approach, whereby separate cybersecurity frameworks are developed with bespoke requirements, introduces operational risks and inefficiencies in an environment where there is a known dearth of security resources. Such an approach leads to less security at individual firms and potentially weakens the security of the financial sector as a whole, as a system is only as strong as its weakest link. Instead, minimum, risk-based, global cybersecurity standards are needed to govern critical institutions, enabling industry participants and authorities to align efforts to effectively manage cyber risk and maintain financial stability.

With respect to data use, an increasing number of jurisdictions globally are placing limitations on the cross-border transfer of data, requiring data to be stored, accessible, or processed within a country's borders, or requiring the use of local technology products or services. Such data localisation requirements reduce the efficiency of operations and limit the effectiveness of security and compliance programs. Instead, policymakers should pursue the minimisation of data localisation requirements, expanded bi-lateral and multi-lateral agreements that enable cross-border data flow, and increased interoperability of data protection and privacy rules. The ability to transmit and store data across borders is fundamental to enabling global organisations to efficiently and securely serve local and international clients.

Finally, we must recognise that innovative technologies are not limited by geographic boundaries, irrespective of whether they are developed and deployed by an incumbent or a start-up. Supervisory and regulatory frameworks should endeavour to be coordinated and consistent, with a focus on activities- and risk-based oversight – similar approaches >>>

>>> should be taken for similar risks, regardless of the entity. This may help prevent regulatory arbitrage, conflicting rules that could hinder innovation, and risks migrating into unsupervised firms outside the traditional regulatory perimeter.

A globally coordinated approach to financial regulation has been invaluable to ensuring a safer, more resilient, and effective financial system. Moreover, it enables global organisations to best add value to clients and consumers, both local and international, ultimately to the benefit of the broader economy. As the financial landscape continues to evolve through heightened cybersecurity risks, emerging innovative technologies, and related data use considerations, policymakers and regulators should avoid a fragmented approach across geographical boundaries. These issues are interconnected and borderless, and the benefits, risks, and challenges will be best addressed via a global approach focussing on consistent standards across jurisdictions. ●

Mark Branson

Chief Executive Officer, Swiss Financial Market Supervisory Authority (FINMA)

Creating an innovation-friendly environment

We have seen two competing trends in recent months.

One side of the coin sees trade barriers being put up again, and in financial market policy fading memories of the last financial crisis mean that a deregulatory race to the bottom is no longer unthinkable.

On the other hand, new and innovative sectors which transcend physical borders and are built around technological decentralisation are growing fast. New products and services are springing up on the financial markets, developed by new players who are highly mobile and think and act internationally.

Fintech providers have not yet substantially disrupted today's financial industry with their innovative products. Nonetheless, innovation on the financial markets will be ever more important in times of continued low interest rates, changing consumer behaviour and low profitability in parts of the sector.

What approach should supervisors take in this environment and what is the role of international coordination?

Innovation cannot be imposed from above. It is only sustainable when it emerges from the initiative and competitive instincts of the private sector. The job of financial market supervisors is therefore to create the right conditions for an innovation-friendly environment.

This is an approach we at FINMA have long championed. We have reviewed existing regulation in Switzerland to ensure that it does not create unnecessary hurdles for innovative business models. By drafting regulations in a technology-neutral and competition-neutral way (for example opening up client identification requirements so that they can be fulfilled online or via video channels), we ensure there is a technological level playing field. We have regular discussions with the growing fintech sector and keep track of the latest developments to allow us to respond quickly with clear and reliable guidance on the regulatory treatment of new products and services (for example our groundbreaking guidance on the categorisation of blockchain tokens and the regulatory treatment of ICOs). This promotes greater legal certainty, allowing innovators to concentrate more of their energies on developing their technologies and less on the intricacies of the law.

However, we should not be naïve. Both risks and opportunities need to be kept in mind. New technology is only sustainable if customers can rely on it and it does not destabilise the financial system. This is why we also rigorously pursue misconduct in the fintech sector.

What is the role of international regulatory coordination in all of this? Healthy competition between regulatory jurisdictions can help to promote innovation. However, such competition is only healthy as long as it does not lead to a damaging race to the bottom. It therefore makes sense to maintain an active dialogue among regulators and develop a common understanding of the risks. In some cases only internationally coordinated solutions will be effective. For example, the money laundering risks of cryptocurrencies cannot be adequately addressed at national level without leaving obvious gaps. Systems that are by definition organised in a decentralised manner can only be protected from abuse if regulators combine forces. By acting together to safeguard market integrity, we can help to promote sustainable innovation worldwide. ●

Hiroshi Nagamine

Managing Executive Officer,
Head of EMEA, Mizuho Financial Group Inc.,
Mizuho Bank Ltd.

Enhancing global equivalence

Global equivalence determinations are vital in allowing firms to provide services without being subject to duplicative legislation. Equivalence determinations can be extremely powerful tools, and it is axiomatic that each jurisdiction should be able to decide whether to issue an equivalence determination. I believe that improving the functioning of the equivalence framework should be a priority. Brexit should provide the momentum and inspiration to achieve this. Equivalence determinations should never be used as political bargaining chips but should be based on an objective legal assessment.

It is clear that the current EU equivalence regime must be enhanced, allowing greater transparency, while always looking to improve the usefulness of determinations. This benefits firms and regulators alike. Brexit has highlighted the complicated nature of the EU equivalence regime, with no single harmonised approach to how equivalence is approached across EU financial services legislation. Many equivalence determinations focus on very narrow points, and it would benefit all to have equivalence framed in higher level terms.

There appears to be no consistent equivalence strategy when drafting or amending legislation, meaning that each point of equivalence has to be assessed on its own legal basis and / or in accordance with different procedures. Again, perhaps Brexit will be the catalyst for such a strategy and strip out some of this unnecessary complexity in future. From the industry side, it remains disappointing that even on relatively straightforward matters such as OTC derivatives reporting under EMIR, no equivalence determinations have been issued, notwithstanding that the reporting requirement stems from a G20 commitment and there appears little value for anyone in upholding fragmentation.

The unilateral nature of equivalence determinations poses considerable uncertainty to firms, and the recent SIX equivalence situation does not give cause for optimism. Firms should rightly feel aggrieved if their business is impacted due to getting caught in political cross-fire. If firms cannot rely on equivalence determinations, then they are left constantly having to plan for that determination being taken away.

"Equivalence should be presumed until the contrary is proven."

- HIROSHI NAGAMINE

One solution would to have a global (perhaps G20) commitment that where requirements stem from globally agreed standards, equivalence should be presumed until the contrary is proven. This would be a step towards re-establishing the primacy of international standards, enhancing the global level playing field, and signal a shift away from the worrying trend towards localization. Global rule setters such as BIS, FSB could be encouraged to extend their role into implementation, thereby fostering a spirit of equivalence at an international level, attempting to harmonise new reporting rules could be a good place to start. As long as rule drafting and implementation continue to be treated separately, the industry will remain subject to overlapping compliance costs. ●

William Coen

Secretary General, Basel Committee on Banking Supervision (BCBS)

The revised Basel III framework: have we gone too far or not far enough?

When it was finalised in December 2017, the Basel III framework marked an important milestone for the post-crisis movement to reform and strengthen financial regulation. But what impact do these measures really have in enhancing global financial stability? Some object that the minimum standards will hinder banks from supporting the real economy. Others say that the standards are undercalibrated – that is, too weak to shore up large banks and banking systems against future crises. The Basel Committee's current work programme will help to resolve such disagreements by shedding light on whether the reforms are meeting their objectives.

Any discussion about the impact of regulation must start with a look at the costs and benefits. The evidence to date shows that any costs to regulation are far outweighed by the benefits. For example, the Basel Committee's 2010 study on An assessment of the long-term economic impact of stronger capital and liquidity requirements[1] found that clear long-term economic benefits will accrue from increasing minimum capital and liquidity requirements. These benefits consist in making financial crises less likely and reducing the associated output losses.

Experience since 2010 suggests that the actual net benefits have been even larger than expected. >>>

>>> Looking forward, the Committee will focus on three key areas.

First, it will continue to promote full, timely and consistent implementation of its post-crisis reforms. In this regard, I am concerned that, for a variety of reasons, progress in the timely implementation of reforms has slowed. The complete implementation of minimum standards will strengthen the global banking system, promote confidence in prudential ratios, and foster a predictable and transparent regulatory environment for internationally active banks.

Second, the Committee will evaluate the effectiveness and impact of its post-crisis reforms, as they are implemented. Much of the regulatory framework is new, such as the leverage ratio, the Liquidity Coverage Ratio, and the Net Stable Funding Ratio. The Committee's minimum standards for large internationally active banks were agreed on the basis of thorough quantitative impact testing and careful public consultation. However, since implementation has only recently started, we now need to assess the real-world impact of the standards based on solid evidence and rigorous analysis.

Third, the Committee will carefully monitor emerging risks, including both cyclical and structural risks (eg those related to cyber-threats and crypto assets). It will also assess how banks are responding to the reforms, paying careful attention to any potential optimisation or regulatory arbitrage techniques that may not meet the letter or spirit of the Basel standards. In either case, the Committee will consider whether measures are needed to address emerging risks or imprudent responses to the reforms. ●

1. Available at www.bis.org/publ/bcbs173.htm. The Basel Committee is currently in the process of updating this study.

Sylvie Matherat

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

Fragmentation risk – the next big regulatory challenge?

The final agreement of the Basel Committee on Basel III (IV) in December 2017 saw the last piece of the international post crisis regulatory agenda effectively completed. With the bulk of the wave of post crisis

reforms now complete, regulation is moving to an implementation phase which brings with it a new set of risks around divergence. Add to this new political challenges to free trade and cross-border cooperation as well as changes to banks' business models driven by rapid digitisation and you get heightened risk of fragmentation in financial regulation. This in turn threatens to undermine the progress made in making the global financial system more resilient and safer in the wake of the financial crisis. If this risk is to be managed effectively, balancing consistency and calibration will be key to success.

In spite of the success of international rule makers in delivering against the G20 agenda for regulatory reform, important elements of the international regime still need to be implemented. The Basel IV package will lead to a fundamental overhaul of capital requirements for credit and market risk, whilst the full roll out of margin requirements for derivatives counterparties is yet to be completed. With implementation will also come a calibration of rules, to ensure that regulatory objectives are efficiently met in local markets. That fine tuning of regulation is important to ensure unintended impacts are avoided and new rules are sustainable.

Initiatives to look at rule calibration internationally, are therefore welcome and do not pose an immediate threat to consistency. However, to avoid the risk of calibration leading to fragmentation it is important that there is (a) ongoing cooperation between regulators to maintain common outcomes and (b) alignment in timing and scope of calibration.

Unfortunately there are a number of areas where deeper divergence of rules has occurred and more where a fragmented regulatory approach looks likely. Highly differentiated approaches to structural reform have been implemented in different jurisdictions, ranging from intermediate holding company requirements for foreign banks in the US and suggestions for intermediate parent undertakings in the EU. The result is a fragmentation of capital and liquidity leading to reduced efficiency and increased cost, or reduced choice for clients. Within the EU solo level application of prudential requirements and internal MREL risks create additional intraregional fragmentation. In light of Brexit, possible ring fencing temptations in the UK, the tightening of equivalence requirements and recalibration of supervisory cooperation risks further compound this trend.

Looking to the future, a fragmented approach by regulators to new market entrants, products and services as a result of digitisation and rapid change in the financing sector, will further accentuate the risk of divergence. The regulation currently rolled out is designed to address the risks of the last crises. But today's banking models will look fundamentally different in the next decade in light of technical developments. In the interest of financial stability and crisis resistance, closer cooperation between politicians, regulators and the industry is required.

How then should we address this risk of increased regulatory fragmentation? The answer I believe lies with a number of relatively simple actions:

1. Secure supervisory and regulatory cooperation – both within the existing framework and international rule making bodies, but also through new intra-regional and local forums.
2. Ensure coordinated approaches to calibration – continuous, responsive and effective calibration efforts at the international level will reduce risk of individual jurisdictions taking precipitous action. This could be encouraged via explicit objectives/commitments for regulators to pursue 'efficient' as well as effective regulation – i.e. by ensuring consistent and rigorous assessment of costs vs. benefits of proposals.
3. Allow for implementation before introducing any new rules – a sustained period of implementation and calibration of the global regulation is necessary to ensure the framework is operating as intended and is meeting its objectives.
4. Deliver closer dialogue with the industry – both in order to inform the fine tuning of rule frameworks to make sure they are operating as intended, but also to shape thinking on how regulation might be made more flexible to ensure it is future proofed.

By keeping these actions in mind, it should be possible to strike the right balance between efficient regulation and effective risk management. ●

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Brexit impacts and challenges

Bruce R. Thompson

Vice Chairman, Bank of America

What are the main operational and practical challenges of Brexit?

Brexit presents a range of practical and operational challenges for financial services firms and, for some, it will change both their footprint and their operating model across the continent of Europe. Bank of America has already announced that we will be moving certain of our legal entities to Dublin post-Brexit to ensure that we can continue to serve our clients seamlessly; and we will be increasing our presence in several European cities to reflect client needs.

From an operational perspective, we are undertaking a cross-border merger of two of our entities, as well as applying for new licenses and authorisations. All this involves a significant amount of dialogue with regulators, as it is a matter not just of data provision but of regulatory judgment – and is, quite rightly, a time-consuming process. Indeed earlier in the summer the ECB warned that if applications were not submitted by the end of June, it could not guarantee they would be processed in time for 29 March 2019.

Other operational challenges include ensuring continued access to CCPs and stock exchanges for different legal entities, as well as the need to communicate with our clients. In our case this involves detailed client segmentation work and the expansion of websites to share information on Brexit; customer communication is likely to be an even bigger task for businesses with a larger retail presence. Contract continuity also remains a concern, and while the sector continues to work on the issue, we hope that policymakers will stand ready to act as necessary.

On a practical level, we are refurbishing and expanding our offices in Dublin, and have taken new offices in Paris. More importantly, we are moving staff to Dublin and to Paris – we have announced leadership positions in both locations, and are in discussions with other colleagues. As I have said before, the potential impact on colleagues is one of the hardest aspects of Brexit planning.

A further challenge has been capacity over the last two years – our colleagues have also needed to stay focused on running the business during this period of uncertainty. While we have, to an extent, ring-fenced our Brexit planning, the amount of senior management time that has been devoted to Brexit changes should not be underestimated. Setting a hard Brexit as our baseline was also helpful in clarifying our strategy, though we remain hopeful there will be upside in the form of transitional arrangements and future co-operation.

>>>

>>> We are confident that we will be in a position to service clients seamlessly by the end of March 2019. However public authorities are right to be aware to potential challenges around that time, and the creation of the ECB / Bank of England working group is a welcome step. Indeed, post-Brexit, such co-operation will play a crucial role in avoiding regulatory and market fragmentation.

Looking more widely, Brexit must not lead to a step away from global standards. We would encourage supervisors in the UK, the EU and the US to maintain and enhance their participation in global standard-setting bodies, to avoid the possibility of macro differences in policy and micro differences in implementation, as both add to costs for customers. We stand ready to support policymakers and regulators in this endeavour. ●

Levin Holle

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

Options for market access post-Brexit

Now, close to six months before the withdrawal of the United Kingdom from the European Union time is becoming a decisive factor. Neither the EU nor the UK can be interested in a disorderly Brexit with potentially detrimental effects for both economies – therefore, timely preparation is key for all parties involved. At the same time, EU and the governments of UK and the Member States need to find pragmatic solutions for both, their future relationship and a workable transition. A transition period as provisionally agreed between the EU and UK would, as an integral part of the exit agreement, significantly help to ensure an orderly Brexit and leave more time to negotiate a possible Free Trade Agreement (FTA) covering also financial services.

The White Paper issued by the UK government on 12 July states that the UK intends to keep regulatory flexibility in the area of financial services and, at the same time, desires to preserve the mutual benefits of integrated markets and protect financial stability – whereas in other areas, UK intends to commit to ongoing harmonization with EU rules. The European Council guidelines of March 2018 clearly state that the four freedoms are indivisible and that participation in the Single Market based on a sector-by-sector-approach is not acceptable. Further, the guidelines firmly reiterate the principle to preserve the Union's autonomy as regards its decision-making and to respect the role of the European Court of Justice (ECJ). Whether or not a common ground between the EU and the UK positions can be found has to be explored in the negotiations.

Under these preconditions, any arrangement granting mutual market access between the UK and the EU would have to maintain full regulatory autonomy, including the right to unilaterally withdraw market access at any time. A dispute settlement mechanism governed by an independent judicial body (and not the ECJ) deciding on disputes about regulatory principles would restrain both, the regulatory sovereignty and the competence of the ECJ and would therefore most likely not be acceptable for the EU. For the reason of maintaining regulatory sovereignty, current FTA (e.g. CETA and proposals for TTIP) explicitly leave all decisions as to pruden¬tial standards and regulatory market access to the jurisdictions involved. Efficient equivalence systems - if used from both sides - could actually be seen as a path towards mutual market access, as they clearly define the conditions under which mutual recognition of regulation can be granted. >>>

>>> The existing EU equivalence regimes are designed to balance the EU's capacity as an open market economy with the need to mitigate risks for market participants and the financial system. Given new develop¬ments and risks – such as Brexit – these systems should be adapted accordingly, as currently done with regard to systemi¬cally relevant Central Counterparties (EMIR 2). Expanding equivalence regimes to other areas (e.g. on banking) however, seems less likely in the short term, since this would touch fundamental questions of EU supervision of these regulated activities on the one hand and national preferences of member states on the other. What could be achieved by the end of 2020 are equivalence decisions in important areas with then existing regimes (e.g. EMIR 2). In addition, processes for extensive and ongoing supervisory and regulatory cooperation should be developed to maintain equivalent high regulatory standards on both sides of the channel.

Summary: It is in the interest of both, EU and UK to follow the aims of preserving mutually accessible financial markets and to ensure financial stability on the basis of high regulatory standards and intense supervisory cooperation. However, within the current positions, this can only be reached on the grounds of full regulatory and judicial autonomy and reciprocal regulatory equivalence. ●

Denis Beau

First Deputy Governor,
Banque de France

Brexit: getting prepared for all options

While the negotiations between EU and UK authorities are underway, leaving open all the options concerning what will happen after March 2019, including the so-called "hard BREXIT", without any transitional period, it is of utmost importance that all the stakeholders of the financial sector get and remain prepared to the worst case scenario. Considerable efforts have been made over these last months in this regard but the persistent uncertainty on the outcome of the discussions calls for a steady enhancement of the preparedness. Different issues are at stake here.

Considering banks and insurers, the most critical challenge is to avoid any disruption in the provisions of services, vis-à-vis both their wholesale counterparts and their retail customers. This is a matter of financial stability as well as of protection of clients, which can be seen from different angles, legally and operationally.

On the legal side, the issue of contract continuity is – and must remain - under close scrutiny, given the effects of the withdrawal of the passport for UK regulated entities developing activities in EU countries; there are different ways to overcome the problem - including, when relevant, the transfer of contracts – but they are predominantly of the responsibility of the private sector. The EBA and the EIOPA have issued several opinions on this aspect, calling the actors to take the necessary steps as well as to inform the clients of the risks at stake and the possible mitigations. The ECB/SSM monitors this closely, in the framework of the supervision.

"Intensified efforts of preparation to withstand uncertainty are the best line of defence."

- DENIS BEAU

On the operational side, banks and insurers must prepare and put in place the necessary arrangements so as to ensure the continuity of their activities. This covers a wider array of aspects but the prominent one probably lies in the way the operations will be conducted and booked, and the risks managed as well as mitigated. Supervisors will closely look at the robustness of the organizations that will be set up in this regard, in particular when it comes to risk management and governance, each local entity, whatever its legal status, being expected to have adequate resources in these areas - without of course hampering the necessary management at the group level -. The ECB/SSM has in particular disclosed its supervisory expectations on these aspects, especially to avoid >>>

>>> the establishment of empty shell institutions in the SSM countries and ensure that supervisory expectations are consistently applied.

In a nutshell, contingency planning for banks and insurers are pivotal. They are by definition part of their primary responsibilities – and they should in this regard not take into account the potential for a public solution, quite uncertain -, the role of supervisors being to monitor their proper elaboration and activation.

For financial market infrastructures, the issues at stake are, to a certain extent, of a different nature. The 'cliff-edge effect' risk, where UK entities (CCPs, CSDs and TRs) would no longer be able to serve EU participants and vice versa, requires prompt action from all stakeholders. There is the need for the EU financial market infrastructures to continue developing the fullest scope of services which EU participants currently resort to in the UK; there is also the vital need for market participants to steer an adequate and diversified offer in the EU –and beyond- in order to avoid the build-up of "too big to fail entities" as it might hamper innovation and nurture moral hazard behaviour, jeopardizing financial stability.

In addition to a 'cliff-edge effect', Brexit induces a financial stability risk for the EU related to the particularly systemic importance of UK CCPs for the single market. The Commission EMIR 2.2 proposal addresses such risk, as it includes a location requirement for the most substantially systemic ones; its implementation only will ensure that EU financial stability remains the core concern of the substantially systemic CCPs and their lead overseers.

Brexit, as any exogenous shock, may have several collateral effects on financial markets and their participants. All related risks may not materialize at the end of the day, but nothing at this stage allows to exclude a darker scenario. Intensified efforts of preparation to withstand uncertainty are the best line of defence. ●

Sharon Donnery

Deputy Governor, Central Banking, Central Bank of Ireland

Collective preparedness in the face of an unknown Brexit end-state

The financial world is well accustomed to, and indeed often embraces, uncertainty. However, the uncertainty associated with Brexit is unprecedented. Since the UK voted to leave the EU over two years ago, politicians and central banks have made considerable efforts to prepare for the spectrum of Brexit scenarios. However, with the expected March 2019 deadline for the UK withdrawal from the EU now fast approaching, many questions remain unanswered.

One thing is sure: without the necessary preparations, a hard Brexit (with no deal and no transition period) could present significant challenges to financial stability. Given the degree of direct and indirect exposure of Irish financial and non-financial firms to the UK economy, Brexit in any form is likely to be negative for the Irish economy and financial system. The question of the Irish border and the settlement of Euro-denominated equities traded on the Irish stock exchange present particular challenges for Ireland. However, a disruptive hard Brexit would also present significant challenges for the EU as a whole.

Financial stability risks are being closely monitored. Possible 'cliff edge' risks that could cause a significant disruption to the financial system include a lack of service continuity for insurance contracts, loss of market access (to central counterparties (CCPs)), loss of passporting and lack of equivalence across all sectors, but particularly in the context of data protection and transfer.

Under the current circumstances, preparation and cooperation are key. Much is being done by authorities to prepare for plausible worst case scenarios in order to safeguard stability in the face of such uncertainty. Supervisors across the EU continue to prepare for these challenges in a coordinated and consistent approach. The Central Bank of Ireland is working as part of the Single Supervisory Mechanism, the Eurosystem, and within the European System of Financial Supervision (which incorporates the European Supervisory Authorities and European Systemic Risk Board) to ensure consistent, European approaches to mitigate Brexit-related risks. Supervisory expectations have been developed and communicated to industry in a number of areas, for example with regard to booking models, internal governance, risk management and internal models, and work continues in this regard.

Preparedness and contingency planning on the part of firms is imperative. This is true for firms which are already present in the EU, as well as those who intend to move to the EU as a result of Brexit. The transition period is not guaranteed and would only become a certainty if it were reflected in a signed Withdrawal Agreement. We at the Central Bank of Ireland, in line with other EU supervisors, urge all firms to prepare for all plausible worst-case scenarios, including a no-transition scenario.

"Under the current circumstances, preparation and cooperation are key."

- SHARON DONNERY

In its recent Opinion on preparations for the withdrawal of the UK from the EU, the European Banking Authority highlighted that financial institutions' contingency planning and preparations should have advanced more rapidly in a number of areas and that even where planning is taking place, it would appear that some institutions are delaying carrying out the necessary actions. Whilst we recognise the challenges that firms face when making preparations for Brexit, the only way to minimise disruption is for firms and regulatory and supervisory authorities to work together to consider and take all necessary mitigating actions in a timely fashion. ●

Tetsuro Imaeda

Chief Executive Officer, Sumitomo Mitsui Banking Corporation Europe (SMBCE), Managing Executive Officer and Head of EMEA Division, Sumitomo Mitsui Banking Corporation (SMBC)

The practical challenges of Brexit

Market Access/Regulatory Approval. It is now almost certain that no cross-border passport or similar arrangement will exist between the EU27 and the UK after Brexit. Available third country equivalence regimes do not form a coherent regime and are always open to interpretation and it is unwise to rely on transitional arrangements being agreed. For UK banks creating a subsidiary to market cross-border in the EU27 after Brexit time is now of the essence. UK authorities have ensured that a temporary licensing regime will be available, but the same is not true in the EU27 and banks that are not already far advanced in their applications will struggle to be ready by March 2019.

Post Approval. Transfers of branches (such as the transfer by a UK bank of its branches in the EU27 to a new EU bank) are complex since there is no simple mechanism for dealing with all the issues (asset transfers, customer consents, local filings, etc.) in a single legal process, and transfers can only be implemented after regulatory approval of the new EU bank is obtained. This is also true for obtaining access to market infrastructure (SWIFT, BIC, payment systems).

Human Resources. Hiring for roles outside London may be difficult, particularly in specialist areas of Treasury and Risk Management, where a lack of local expertise and competition for talent may delay the onboarding of key local staff. This is an execution risk if hiring must occur before regulatory approval of a new bank is achieved.

Continuity of Contracts. There are major concerns relating to the continuity of a huge volume of financial contracts, particularly derivatives and insurance agreements. "Lifecycle" events occurring after Brexit in respect of legacy contracts (rollovers, novations, exercise of various rights) may constitute regulated business – and without the passport they may be unauthorised. It is hard to obtain clarity on the regulatory impact of the various types of lifecycle event on products provided by a third country bank in each of the EU27 countries, but unless the authorities in those countries assist there is a real risk that contracts may become unenforceable. Some UK banks are contemplating transfers of their affected back books to EU27 affiliates, but this is a cumbersome process and brings with it high levels of operational risk.

"There is a real risk that contracts may become unenforceable."

- TETSURO IMAEDA

Liquidity Management. A new bank in the EU27 taking a transfer of pre-existing assets from a UK bank may encounter a currency mismatch between pre-existing assets and the new bank's liabilities which will pose problems from the start of operations for liquidity management.

Clearing. If UK CCPs are not treated as equivalent after Brexit the inability of EU27 firms to clear euro instruments through UK CCPs will fragment portfolios and lead to less effective risk mitigation.

Data Transfers. The UK will be compliant with EU data protection law on the date of Brexit, but its status as a third country may jeopardise cross-border data flows (key for many banking operations, such as KYC) from the EU27. To ensure that data can be transferred to the UK seamlessly, banks and the authorities must cooperate to solve this issue. ●

Christian Noyer

Honorary Governor, Banque de France

EU-UK: how to build a close relationship on realistic grounds

In a speech delivered at Lancaster House on January 2017, Theresa May ruled out for the UK to stay in the single market Since then, I have always considered that the UK would consequently loose the rights that are intrinsicly linked to this single market: passporting, and a comprehensive freedom for the cross-border provision of services. Simply because only the single market provides what makes them possible, i.e. a single regulation and a single judge to interpret it. Moreover, Financial services cannot be part of any trade agreement, whether it is an FTA or a customs union, because they do not belong to the WTO universe. In the White paper published after the Chequers' agreement, the UK government has drawn the necessary conclusions, and concentrated its proposal on goods. The financial institutions I met over the last 18 months have fully understood that reality and have designed their contingency plans taking it into account.

Nonetheless, I think that the EU should have a close relationship with the UK, also in financial services. This is our common interest. I see a number of ways to achieve this. >>>

>>> First, the EU Single Market is open to third countries, in general, as free movement of capital benefits them. As regards market access to provide financial services, the European Council made clear that our future Agreement with the UK should include the right of establishment, with EU rules applying in the EU.

Second, the EU has a long history of relying on the regulation and supervision of third countries, with what we call "equivalence". True, our rules, which should probably be reviewed, are a unilateral competence of the European Union, but they offer many opportunities. As examples, we can think of back to back hedging for specific market risks, when justified, or the delegation mechanism in the Asset management industry. But these useful tools should be used in a reasonably symmetric way, and not to a degree that would generate "empty boxes", with minimal or no EU presence. Financial services bear systemic risks and it is the duty of the EU to ensure that it can adequately preserve financial stability.

"I think that the EU should have a close relationship with the UK, also in financial services. This is our common interest."

- CHRISTIAN NOYER

We learnt tough lessons from the global financial crisis, and as a result, we decided to strengthen the entire EU regulatory framework and to create supranational agencies (ESMA, EBA, EIOPA, ESRB) to enable us to manage risks at the level of the single market. As close a partner as the UK may be in the future, its regulations may diverge, it will not be subject anymore to the decisions of those supranational agencies. As in any jurisdiction, our regulators will need to be able to assess how market operations, asset management, risk control, compliance, etc. are performed. This means that they will need to overview a critical mass of operations in their jurisdiction, and that the recourse to equivalence must be limited. This is exactly how it functions today between major jurisdictions, including an adequate oversight capacity abroad.

Third, building on lessons taken from the financial crisis, we have collectively developed at the global level (G20, FSB...) more effective regulation and supervisory cooperation. Once the UK, to our regret, leaves the EU, we should continue exchanging views on regulatory matters in a close and voluntary cooperation. ●

IV. CMU IMPLEMENTATION AND SUSTAINABLE FINANCE

Issues at stake

Developing EU capital markets is essential for providing alternative sources of financing to businesses and infrastructures and better connect savings with the huge investment needs across the Union notably required to achieve the de-carbonization of the economy. A wide range of measures has been proposed by the Commission to develop and further integrate different parts of EU capital markets, achieve more consistent supervision, develop sustainable finance and also support fintech development.

However at this stage only a limited number of CMU-related legislative proposals have been adopted and the priorities for achieving the CMU are difficult to identify. Major changes are also happening in the market with Brexit and the growth of new technologies that need to be acknowledged appropriately in the CMU action plan. Finally the connection between the CMU and the Banking Union needs clarifying.

Content

Building an effective CMU for the EU27

John Berrigan

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

Towards the completion of the CMU

The Capital Markets Union (CMU) is a comprehensive reform agenda, initiated three years ago, with the aim of creating deeper and more integrated EU capital markets. The CMU improves companies and investors' access to capital market funding across the EU. Well-functioning capital markets are important to provide financing for innovation and sustainability and also strengthen private-risk sharing across borders?

The Commission's CMU objectives announced in 2015 are to put in place the 'building blocks' of the CMU by 2019, so as to provide market participants with the right incentives and tools to develop and strengthen market-based finance across the Union. The CMU Action Plan and its Mid-term review in 2017 have announced some 70 actions and the Commission has delivered to date all the legislative proposals, including most of the priority actions. Important achievements include the adoption of measures to support venture capital, issuance of debt and equity and securitisation. We call on our legislators now to adopt by the end of this legislative cycle the nine pending legislative proposals indicated as priorities in the Commission's CMU Mid-Term Review.

While progress in implementing the CMU Action Plan is well advanced, further effort is required in some more fundamental areas. One such area is prudential supervision. The completion of CMU requires more supervisory convergence. The regulatory framework has undergone substantial reform in the last decade to facilitate and promote market integration, while ensuring sufficient investor protection. Now the key objective is to ensure that our legislation is applied and enforced in a consistent way and that oversight is better coordinated across sectors and borders.

There is clearly an asymmetry in promoting pan-EU markets while maintaining exclusive national supervision, with the risk of important differences in how the law is applied in practice. Keeping entirely decentralized supervision in a CMU will create inefficiencies and an unlevel playing field. This is why the Commission put forward the ESA review. The ESAs, and notably ESMA in the area of capital markets, have a significant role to play. We put forward a proposal related to the powers, governance and funding of the ESAs with a view to ensure that they can deliver and contribute to more consistent, effective and efficient supervision in all areas of the EU financial services market. We have proposed

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>>> that new responsibilities be allocated to ESMA, such as in relation to equivalence decisions. The development of ESMA should be consistent with what we want to achieve with the CMU; we need an ESMA that can effectively ensure convergence within the EU and bring credibility and consistency in the supervision of the EU capital market.

Brexit will certainly have an impact on capital market access in the EU 27. After Brexit, the United Kingdom will no longer be within the EU jurisdiction and so the EU27 e cannot rely on London to the same extent as now. It is essential, therefore, that the EU27 strengthens its own capital markets through greater development and integration. Together with a completed Banking Union, CMU will promote a stable and integrated financial system in the EU delivering jobs and growth, as well as greater resilience to negative economic and financial shocks.

Last but not least, let me highlight a key priority area of the CMU where further work needs to be done: sustainable finance. Over the next decade, Europe needs around €170 billion a year until 2030 just to meet our energy and climate objectives. The scale of the challenge is thus large and the involvement of private sector inevitable. The Commission is fully determined to tackle these issues with concrete actions and tangible results. The Action Plan on financing sustainable growth presents a comprehensive strategy for a financial system that supports the EU's climate and sustainable development agenda. ●

Vittorio Grilli

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

Towards a new Financial Services Action Plan

We are delighted to be in Vienna. Coming shortly after a global financial crisis, it was under Austria's first Presidency in 1998 that the European Council recognised "the importance of the financial services sector as a motor for growth and job-creation" and called for "the necessary steps towards a single financial market". That commitment was the basis for the European Commission's "Financial Services Action Plan" published the following May. The Capital Markets Union (CMU) initiative has similar aims and has made a lot of good progress. However, CMU was never foreseen to be completed by the end of the current Commission's term and was envisaged pre-Brexit. It will therefore require continued efforts. Twenty years after that original 1998 commitment, and looking towards the agenda of the next European Commission and Parliament, I believe we need to put forward a renewed and bold vision towards a truly single financial market.

There are three key areas which would be important to move towards that end; insolvency reform, post-trade reform and global connectedness.

As I have said before, confidence in company bankruptcy procedures is crucial for investors to commit cross border funding. The lack of harmonisation of rules across Europe – with a complicated patchwork of 27 different legal regimes – discourages investors to look beyond the markets they know best and ties banks to corporate borrowers in their country of origin. As a result, credit provision becomes more prone to local shocks and more pro cyclical. I hope that a successful adoption of the Insolvency Directive will bring efficiencies to the overall insolvency procedure in Member States and encourage the next Commission to continue the work of harmonising the rulebooks across Member States. The next Commission should therefore continue its work to harmonize the rulebooks that exist in all the different Member States. However, Member States must also seek reforms to national court systems, speeding up procedures and providing fair and effective judgements by an independent third party. >>>

>>> Higher levels of harmonisation and efficiency are also important for Europe's post trade environment, towards which policymakers and industry have been striving for many years. This process first started off with the Giovannini Group, which identified the key barriers to an efficient and resilient single post trade market in 2001. Many notable initiatives and regulatory changes have been introduced since then, such as the European market infrastructure regulation (EMIR), Central Securities Depositories Regulation (CSDR) and the introduction of the TARGET2-Securities T2S settlement platform. While it is true that each has brought improvements, the reality is that post trade remains segmented and processes continue to be delivered at a national, rather than pan-European level.

Policymakers should put renewed focus on finding a sound legal basis for cross border settlement, an efficient method of reclaiming withholding taxes, ensuring open access and interoperability for European CCPs, ensuring collateral management is harmonised and unencumbered by unnecessary restrictions and continuing the process of fully embedding T2S as a low cost, pan-European settlement platform. Legislators should also make good on their commitment to set up a single reporting source for consolidated tape by 2020 to help boost Europe's market for exchange traded funds (ETFs). The thorough analysis performed by the European Post Trade Forum on post-trade barriers, should be embedded into the next Commission's action plan with concrete initiatives to address them.

As well as deepening European markets, we should make sure they are open to the rest of the world. For example, the delegation of portfolio management allows investors to access centres of excellence all-over the world. We are concerned that certain Commission proposals could lead to restrictions of these well-established market practices and the openness of European funds. To avoid globally divergent approaches, the European Commission should also continue to play an active role in international fora. Global agreements, such as Basel, should be implemented nationally or regionally across the globe. In case of deficiencies in these rules, they should be amended at a global level.

The first Austrian Presidency laid out an ambitious path towards a single financial market. Great progress has been made but barriers remain. As the UK leaves the EU, this is perhaps the moment for a New Financial Services Action Plan that puts forward a renewed commitment to the frictionless flow of capital for the ultimate benefit of the people of Europe. ●

Susan Revell

Deputy Chair and General Counsel, EMEA,
BNY Mellon

The Capital Markets Union project – seizing the future

We are fast approaching two important milestones in the Capital Markets Union (CMU) project. The first is the end of a legislative cycle. We shall be able to evaluate what has been achieved so far, and what will need to be achieved by the next European Commission and Parliament. The second is the departure of the UK from the EU. Both milestones will be of transformational importance.

The current European Commission has often explained that the rationale for the CMU project is to help channel savings into long-term productive investment, improve returns for savers, and increase the resilience of the EU economy to external shocks. But if we look at the current reality of capital market activity across the EU, it is tempting to conclude that EU and national political authorities have been more successful in stopping capital market activity, than in encouraging it. >>>

>>> The UK's departure will result in a rebalancing of capital markets activity from the UK to several cities across the EU27. As a result, markets that were integrated because all major participants were located in the same place are now at risk of losing that degree of integration, as their participants are dispersed across different geographies.
Both milestones raise the same questions. Shall we step backwards into the future with our eyes focused on the dangers, risks and barriers of the past? Or shall we move forward into the future with our eyes focused on the needs and opportunities to build open and effective markets that deliver the promised benefits of the CMU project?

We do not yet have answers to these questions. With 450 million individual savers, pensioners and consumers in the EU27, there is a lot to play for. I suggest we prioritise supervisory architecture, tax, retail investors and processes. We need a more effective, more authoritative, and better-resourced ESMA that achieves regulatory and supervisory convergence in EU capital markets. We need progress on tax reform. I support Vitor Constâncio's call in a speech on 3 May 2018 for the harmonisation of taxes on financial products. At a minimum, we need implementation of the practical proposals set out in a letter dated 18 June 2018 from the ECB's Advisory Group on Market Infrastructure.

We need to give retail investors better access to capital markets. Retail investors bring significant benefits to capital market eco-systems. But today they are often excluded. We need to be clear that the solution for information asymmetries is not more bureaucracy and more restrictions, but rather better information, integrity, and transparency. Finally, we need to retire legacy processes and infrastructure. We have partially built the legal, regulatory and technical infrastructure for a real CMU. But many elements of the old national infrastructures are still in place, and are blocking progress.

Progress in these areas would be of transformational importance in achieving the objectives of the CMU, and will allow us to move forward into the future for Europe and the globe. ●

Steven Maijoor

Chair, European Securities and Markets Authority (ESMA)

Stronger consumer protection is key to a successful CMU

The CMU remains one of the flagships of the European Commission – and rightly so. The economies of the Member States as well as the European Union as a whole would benefit greatly from deeper and more integrated capital markets, in addition to a more resilient banking system. Among the various preconditions for the CMU to become a real success, I would like to point to two: a pan-European perspective of capital markets and encouraging consumers' participation in the CMU by strengthening their protection.

Firstly, the CMU is designed as a combination of a broad range of legislative and non-legislative initiatives.

We are all aware that the legislative part has intensified with a high number of proposals coming from the European Commission in recent months, and it will be important to adopt them in a smooth and coherent manner, while also taking into account existing frameworks, at both European and national level.

We should avoid patchwork solutions, which would result in fragmentation of financial markets. Moreover, the correct application of the regulatory framework and its robust supervision and enforcement are crucial to completing the entire project. Indeed, >>>

>>> additional legislative acts alone will not help if the existing ones are not supervised and enforced consistently – and will result in higher direct and indirect compliance costs. Consistency of supervision and enforcement removes barriers and ensures that cross-border risks are addressed adequately.

A further important aspect of making the CMU a pan-European success is to ensure that the EU strengthens its position in global financial markets. The departure of the biggest financial centre creates opportunities to build up the required expertise and capabilities and to make the EU27's capital markets attractive for overseas users. One point of entry and full integration are essential for the attractiveness of the EU as a global capital market.Secondly, the participation of individual retail investors is one of the essential features of the CMU. For several reasons it is also one of its biggest challenges.

Despite the persistent low-interest rate environment, retail investors only rarely abandon their traditional savings accounts and move into capital markets. A number of factors play a role here, including transparency and costs. But more importantly, we need to work on giving retail investors more confidence that their rights and interests are protected, and this should be a joint effort by regulators and market participants involved in both product development and distribution. Without that, we run the risk that it will take years before retail investors truly benefit from the CMU. ESMA has been playing an increasingly active role in this area, by supporting the implementation of the relevant legislative framework, with MiFID II and PRIIPs at the forefront, but also in cracking down on certain unsuitable, speculative products at the EU-level, like binary options and contracts-for-difference.

Indeed, the EU's product intervention powers serve as a good example of a proportionate framework, building on good cooperation between national securities regulators and ESMA, with direct intervention powers for the latter in cases of wider, cross-border consumer detriment.

Looking ahead, the ESAs Review legislative process will certainly offer some good opportunities to reflect further on what more ESMA could do to enhance consumer protection, in particular through targeting specific enhancements of supervisory convergence tools, such as independent reviews of national supervisory practices or reviewing delegation/outsourcing measures under assessment by national authorities. ●

Stéphane Boujnah

Group Chief Executive Officer, Euronext

Refocusing CMU in a post MIFID II environment

Ahead of 2019 and the European Parliament elections and appointment of a new European Commission, it is important to place progress on the Capital Markets Union (CMU) agenda in the context of a geopolitical and macroeconomic environment which is changing in fundamental ways. With the UK leaving the EU, established capital market ecosystems are fragmenting with consequences for capital flows and liquidity. The US is pursuing a deregulatory agenda which may prove seductive to European capital market activity, while Asia continues to focus on the business of growing and creating its own economic reality.

At the same time, technological evolutions are likely to create transformational change across the entire value chain, leading to disruption in the business of advising, distributing, securing, managing, trading and settling securities. In parallel, regulation has permanently redistributed the incentives among market ecosystems, with disintermediation likely to become a key feature. In order to address these challenges, it is important to undertake a holistic review of public capital markets with a view to identifying those measures which need to be both priortised and accelerated. In so doing, it is critical that each proposal should >>>

>>> demonstrate a clear relevance and benefit to the development of the CMU agenda. This translates to a requirement for thorough analysis and impact assessments with empirical evidence of the value to CMU accompanying each initiative. Central to this should be an integration of the upcoming MiFID II reviews into the CMU policy agenda. Such reviews should establish a set of parameters against which the legislation's impact can be assessed.

In the first instance, any economic assessment of the impact of MiFID II on end-user costs should address all participants in the market ecosystem and value chain. As an example, reviews of the market data provisions should consider whether the transparency obligations introduced on Exchanges need to be extended to all market participants within the value chain in order to deliver on the legislation's objectives. Secondly, in assessing progress on reducing costs to end-users, the Commission should balance this with a focus on the macroeconomic impact of MiFID II on the national and local ecosystems which support financial markets. An example of this latter point is the impact of the MiFID II inducements framework on the provision of equity research and promotion of equity investments. While there was already a deficit in the research coverage of SME and midcap companies prior to MIFID II, it is imperative that a review be undertaken as to the impact of MIFID II as the evidence to date appears to be that it has been negative.

Alongside a holistic review of progress on developing public capital markets and taking stock of MiFID II, it is important to reconsider priorities in certain other areas. In particular, the proposals on strengthening EU supervision should focus on improvements to the current supervisory architecture which can deliver real benefits in the short-term as opposed to a radical shake-up of EU supervisory structures. Securing improvements in supervisory convergence would deliver concrete benefits in terms of strengthening the EU's Single Market, thereby supporting EU financial markets.

In a similar fashion, it is also important that the EU equivalence regime governing relationships with third countries be reviewed and updated, particularly in the context of Brexit. These reforms should be guided by the principles of safeguarding the integrity of the EU's Single Market and ensuring financial stability across the EU, whilst acknowledging the reality of investment flows from third countries into the EU, often focused on long term equity investments.

Last but not least, it is critical to focus on investors' participation in public capital markets, both institutional and retail. For instance, a review of equity capital charges under Solvency II should be a clear priority with the Commission's current work in this area setting the agenda for possible initiatives in 2019 and beyond. ●

Robert Ophèle

President, Autorité des Marchés Financiers (AMF)

CMU needs a rethink to serve the interests of strong and open EU financial markets

The Capital Markets Union project remains a major initiative for the future of the European Union's financial markets. It must be pursued and expanded to support the attractiveness of EU capital markets.

Unfortunately, like the completion of the Banking Union, the CMU project faces fundamental challenges, albeit for different reasons. While the CMU could benefit fully from the freedom to provide financial services and from an effective freedom of capital flows, it suffers from a lack of a common supervisory mechanism, from >>>

>>> the absence of a common bankruptcy law and from a largely inconsistent framework for equivalence with third countries.

The Banking Union, on the contrary, has a strong supervisory institutional setting with a single supervisor and a single resolution Authority, but it suffers from a resolute ring-fencing of capital and liquidity around national borders, justified to some extent by the national nature of the deposit guarantee schemes and reinforced by the resolution approach which favors the solo basis and will require high internal MREL. In both domains, the EU landscape is at a disadvantage vis-à-vis the US and tomorrow probably vis-à-vis the UK.

How could we overcome these difficulties? While the keys are obviously in the hands of the European co-legislators, it is our common responsibility to document how detrimental it is for the EU taken globally, but also for every individual Member State, to have a fragmented and unattractive internal financial markets. It is not desirable to depend in the long term on third countries for the management of EU savings, the arrangement of the funding of our large investment projects and for supporting the development of European corporates abroad.

The Capital Markets Union is therefore still a fully legitimate objective. Reforms published by the Commission but not yet adopted should be finalized including the proposal to create a pan European Personal Pension Product, the proposal to remove barriers to the cross-border distribution of investment funds as well as the Investment Firm Review.

Key to the development of more integrated EU capital markets is the proposed reform to strengthen the European Supervisory Authorities, and especially the role of ESMA. Given the high degree of cross border activity, furthering common supervisory practices is vital to the creation of a true Capital Markets Union. It is therefore also our responsibility to use the regulatory tools that are already at our disposal to foster convergence. There are actually many ways to make progress in our Capital markets and Banking Unions without waiting for new grand regulatory reforms.

Reducing the scope of Pillar 2 requirements for banks below the consolidated level, developing branches instead of subsidiaries, taking full advantage of digital innovations for proposing trans-national services, fully taking into account the requirements of GDPR … would support the emergence of a strong EU located finance industry. While its initial goals to diversify sources of funding, unlock capital and lift barriers to cross border investing are still valid, the CMU project needs new impetus. It requires to concentrate on what would bolster the EU27 capital markets' competitiveness.

The EU needs to leverage on its strengths to develop its attractiveness and gradually reinforce its own financial capabilities in support of an EU located financial industry. Hence, beyond the objective of deepening the EU financial markets (i.e. lifting internal barriers) and the need highlighted above to enhance common supervisory practices, the CMU should focus on targeted initiatives.

Looking ahead, two areas, will require a clear EU steer and can constitute pillars of the CMU going forward: innovation and sustainable finance. In both areas, expectations are high.

It is our collective responsibility to contribute to the definition of the new CMU priorities in support of strong and open European financial markets. ●

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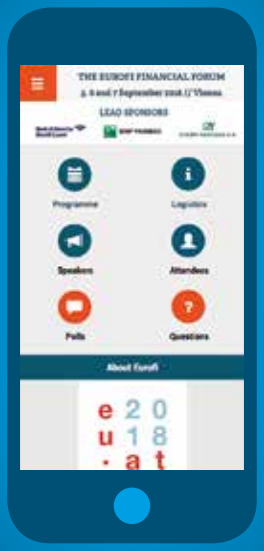

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Challenges and prospects of the EU fund sector

Patrick Thomson

Chief Executive Officer, EMEA,
J.P. Morgan Asset Management

Safeguarding UCITS for today and tomorrow

Asset managers play a vital economic and societal role in managing risk and return for investors, and contributing to the financial security of Europe's pensioners and investors.

We are encouraged by the collective efforts of EU policymakers to facilitate a well-regulated and healthy investment landscape and excited by the opportunity the Eurofi conference presents to continue to collaborate on important regulatory framework improvements.

Europe has thrived as an asset management policy leader in the development of UCITS. In the early 1980s, EU policymakers had the foresight to create a harmonised regime for collective investment schemes throughout Europe, enshrining healthy regulation and robust investor protection standards. UCITS has become so popular with investors that the framework has been adopted all over the world, anchoring Europe firmly at the centre of the global funds industry and contributing to significant investment into Europe.

There is no room for complacency however, especially with growing competition from other jurisdictions. One area is funds distribution. We support the regulation on cross-border funds distribution which MEPs and EU Member States are debating in Brussels. This proposal aims to tackle some national impediments to marketing funds across the EU, which would be a positive step in the right direction.

The European Commission recently published a report on distribution of retail financial products, highlighting discrepancies in costs and transparency across EU Member States. Greater transparency, consistency and reliability of disclosure of costs, across the value chain, could help improve markets and deliver better value to investors.

We strongly support the overarching intent of PRIIPs, to make funds more transparent and comparable for investors. Unfortunately, the metrics for disclosing certain costs to investors can be misleading.

We need to ensure that transaction cost disclosure is fit for purpose if we really want to push down prices and empower investors.

The Review of the European Supervisory Authorities (ESAs Review) is another area of concern. We fully support the EU Single Market and regulatory convergence with a central role for ESMA. But we question whether ESMA is ready to become the

>>>

>>> supervisor of supervisors. A system of second-guessing decisions taken by national regulators risks creating confusion for market practitioners. The ESAs Review also proposes changes to supervision of third country delegation which are a concern. Third country delegation, along with investor protection, diversification and liquidity, is one of the key pillars critical to the global success of the UCITS brand.

Finally, we are encouraged that Europe is taking the lead in the area of Sustainable Finance. Incorporating sustainability considerations systematically and explicitly in investment decision-making is consistent with our approach. However, it is important to remember that not all clients will want a preference for sustainable investments to be included in their investment decisions, and those that do will have differing conceptions of what a positive ESG return means. As asset managers, we would not support regulation that doesn't allow sufficient flexibility or take full account of client choice.

Europe's policy framework for funds remains one of its huge assets. I am excited to be here in Vienna to discuss our industry and how we can work with policymakers to bring more improvements and opportunities for investors and savers in Europe. ●

Dr. Mario Nava

Chairman, Commissione Nazionale per le Società e la Borsa (CONSOB)

Cross border distribution of funds: new rules and challenges

The proposal of a Directive and a Regulation on cross border distribution of funds represents a relevant step forward into the removal of restrictions to the free movement of collective investment undertakings in the Union and, accordingly, a step forward into the achievement of Capital Markets Union.

The proposal improves the current situation in terms of the the common European legal framework, disclosure and costs for market participants. In particular, it introduces:

- the definition of premarketing activity and lays down the conditions for carrying it out, ensuring a common understanding of activities prior to real marketing, allowing management companies (ManCos) to perform market sounding and prohibiting, at the same time, that units or shares are sold during the pre-marketing;
- transparency on fees and charges levied by host Authorities for supervision on cross border marketing, that shall be published on National Authorities' and ESMA's websites;
- the prohibition to Member States to require a local physical presence to provide facilities to retail investors.

Nonetheless, there is still room for additional improvements to smooth further cross border funds' distribution in both the areas already falling within the scope of harmonization and the areas currently outside that perimeter.

For instance, the notification procedure for passporting, currently based on e-mail messages from the "home" Authority to the "host" Authority, could be simplified through an automatized and structured system, enabling the "host" Authority to access, anytime and by a simple query, the name and the number of products marketed on a cross border basis. The potential benefits of such a system would be even more significant if it was integrated at European level.

Improvements should be sought also with respect to the perimeter of harmonization and the divergences among national legal frameworks, since national fiscal systems >>>

>>> for the investment in units/shares of collective investment undertakings remain highly heterogeneous across Member States.

As for the perimeter of harmonization, divergences remain between the UCITS and AIFM directives with respect to the rules of conduct for the marketing of products undertaken directly by ManCos. These divergences leave room to potential regulatory arbitrage across Member States. For instance Member States - like Italy - extended the product governance requirements and the other conduct rules as foreseen by MiFID II also to the management companies when marketing collective investment undertaking's quotes/shares, differently from other Member States that have not adopted such policy choice. Unleveled playing field may further concern entities authorized under different directives (MiFID entities on one side and UCITS or AIFM ManCos on the other) but undertaking the same activity (distribution).

The incoming review of the UCITS Directive and the AIFMD represent a great opportunity to extend harmonization to the abovementioned features. In addition, supervisory practices need to be fully aligned in order to ensure a really integrated environment for funds' distribution. For instance, the criteria for the computation and the payment of specific kind of fees (i.e. performance fees) are still highly heterogeneous across Member States, raising investor protection issues.

In the European financial system, ESMA plays a crucial role into fostering the supervisory convergence. The proposal of the ESAs review could combine the advantages of a "close to investors-surveillance system" with a strengthened role for ESMA.

Brexit will bring changes and new challenges for European asset management sector. The relocation of entities, activities and functions does represent an opportunity for Member States and the EU as long as the process is run under a consistent supervisory approach to safeguard investor protection and the orderly functioning of financial markets and financial stability. ●

David Claus

Luxembourg Country Head, BNY Mellon

Backing a winner: Europe should retain its' competitive regulatory advantage in the funds sector

With the 2018 World Cup now over, what have we learned from international sport that can be translated to the financial services policy maker scene? Teamwork? High stakes? I would suggest it is simple: when you have a winning strategy, don't change it.

Indeed, the European fund sector does represent the 'winning team' in many regards – Europe has had led the globe on the gold-standard UCITS and AIFMD model, underpinned by strong foundations for appropriate outsourcing and delegation. These are real success stories – policy makers are, and should be, rightly proud of their success – with the brand exported globally and allowing increasing numbers of funds to access Europe in return. Given funds represent only represent 10% of EU household assets, this can only be a positive.

However, the flip side of backing a proven winner is that change is a constant – with new entrants in the form of overseas jurisdictions nipping on Europe's heels. We need to constantly adapt our tactics (both external to Europe, and internally) to future proof our strategy.

"Policy-makers are particularly focused on using regulation as a tool to open opportunity for their funds."

- DAVID CLAUS

Externally, new entrants are fundamentally changing the commercial landscape of distribution, sales and marketing. In APAC, for example, policy-makers are particularly focused on using regulation as a tool to open opportunity for their funds. Pan-Asian fund passports are being introduced to mirror the UCITS strategy, while Hong Kong, Japan, and South Korea access to distributing non-EU AIFs in Europe via equivalency >>>

>>> determinations with ESMA. China, meanwhile, has launched its first sustainable finance consultation for asset managers and put considerable incentives behind green technology R&D. The successes of Europe are increasingly being challenged by Singapore, Sydney and Shanghai.

Internally, European asset managers also have to respond to changing demographics (both an ageing populating and an increase in the buying power of Millennials), very different public finances to pre-2008, and digitisation. These present opportunities – but also threats, if we don't adapt effectively.

Europe must tap into all sources of growth available by ensuring it continues to serve the real economy. The Capital Markets Union project should be focused on ensuring not only resiliency, but also ensuring openness and competitiveness with international markets.

For example, we remain concerned that MiFID II and PRIIPS regimes need revision to make them fit-for-purpose. We question the need for the cross-border distribution review to impose additional regulation on pre-marketing, which would slow capital issuance to the real economy. We also urge policy-makers to ensure that the sustainable finance reforms (such as the asset taxonomy) allow investors to access a full range of outcomes-based strategies (passive and active). Finally, it is integral that appropriate reforms to our European supervisors do not otherwise undermine the guiding principles of outsourcing and delegation.

In sum, we have a winner with the current gold-standard model that has been exported worldwide, and we must protect it, in order to promote real economy growth and serve investors who ultimately are everyday consumers. ●

Stéphane Janin

Head of Global Regulatory Development, AXA Investment Managers

Effectiveness and integration of the fund sector: taking into account EU regulatory competitiveness

To date, the EU has already achieved a high level of effectiveness and integration in the fund sector. The EU legislation, progressively from the initial 1985 UCITS Directive until the AIFM and UCITS V Directives following the crisis, is now encompassing all aspects of fund management, both for UCITS and non-UCITS.

In parallel, with full legitimacy, investors are putting pressure to get the lowest costs while keeping products diverse and of high quality. If we want to keep the costs low, but not at the expense of the efficiency of the active management of funds, European institutions must take into account the quality and cost of the regulatory measures for EU-based asset managers[1].

In addition, since the crisis, the fund market has become even more global, meaning that on all continents local players have more and more to compete with non-local ones.

Therefore, our requests today towards EU institutions are the following:

1. Regarding EU legislation, various post-crisis market events – e.g. the euro crisis, the Brexit referendum – were actual tests which proved the resilience of the current set of rules. We don't see the need for any significant revision of the existing legislative framework;
2. Conversely, we see some targeted needs for practical granular improvements. But what is the right place to get such improvements? Obviously not at Level 1, which needs stability over time: improvements must be searched at Levels 2 and 3, to get adjustments - only if and when needed. European institutions have to revert to the original Lamfalussy approach – with the Level 1 setting the 'essential principles' only[2].

This stabilization of Level 1 provisions over time is even more crucial today, considering the new global competitiveness environment:

1. On other continents, governments are more and more frequently taking pro-business approaches. For instance in the US – knowing that the US represents already more than 45% of the worldwide industry[3] – the Treasury issued a very pro-business report on asset management on 26 October 2017, asking for lighter-touch domestic regulation[4];
2. Even at global level, international regulatory bodies are asking for not launching new regulatory initiatives in the financial area for the time being: the FSB expressed such a view on 13 March 2018[5].

As a conclusion:

1. Obviously EU-based asset managers have to take their own part in ensuring and increasing their competitiveness vis-à-vis non-European players and products, by keeping innovation and cutting-edge technologies at the heart of their activities[6];
2. But European institutions too have to ensure keeping their own fund industry at pace with its non-European competitors, so that the Single Market can keep offering to European investors a satisfactory range of players and that on non-European markets the European players remain competitive from a regulatory cost perspective. Today, among the top 20 asset managers at global level, only 5 remain globally headquartered in the EU[7]. ●

1. From this perspective, it is clear that some post-crisis legislative measures generated significant costs within asset managers. At AXA Investment Managers for instance, regulatory costs doubled between 2011 and 2015, on compliance and IT.
2. Otherwise, we will continue seeing an over-inflation of measures at Level 1 + Level 2 + Level 3. Let us ESMA work and update, instead of having permanently to cope with revisions of Levels 1 which generate a lot of efforts and costs within firms.
3. https://www.efama.org/Publications/Statistics/International/Quarterly%20%20International/International%20Statistical%20Release%20Q1%202018.pdf
4. https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf
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7. https://www.ipe.com/reports/special-reports/top-400-asset-managers/top-400-asset-managers-2018-10-years-of-asset-growth/10025004.article

Niels Lemmers

Managing Director,
European Investors

Getting to a genuine single market for cross-border investments

European Investors strongly supports legislative initiatives for supervisory convergence in financial markets. We therefore applaud the European Commission and Parliament on the proposal to reduce barriers for cross border distribution of investment funds within the EU. Harmonisation of rules applicable to the review of marketing communications by the National Competent Authority's (NCAs) as well as the safe harbour for pre-marketing are positive developments for investors and fund managers alike.

Barriers

Member States' marketing requirements, regulatory fees and administrative and notification requirements, represent a significant barrier to the cross-border distribution of investment funds. European Investors supports the amendments to the UCITS and AIFM regulations. The new measures aim to reduce the cost for fund managers and should support more cross-border marketing and distribution of investment funds. This should increase the availability of competitive, low cost investment opportunities for investors. It also recognises that end-investors in Italy or the Netherlands are not fundamentally different than those in Denmark, Belgium or Spain. End-investors are a homogeneous group to which at least the same elementary rules on disclosure and protection apply if anyone want to approach them with a valuable investment opportunity.

"Significantly to improve regulation and achieve a single market for investments."

- NIELS LEMMERS

Improvements

Increasing the supply of capital to businesses by removing regulatory barriers on cross-border investments is essential for real economic growth. However, in order to significantly to improve regulation and achieve a single market for investments, more severe measures are needed. Let's just name one for each type of fund and its targeted investors.

(i)Language UCITS

In its Compromise proposal of 15 June 15, 2018, the European Parliament rightly suggest that NCAs should allow information documents disclosed to end-investors to be provided in the official language of the Member State where the UCITS has been marketed or in a language approved by the NCA. If this proposal where the ultimate text, European Investors encourages the NCAs and ESMA to take up this opening to come up with regulation which permits these investment funds to offer end-investors the possibility to opt-in to be informed in another than their native language. In practical terms, this could mean that an end-investor in Germany should be able to choose to receive information in the English language from an investment fund of which the distributor is incorporated and supervised in Portugal.

(ii) Pre-marketing AIF

European Investors acknowledges the benefits in the proposals to provide a safe harbour for pre-marketing to ensure that AIFMs can test the interest of professional investors in a proposed AIF without being required to incur the significant costs of producing full documentation and obtaining regulatory approval to market an AIF which might never be launched. However, the safe harbour currently proposed needs to be clarified and should be extended to UCITS. Formulating clear definitions on "investment strategies" and "investment ideas" would be highly appreciated. ●

Hanzo van Beusekom

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

"AIFMD II" offers an opportunity to improve the regulatory framework

A competitive EU fund sector is beneficial for both retail and professional investors. The ultimate beneficiaries of professional investors are very often private individuals. The EU fund sector plays a pivotal role in achieving the goals of the Capital Markets Union. The sector is changing rapidly, and market participants, supervisors and regulators all need to adapt.

Professional financial markets are fully international in nature. Professional investors see the world as their universe when deciding where to allocate investments. A small percentage shift in fund allocation from one continent to another can have a huge impact on the total amount of funds available. The ability of EU fund managers to attract funding depends on internal factors, such as their own intrinsic quality and >>>

>>> on external factors such as the financial, political and regulatory context.

Regulators need to find a balance between mitigating risks while allowing enough room for innovation and competition. Regulation of the fund industry should both serve the legislators' objectives and at the same time not be unnecessarily burdensome, also in comparison to other jurisdictions. UCITS is important, but my focus for now will be on the AIFMD. This is because the regulatory framework for the AIFMD is less crystallised. The assessment of the AIFMD, and its likely successor "AIFMD II", offers an opportunity to review effectiveness and competitiveness. Generally speaking therefore, the introduction of new rules should be subject to thorough impact assessments. Copying legislation appropriate for retail investors into areas reserved for professional investors should be avoided.

"Regulators need to find a balance between mitigating risks while allowing enough room for innovation and competition."

- HANZO VAN BEUSEKOM

There are several issues in the AIFMD that require clarification at Level 1 or Level 2. The AIFMD passport regime could be improved, as it entails too many administrative and financial hurdles. The EuVECA regime also needs further assessment before it can achieve the envisaged level of success. Improvement of legislation can remove uncertainties for market participants and contributes to supervisory convergence. A more robust legislative framework can further enhance the reputation of the AIFM sector. A solid regulatory reputation will increase the sustainability of this major part of the EU fund sector.

In addition to a solid legislative framework, we need further supervisory convergence. The aim is a level playing field without regulatory arbitrage or a race to the bottom between Member States. The initial steps have been taken with ESMA's Q&As on the AIFMD and ESMA's Brexit opinion. The proposals from the European Commission on the functioning of the ESAs can enhance ESMA's role in supervisory convergence, helping to promote efficient and consistent supervision throughout the EU. ●

Dennis Gepp

Senior Vice President, Managing Director & Chief Investment Officer, Cash, Federated Investors (UK) LLP

How to improve the competiveness and integration of the EU fund sector

The EU sets the market standard for registration, distribution and supervision of truly global investment products. EU financial service regulators, comprised of a balance of expertise at the Commission, ESA and NCA levels, are universally recognised as applying prudential supervision while maintaining key market drivers such as access to global portfolio management and efficient distribution mechanisms.

However, in the aftermath of the financial crisis and in the shadow of Brexit, these same principals which led to the growth and prosperity of the EU fund industry are at risk of falling victim to overregulation, including punitive regulation measures and shift from market efficiency should NCAs' authorities be usurped by a central organisation. This must not be allowed to happen.

The achievements of the EU fund industry have been appreciated over the years due to the implementation of well reasoned, transparent and informed financial services directives and regulations focused on investor protection, systemic risk, competitiveness of industry and integration of services within the EU. The EU has also recognised the need for a truly global product that has the ability to leverage portfolio management talent anywhere in the world.

Hand in hand with the success of the EU funds industry has been the development and globally recognised expertise of financial services regulators in Brussels and individual Member States. The regulators in Ireland, France and Luxembourg, for example, have developed expertise in the regulation of registered and unregistered collective investment vehicles. Deference to such expertise is critical. Proposals such as the ESA review, which look to shift regulatory supervision away from NCAs to the ESAs threated the delicate balance of supervisory authority between Member States and the EU Supervisors and could shift regulatory oversight to agencies with far less expertise.

"The EU must be careful not to undermine the NCAs."

- DENNIS GEPP

European and global investors choose EU funds in no small part due to the very robust, knowledgeable NCAs that have existed for decades. If NCAs can be countermanded, fund managers may consider their jurisdiction as less certain and attractive.

The EU must be careful not to undermine the NCAs, either directly, by looking to remove supervisory powers, or indirectly, by eliminating discretion in how the EU reform process in and of itself operates.

Member State Financial Services Regulators have demonstrated a strong commitment to supervisory diligence, a mastery of complex product and market issues and a willingness to engage in a transparent and meaningful way with all stakeholders – end investors, distributors, fund managers and policy makers in Brussels and globally.

We are only a decade on from one of the worst financial crises in history, starring down a hard Brexit and in a time of tremendous political instability. Focus must be on investors and market protection.

For the EU financial services industry to continue to thrive and retain its position as a global leader it must maintain and enhance the transparency of the regulatory process, maintain and encourage continued development of NCA expertise and stop thinking about proposals which do not address investor or systemic risk protection which may have been a knee-jerk reaction to Brexit. ●

Eric Derobert

Group Head of Communications
& Public Affairs, CACEIS

The ongoing search for competitiveness within the EU funds industry

In recent years, the barrage of regulatory measures at European and local level has been driven by both investor protection and industry efficiency. But, aside from the regulations designed to increase marketplace efficiency, the implementation and additional duties of other regulations have added considerable administrative complexity to the fund industry, thereby driving up costs.

There is most certainly a case now for reviewing regulations and a subsequent harmonisation of requirements, such as regulatory reporting through the creation of an all-encompassing reporting standard. National regulations, for example the need for a local representative agent, could also assessed to understand what really needs to be local and how efficiency is affected.

The fund industry has a key role to play in boosting its own competitiveness. US average fund sizes far outweigh those in the EU, and such economies of scale permit greater competitiveness. Despite the fact that the US and EU markets are not directly comparable due to intra-EU domicile competition, the EU has everything in place to enable those market participants to emulate their counterparts across the pond - master/feeder structures, pooled investment, uncomplicated corporate actions rules and EU-wide distribution from whatever jurisdiction best suits a company's strategy – and many of those operating in the EU market are taking advantage of this to increase the competitiveness of their business.

There are also efficiency-focused industry initiatives that seek to pool the significant administrative burden associated with AML and KYC duties, and the distribution of regulatory data such as PRIIPs and MiFID II data.

Without a doubt, technology has the capacity to significantly increase industry efficiency. Blockchain (distributed ledger technology) is heralded as a key disruptor of the industry, and many working groups are dedicated to designing its practical applications. It has already shown it can take over some of the low hanging fruit, but as yet, its ability to substitute complex in-house systems is far from evident.

"The fund industry has a key role to play in boosting its own competitiveness."

- ERIC DEROBERT

A clearly promising route is RPA (robotic process automation), that uses various technologies to enable it to use the complex, in-house systems, and shows enormous potential to reduce operational risk and free-up staff for tasks where human intervention is key, whilst retaining full local control of processing. Lastly, AI, in combination with data analytics, could help managers make increasingly accurate predictions about stock market movements and clients' investment decisions while improving the efficiency of product marketing strategies.

From regulation through business strategy and on to technology, the scope for increasing the fund industry's competitiveness is large.

CACEIS, a leader in asset servicing, is investing significantly and is fully committed to taking advantage of these opportunities in order to achieve our prime objective of creating value for our clients and their investors. ●

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Regulatory implications of sustainable finance

Daniel Calleja Crespo

Director General for Environment, European Commission

Sustainable investment as an economic driver for Europe

We are witnessing the consolidation of Europe's economic recovery, with growth and employment back to pre-crisis levels and continued improvement in the forecasts. However, in light of our long-term challenges and commitments, notably the 2030 Agenda with its 17 Sustainable Development Goals and the Paris climate change agreement, we cannot afford to become complacent. We need to redouble our efforts to achieve these objectives, which the EU played an instrumental role in shaping and which are strongly supported by European public opinion and an increasing share of businesses. What we now need is for the financial system to play its role in supporting sustainable growth.

This is precisely what the European Commission has set out to do with its work on sustainable finance, which was kicked off under the Capital Markets Union and led to the Action Plan on Financing Sustainable Growth tabled in March 2018[1]. The Plan marks a step change in taking the environmental agenda forward.

We will soon be 9.5 billion on a single planet with limited resources, which is already facing huge environmental challenges. If current consumption trends continue, we will need 40% more energy and water in the next 20 years and three times more material resources by 2050.

The obvious conclusion is that we need to rapidly decouple our economic growth from environmental pressures. Failing to address environmental degradation poses risks, not only to health and the environment, but also to long-term economic growth and the stability of the financial system itself.

In its Global Risks Report 2018, the World Economic Forum points to biodiversity loss and ecosystem collapse as being among the top 10 global risks in terms of impact, well above risks of common concern to financial actors, such as asset bubbles or fiscal crises. In fact, among the top eight global risks, six are environmental or relate to environmental degradation (e.g. water scarcity, food scarcity). If these risks are so important for the global economy, it is obvious that there are significant implications which the financial system cannot ignore. Broadening the perspective beyond climate change to natural risks as a whole is the next key step in sustainable finance.

However, it is not all about risks. These challenges also entail major opportunities. Green investment is increasingly recognised as investment that makes sense. By ensuring >>>

>>> that natural resources are appropriately priced and taking external costs of our activities into consideration, environmental policy makes an essential contribution to the overall efficiency of our economies and thus the competitiveness of our industry.

The Circular Economy is a case in point, with advantages for economic growth, innovation, new standards and even new product categories and services; for job creation, providing for new skills; and for a healthier environment, by reducing the pressure on resources.

A recent Commission study on the Impact of Circular Economy Policies on the EU Labour Market[2] confirms that it is possible to become more resource efficient and increase growth and employment at the same time, with a net increase in jobs of approximately 700,000 by 2030 and a GDP increase of almost 0.5%[3].

Of course, transition means change, and as with any change, the transition towards a greener circular economy will inevitably have winners, while some will lose out. By becoming aware of the full implications this transition – which is already happening - and anticipating its impacts on various sectors, actors of the financial system will be able to identify and seize the associated opportunities, while making their investment future-proof.

The work launched by the European Commission both within its Circular Economy Strategy but at the same time in the framework of the Capital Markets Union towards a more sustainable financial sector, will be crucial to meet these challenges. ●

1. https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en
2. https://publications.europa.eu/en/publication-detail/-/publication/fc373862-704d-11e8-9483-01aa75ed71a1/language-en
3. This is in line with the conclusions of other recent studies, by the Ellen MacArthur Foundation, SUN and McKinsey, or the WRAP and Green Alliance.

Sirpa Pietikäinen

MEP, Committee on Economic and Monetary Affairs, EPP Shadow Rapporteur on Sustainable Finance, European Parliament

Sustainable finance will be the greatest revolution since the introduction of accounting

The material risk arising from the climate change to assets is becoming increasingly tangible, making it no longer possible to be ignored by market participants and governments. Today, natural disasters cost the global economy US$520 billion each year, according to the World Bank. It is becoming clear that sustainability risks have a financial value. By 2100, expected financial losses could amount to over US$4 trillion in present value terms, a study conducted by Economist Intelligence Unit has estimated. A 6°C scenario could put US$13.8 trillion at risk, threatening 10% of global assets under management, and therefore posing a risk to the financial system as a whole.

Climate and environmental risk represents risk to which companies, investors and governments need to prepare. Private sector is in a key position as it accounts for 80% of investment decisions. By correcting the incentives of market actors, the US$84.9 trillion of assets under management could be put in use to support of sustainable innovation and technology. At the same time, globally, US$5 trillion of fossil fuel subsidies are distributed every year, a staggering 6.5% of the global GDP, which governments could redirect to energy efficient and low-carbon economy.

The EU's Sustainable Finance Action Plan presented by the European Commission in March and the Commission's High-Level Expert Group's recommendations earlier >>>

>>> this year were historic steps forward in taking the sustainable finance agenda in the political and economic mainstream where it merits to be. Sustainable finance is here to stay. It is in fact becoming the greatest revolution in the financial services since the introduction of double accounting.

In the near future, sustainability considerations will need to span through the entire financial services sector, as the. European Parliament's Own Initiative report adopted in June called for. But in order to put in place a framework of right incentives for market participants, a robust system of metrics needs to be taken as the foundation of financial services. Several institutions have already developed indicators that measure impact on sustainability. The European Union has developed Circular Economy indicators, which enable measuring the consumption of energy, waste, raw materials, water as well as impact on biodiversity and emissions, among other indicators.

Redirecting investments to sustainable purposes is a necessity but can only be effective if we simultaneously have a look at production and consumption and support transformation of business models themselves. The sustainability indicators, once established, can then be employed as the foundation of a thorough Life Cycle Analysis, developed by the European Commission.

Once a robust set of indicators has been established, the next step would be to put in place metrics and methodologies for their use, mirroring accounting standards. Accurate and measurable indicators will ideally be treated as part of international accounting standards allowing for integrating sustainability in the formulas calculating risk and return on investment. With a harmonised set of indicators, metrics and accounting standards it will then be possible to develop a meaningful, fit for purpose company reporting framework, where financial and non-financial elements are treated jointly, as an essential part of annual, audited reporting.

In the long term, to ensure an orderly transition to a sustainable financial sector the sustainability indicators will need to be integrated in all financial services legislation, such as credit ratings, benchmarks and the fiduciary duty of investors. But before further reforms can be credibly discussed, there is a need to set the building blocks, the indicators, right.

For a future EU sustainability taxonomy to be viable, these indicators need to be taken as the basis of the new classification system that Commission is preparing. The European Commission's Technical Expert Group set up to develop an EU taxonomy is an opportunity to take the sustainability indicators on-board, setting the foundation for other reforms to come. ●

Suzanne Buchta

Managing Director,
Global Head of ESG Fixed Income,
Bank of America Merrill Lynch

A European vision for sustainability in finance

As we move from a world of assumed infinite resources to a world of constrained natural resources, economic value will move to favor those jurisdictions which value, preserve and carefully optimize their natural resources. Europe can lead a shift from "wealth marked by waste" to "prosperity built on sustainability."

When I first started working on Green Finance back in 2010, I was met with skepticism. Now that the mainstream has seen the value of green and social finance, BofAML has been rewarded for being a forerunner and a thought-leader in this space. The future populace is also likely to reward those leaders with a vision of sustainability in finance and manufacturing. The peace and stability of the populace will depend on access to clean water, on breathable air and on the job opportunities that come from sustainable innovation.

The European Commission's Action Plan for Sustainable Finance established a robust approach to mitigating financial risks posed by the environment. Member states could expand individual tax incentives for installing residential renewable energy and >>>

>>> for purchasing electric/fuel-cell cars powered by that renewable energy. Regulatory requirements for minimum efficiency for new homes could also be expanded and continually upgraded as innovation allows.

"Europe can lead a shift from "wealth marked by waste" to "prosperity built on sustainability."

- SUZANNE BUCHTA

The financial sector feels most comfortable basing its risk models on historical performance. However, portfolio shocks based on anticipated future stress are an essential part of sound risk management. Are we considering all of the essential shocks? For example, if consumers and regulation trend away from diesel/petrol vehicles towards hybrids/electric/fuel-cell powertrains, would loan portfolios to fossil fuel cars weather the change? There are currently questions around the resale value of electric cars due to battery life, but there could equally be questions about the resale values of diesel/petrol cars due to changes in consumer preference and/or regulation.

Similarly, if consumers and regulation trend toward more energy efficient homes, would mortgage portfolios to inefficient homes weather the trend? Will inefficient homes be harder to sell in the future? Is the credit quality of an efficient home loan (with lower utility bills each month leaving more money to pay the mortgage) better than the credit quality of inefficient homes? We should at least be asking these questions and analyzing these risks.

Regulators could reward those financial institutions that do so. Europe could incentivize financial institutions to incorporate climate risks/natural resource scarcity risks into their stress test scenarios, with the ability to hold less capital against assets that show to be more resilient in those stress scenarios. Our economic theory is built on an assumption of infinite resources, but we are now living in the footnotes which caveat that natural resources might not be unlimited. Some of the above mentioned stress scenarios might materialize much sooner than we currently imagine. ●

Dominic Rossi

Senior Advisor, Fidelity International

Sustainable investments - towards a more sustainable destination

Sustainable investments, taking into account Environmental, Social and Governance (ESG) factors, is nothing new to Fidelity, nor is it new to legislators. We find references to sustainability in the Lisbon treaty and the recent Paris Agreement, as well as in sector specific rules like IORP II, the Non-Financial Reporting Directive and the revised Shareholders Rights Directive. The "Sustainable Finance Action Plan" and the legislative proposals presented by the Commission do however take the sustainability rulebook to a new level.

The Commission point out in their proposals that significant investments will be required in the real economy and new technology if we want to meet the climate targets agreed in Paris. While these targets will likely not be easy to meet, they will on the positive side provide us with plenty of investment opportunities. As we embark on this new journey, we do however have to keep a few things in mind, if we want to arrive safely at our destination: Any new rules must be balanced and proportionate, based on an honest analysis and discussions with all stakeholders, and we have to be mindful about the sequencing.

We are aware that the Commission has made a huge effort when preparing for the proposals. Given a bit more time, they could have been even better. When looking at these potentially far-reaching proposals, we must keep in mind that we are here not dealing with a market failure or financial crisis situation. Asset managers and our clients are already moving, fast and in an innovative mood. Lots of good work is done at an international level. The Task Force on Climate-related Disclosures (TCFD) and the UN Principles for Responsible Investment (PRI) are prime examples of what can be achieved when policymakers and stakeholders work together.

If we want to get this right, and we do, sequencing will be a key factor. By way of example, in order for us to do a proper ESG analysis of an investment, we must have access to solid and standardised data. As much as corporates work hard on this, we are not there yet.

Similarly, while it looks easy to ask us to ask clients about their views on ESG, it is slightly more difficult to work out what we should do with this information. It is not impossible, but we must get time to discuss the implications of a positive - or negative - response to this question against other relevant factors.

"Any new rules must be balanced and proportionate, based on an honest analysis and discussions with all stakeholders, and we have to be mindful about the sequencing."

- DOMINIC ROSSI

As nothing is impossible, but only takes a bit more time, it would be good if we could take lesson from our past experiences and avoid setting time frames that prove to be difficult to meet, be it for reaching agreements or for implementing the final rules.

The above does not mean that we should not embark on our journey, but that we have to prepare well if we want to arrive safely at our destination. We have to be mindful about the steps that we take, as well as the order in which we take them. We must also allow ourselves to be flexible if we find ourselves to be on the wrong track.

This being said, we look forward to this journey, and look forward to continue to contribute to this discussion, as if we all work together and listen to each other, it is more likely that we all end up at a more sustainable destination. ●

Rami Feghali

Partner, FS Risk & Regulation, PwC France

Accounting and regulatory incentives of long term investments need to be fixed

The argument that accounting and regulatory rules should remain neutral is sometimes used to dismiss the relevance of regulatory or accounting incentives in the context of long term investments. Accounting should indeed achieve a fair representation of performance and regulation a fair representation of risk. But while neutrality is desirable in theory, it is often an illusion in practice. There are at least three reasons that make neutrality difficult to achieve.

First, there is an inherent uncertainty in the architecture of the rules. Regulatory capital is supposed to reflect events that happen once in hundreds years. The end result is therefore rather a set of conventions than science, a large range of equally valid assumptions can be chosen with yet very different outcomes. The same is true for accounting, where many items requires significant judgment, for instance equity or credit impairment relies on estimation of future cash flows that can span through multiple years with high estimation uncertainty. One common way to reduce the uncertainty is then to use short term and mark to market approaches at the expense of long term purposes.

Second, externalities and long term horizon are usually not taken into account because rules are transaction based. Any risk that is beyond the time horizon considered or that is not specific to the transaction is not factored in. Sustainability risk factors which are essentially long term and pervasive are therefore dismissed. Neutrality is dependent on what one is trying to measure.

Third, both accounting and regulation provide incentives by construction. Accounting is a language and language influences behaviors. The same is true for regulatory capital, in current economic and regulatory environment, it is a binding constraint. Regulatory capital consumption drives the performance of activities, the profitability of transactions and ultimately business decisions. Accounting and regulatory capital rules cannot be neutral as they directly impact market behaviors. Anticipated consequences should be taken into account ex ante when designing the rules, so that rule makers can ensure they stay aligned with their original objectives and purposes.

The treatment of equity risk under IFRS9 and Solvency II is a good illustration of the combined influence of these three factors. Under Solvency II, equity risk is measured using a mark to market approach with a one year time horizon, even if the business model is essentially long term. A significant decrease of the equity share was then experienced in insurance portfolios. On the accounting side, because it is indeed not easy to define an impairment rule for long term equity positions, market participants are left with the penalizing choice of either using mark to market or never recognizing a profit or a loss when the equity is sold. These features of IFRS9 combined with IFRS17 could further decrease the share of equity in insurance portfolios.

Incentives exist in current accounting and regulatory environment, but they play against long term investments. They should be fixed. More generally, sustainability considerations need to be factored in and sustainability incentives as green supporting factor considered. ●

Gerassimos Thomas

Deputy Director General for Energy, European Commission

A policy framework for energy transition conducive to private investment

Europe's energy transition is a challenge and an opportunity. The COP21 agreement in Paris set a tight framework for reducing emissions for all participating countries around the world. The UN climate conference COP24 in Katowice, Poland will focus on how signatories will deliver on their commitments. The European Union will therefore outline, in November 2018, a Long Term Strategy (LTS) on greenhouse gas emissions (GHG) reduction[1]. It will set the broader policy goals for 2050, building on recent Commission proposals for a robust 2030 framework. It aims to reassure investors that an overall conducive investment environment will be in place to accompany the transition to a low emissions economy.

The sheer size of the investment required over the coming decades is overwhelming. However, the task in front of us is not an insurmountable one. With the right policies to unleash private sector investment, and policy stability, the energy "ship" can be steered in the right direction.

The Commission presented recently a series of legal and governance proposals – the "Clean Energy for All Europeans" package - that provide a stable framework for investors and companies. The package contains legal proposals covering all parts of the energy system – from the producer to the end user, encompassing all links in the chain. The Council of Ministers and the European Parliament already agreed key targets for 2030 under the Bulgarian Presidency: at least a 32%

share of renewable energy consumption and a 32.5% increase in energy efficiency. These open the door for a possible increase of the currently proposed 40% by 2030 EU target for reducing GHG. The remaining parts of the package will be agreed by the end of the year under Austrian Presidency. >>>

>>> These decisions complement the clean mobility strategy as well as the ongoing gas strategy reinforcing regional cooperation and solidarity.

The implementation of the Clean Energy package will require additional annual investments of close to EUR 200 billion on average between 2021-2030. The bulk of this investment gap arises from the need to invest in energy efficiency in buildings. The Commission has proposed that a large part of the EU budget over 2021-2027 is dedicated to energy transition and low emissions. Either by directly supporting investment at EU level through: (a) a 60% increase in the budget of the Connecting Europe Facility (EUR 8.6bn), (b) a 35% increase in the energy and climate part of Horizon EU (EUR 15bn) and a dedicated Clean Energy Transition sub-program under the LIFE Programme (EUR 1 bn). The European Regional Development Fund and the Cohesion Fund, which will both promote clean and fair energy transition through a new policy objective of a greener, low-carbon Europe: at least 25% of their resources will be dedicated to this policy objective. The same goes for the Invest EU Programme, which like its predecessor, the EFSI fund, will offer debt and equity financing, and will have a large component dedicated to sustainable infrastructure.

National budgets cannot afford to cover all the necessary investment. Nor is it desirable from the policy point of view to support decarbonisation without private investment. Decarbonisation raises more economic opportunities than it does transition costs in the long term. Jobs, innovation, and exports are expected to rise over the next years as public and private actors engage together for the energy transition. An active engagement of the EU financial sector in the transition to a low carbon economy and the facilitation of private investment are therefore more than ever necessary. Earlier in 2018, the Commission set out a "Sustainable Finance Action Plan" for the financial sector to support the transition to the low-carbon economy. Measures in the plan include: establishing a common language for sustainable finance (taxonomy), and the creation of EU labels for green financial products: both will allow investors to easily identify investments that comply with green or low-carbon criteria and enhance disclosure requirements. The Commission is moving fast to implement the recommendation of the High Level Group on Sustainable Finance and strengthen reporting, transparency, fiduciary duties and where appropriate examine how to incorporate sustainability in prudential requirements. ●

1. https://ec.europa.eu/clima/consultations/strategy-long-term-eu-greenhouse-gas-emissions-reductions_en

Dr. John Scott

Head of Sustainability Risk,
Zurich Insurance Group

Challenges and benefits of the proposed EU sustainability taxonomy

The shift of capital flows needed to drive the transition to a low-carbon, more resource-efficient and circular economy has to have, as a key building block, a shared understanding of what 'sustainable' means. A unified EU classification system, or taxonomy, as proposed in the European Commission Action Plan will help provide the clear guidance that is needed for investors. This should include detailed information on relevant sectors and activities, based on screening criteria, thresholds and metrics.

If the aim is to embed this sustainability taxonomy in EU law and to use it in different areas e.g. standards, labels, green-supporting factors for prudential requirements and sustainability benchmarks, then these need to be defined and applied in ways that ensure appropriate outcomes. A technical expert group on sustainable finance has been set up to deliver a first taxonomy with a particular focus on climate change mitigation activities by Q1 2019. This is to be extended to climate change adaptation and other environmental activities by Q2 2019.

"A balance needs to be struck between flexibility and the standardisation of disclosure."

- DR. JOHN SCOTT

Whilst the sustainability criteria in the taxonomy will create value, they have the potential to create challenges in the way they are implemented. Typically the challenges are in terms of competition within and between industries, how the criteria impact existing green financial products and markets and the global acceptability of the criteria:

- Protecting the integrity of and trust in the sustainable financial market, through identifying what is "green" will allow easier access for investors and avoid the challenge of "greenwashing". Green bonds have not always been transparent as to their efficacy in driving various environmental, social or governance outcomes. A clear taxonomy will help integrate this impact investing with truly sustainable outcomes.
- Prudential regulation needs to better reflect the risks associated with climate and other environmental factors. Careful calibration will be required to avoid jeopardising the credibility and effectiveness of the current EU prudential framework and its risk-based nature.
- Disclosure and accounting: There is growing concern that the current accounting rules do not help drive sustainable investment decision-making. A balance needs to be struck between flexibility and the standardisation of disclosure to avoid investors taking decisions that impair critical industries during the transition.
- Sustainability benchmarks: a sound methodology to calculate overall carbon impact, needs to be put into operation once the climate taxonomy is in place to understand compatibility with the objectives of the Paris Agreement. Perhaps surprisingly, it will be necessary over the next decades to maintain investment is some apparently carbon intensive activities as we develop new technologies and approaches in power generation, petrochemicals and transportation.

Despite the value inherent in the EU sustainable finance action plan, a coordinated, global effort is crucial. The private sector across all sectors and major non-EU economies will need to take action as well, to help promote and lead this transformation. ●

Andreas Utermann

Chief Executive Officer,
Allianz Global Investors

Capital for climate change: investor preferences & forward-looking active management

Climate risk factors will undoubtedly have a material impact on the world and the financial performance of our assets over the mid/long-term, and hence represent an important part of our investment analysis. However, whilst the long-term risks and the need for action by policy-makers, businesses and investors are clear, time frames of such actions are unknown, materiality of measures to be implemented by policy-makers and regulators undefined, technologies required for a large-scale low-carbon transition unproven, and data/risk disclosures incomplete. In this context, the main challenge for the asset management industry is the dilemma between allocating capital today towards solving climate problems in the long-term, versus delivering competitive returns in the short/medium-term, which might include owning carbon assets where risk-adjusted returns justify such holdings.

It's a complicated dilemma because neither asset managers nor governments are directly allocating investors' capital without their consent. Some are indifferent on climate issues, some would be willing to restrict their portfolios to allocate capital to the climate problem and some want optimal performance from active managers who have a clear understanding of the risk/reward around climate issues. So, asset managers need to educate investors and understand their preferences around climate, while governments need to promote pricing mechanisms to attract the investors' capital.

There is a significant gap between the amount of capital required to finance the transition to a low carbon, climate-resilient economy and the amount being invested. Providing stable, reliable and economically meaningful carbon pricing mechanisms that help redirect investment proportionately to the scale of the climate change challenge should be the top priority for policy makers at the global and EU levels. This is a necessary step to allow the financial industry to price carbon in appropriately, and provide a sound basis for asset allocation and investment decisions.

Active managers with the right skill and capabilities can monitor their climate risk exposures to maximise outperformance potential in the short/medium-term, with full consideration of longer-term risks. For instance, AllianzGI's integrated ESG approach includes deep understanding and assessment of climate risk at issuer level, allowing us to, say, differentiate between a coal-power utility in China facing low risk of disruption in the medium to long-term, and a pure-play European oil company, which we see as high investment risk. This approach also considers finding and allocating capital toward "brown" companies making successful investments to become "green", and not just toward "green" companies in a backward-looking benchmark construct.

"Asset managers need to educate investors and understand their preferences around climate, while governments need to promote pricing mechanisms to attract the investors' capital."

- ANDREAS UTERMANN

Pursuing portfolio decarbonisation might not go far enough and runs the risk of simply divesting and shifting the risk around. To achieve real world decarbonisation we must engage actively with companies, using our access and influence as investors to encourage reduction of greenhouse gas emissions by the businesses we invest in. We should also engage with policy-makers to develop appropriate carbon pricing mechanisms to allow the industry to continue to generate long-term outperformance and value creation as we transition to a climate-resilient economy. ●

Rhian-Mari Thomas

Global Head of Green Banking,
Barclays Bank

High quality disclosure remains critical for stimulating sustainable investment

In Europe, the latest estimated additional yearly funding requirement for sustainable investments is EUR180bn and the Committee on Climate Change has estimated that the total investment needed to meet the UK's fifth carbon budget is £22bn per year (roughly 1% of UK GDP).

These huge numbers present significant investment opportunities and provide a key role for the capital markets and its intermediaries, the banks.

However, ultimately, the speed and cost at which the private sector will invest in green will be driven by investors' perceptions of the risks and returns involved.

An accurate assessment of those risks and returns can only be derived from disclosure of reliable, high quality data based on an agreed understanding >>>

>>> of what is considered sustainable, requiring a common and shared taxonomy to be developed.

We clearly welcome the EU Action Plan's focus on disclosure, transparency and creating a common standardised language.

Information is without question, the lifeblood of the markets. Quick uptake of the Task Force on Climate-related Financial Disclosures' (TCFD) recommendations will be critical to prompt the market to more appropriately price the risks and returns associated with the low carbon transition.

"Information is without question, the lifeblood of the markets."

- RHIAN-MARI THOMAS

There is seemingly universal agreement that a successful disclosure regime will ensure that the balance is struck between delivering the right information for investors whilst not creating overly burdensome reporting obligations.

There is clearly less agreement on the optimal way to achieve these aims. Over 300 major companies with a combined market cap to $6.5 trillion and financial institutions responsible for $80 trn of assets have already committed to adopt the TCFD recommendations.

We could conclude that the power of market uptake will drive successful implementation of TCFD, however, in the event of slow adoption, setting a medium term target for mandatory disclosure on a comply and explain basis may be required. ●

Fausto Parente

Executive Director,
European Insurance and Occupational Pensions Authority (EIOPA)

Sustainable finance and supervision: opportunities and challenges

Sustainable finance raises a number of opportunities – and challenges - for supervisors. It also forces financial institutions to consider their responsibility and their impact on their

surrounding environment including citizens and society as a whole.

EIOPA is prioritising sustainable finance because we see a clear affinity between prudential supervision – which is concerned with financial sustainability – and other forms of sustainability. Moreover, of all the parts of the financial sector, insurance and pensions have the longest time horizons and hence the greatest stake in sustainability. The sectors, which we supervise, give us a special incentive to care about sustainable finance.

From the supervisory perspective it is however important to emphasise that supervision can only be part of the solution. Only through reorientation of flows of private capital will finance become more sustainable. Wider economic and fiscal policy also needs to play a role.

Nevertheless, EIOPA does not intend that "the best be the enemy of the good". For example, we cannot wait until a credible framework for carbon pricing is decided or indeed for an all-encompassing definition of sustainable finance. In addition, supervision should not be used as an inferior substitute for other measures.

Sustainable finance requires an approach across the spectrum of regulation. Particularly for insurers, ensuring that for example catastrophe risk is correctly priced and that models take long-term climate trends appropriately into account, becomes an issue of wider significance. If there were the inability to insure climate risks – that is to say, if the so-called, "protection gap" were to grow - that would likewise have wider implications: for banks, for governments, and ultimately for society as a whole. On the asset side, insurers and pension funds are owners of a significant portion of the wider economy and their approach to sustainability of their investments is therefore of high importance.

Moreover, from the supervisory perspective, interventions on sustainable finance will be across all the three pillars: quantitative; risk management; and reporting and disclosure.

As a prudent supervisor, let me strike a cautious note on whether regulation should seek to make climate related investments attractive. The protection of policyholders and pension scheme members remains central. EIOPA will continue to base its approach always on evidence. This is even more relevant in an area such as assessing the preference of members for sustainable products. It is also important in assessing the risk and hence capital requirements for sustainable investments.

We see no trade-off between prudential soundness and proper conduct of business on the one hand and sustainable finance on the other. ●

Developing EU securities markets

Verena Ross

Executive Director, European Securities and Markets Authority (ESMA)

The SME listing package and the development of corporate bond markets in the EU

The Commission is currently consulting on a list of measures to promote SME listing on public markets via a more proportionate regulatory environment (so-called SME Listing Package). This covers regulatory interventions in different areas spanning from MAR to MiFID II and Prospectus Regulation (PR) and is part of the more general CMU effort to foster EU capital markets.

Some key amendments proposed by the Commission in relation to SMEs growth markets issuers address: i) the creation of a transfer prospectus; ii) half-yearly reports exemption and free float criteria to be provided by market operators; iii) new definition of debt only issuers; iv) market soundings exemption for private placements of bonds; v) possibility of liquidity provision contracts; vi) lighter regime for delaying the public disclosure of inside information for SME Growth Markets; vii) obligation to have permanent insiders' list only and viii) extended time for the disclosure of managers' transactions.

Overall, based on the proportionality criterion, these changes aim at removing some of the obligations in MAR, MiFID II and PR that have often been considered unduly burdensome for SMEs and as such contributing to raise compliance costs associated with their access to financial markets.

The SME Listing Package should be able to facilitate a progressive increase in the number of IPOs on SMEs growth markets, thereby reducing the relative weight of bank finance for SMEs. Furthermore, some of these proposals such as the one on liquidity provision may improve market conditions on SMEs growth markets and as such attract a wider set of investors, which in turn could benefit from a more diversified portfolio.

At the same time, for the SME Listing Package to be truly effective, market integrity should be preserved so as to maintain an adequate level of investor confidence. It should be noted that, while the proposed SME Listing Package looks generally less controversial from a MAR perspective, the scope of some of the proposed changes to MiFID and PR should be carefully identified to ensure that retail investors maintain access to the necessary information.

To ensure the accomplishment of CMU, the growth of equity markets should go hand by hand with that of debt markets. The role of corporate bond markets in financing the economy in the EU has acquired greater prominence in recent years. At the same >>>

>>> time, periods of high volatility associated with short-term illiquidity in different market segments have increased concerns over a general deterioration of liquidity. In its semi-annual Trend Risks and Vulnerabilities Report, ESMA regularly analyses liquidity risks in fixed income markets and it is currently performing further research to investigate the drivers of liquidity in such markets.

A number of different assessments and recommendations have been made for further developing European corporate bond markets. In particular, the European Commission Expert Group on Market Liquidity issued a report in Q4 2017 on how to improve the efficiency and resilience of EU corporate bond markets as a source of funding for corporates and of investment opportunities for retail and institutional investors. While several of the actions proposed by the Commission Expert Group still need to be implemented, a few have been taken on board via the SME Listing Package and others have a non-legislative nature. Two of these latter are particularly relevant for ESMA.

First, supervisory convergence in the EU is one of the core objectives of ESMA and a key pillar of a genuine CMU. ESMA has a wide range of tools at its disposal to achieve this objective - such as Guidelines, Opinions, Q&As, Peer Reviews - and has used, and will continue to use, them proactively to achieve greater convergence in this area.

Second, transparency and data availability are essential to reduce the fragmentation of EU financial markets and facilitate cross-border supervision. With the post-crisis reforms, including EMIR and MiFID 2, the EU has already made giant steps in this direction. ESMA contributes to this effort through designing common EU financial data requirements, promoting close interaction among the relevant EU authorities on reporting obligations and generally driving forward data completeness and quality. ●

Sebastián Albella Amigo

Chairman, Spanish Securities and Exchange Commission (CNMV)

SMEs and public markets – a few thoughts on a difficult task

In the past few years, the European Commission has boosted initiatives to encourage SMEs to trade on public markets and, in general, seek financing through capital markets, one of the objectives of the Capital Markets Union Action Plan. Many of these initiatives revolve around the concept of SME Growth Markets, the MTF system coined in MiFID II for the dual purpose of easing the requirements and costs for access by SMEs to markets and ensuring a minimum number of controls and less but sufficient disclosure to build investor confidence.

In May past, the Commission published some additional proposals in the same line and also with the objective of promoting the liquidity of these markets, an aspect equally important. In this area, it is crucial to not only take companies into account, but also the other side of the equation: investors in securities issued by SMEs. From this perspective, in the different stakeholder consultations, some relevant factors have been identified such as liquidity, the existence of financial and credit analysis, as well as brokers and intermediaries specialising in SMEs and liquidity providers.

In an SME securities market, liquidity tends to be limited by its very nature, which means that generally investors dedicate only a small part of their portfolios to these securities. The EC proposals in this regard, such as the availability of a framework for the provision of common liquidity in the EU, are positive, but we must acknowledge that the issue is complicated and more so the smaller the company and its free float. >>>

>>> Likewise, it is necessary to promote analysis of the SMEs listed on these markets. In Spain, for example, an interesting initiative has recently been launched to foster the analysis of as many securities as possible, including those traded on the Alternative Stock Market (MAB). This initiative, and other possible ones like the involvement of the academic world, can be useful in an environment such as the current one in which MiFID II implementation is making the sale of analysis more difficult.

As for fixed-income markets, it is advisable to be cautious. A prudent approach, especially for initial or development phases, is to reserve SME fixed-income markets for institutional investors as in the Spanish MARF, which is evolving satisfactorily.

The trust factor is absolutely key also for the development of equity markets. It is important that being listed on them brings prestige to companies and helps to reinforce their good image, which makes advisable to not neglect controls or aspects such as corporate governance. Companies' mortality rate, by definition, must be higher in markets specialising in SMEs than in public markets in general, but it is necessary to make an effort to attract quality SMEs and to make it harder for projects that are too immature or poorly structured to access them.

I will conclude by making two observations. The first one refers to the current process of supervisory reform in Europe, which affects the European Supervisory Authorities. It is necessary to move towards integrated supervision in Europe, but integrated supervision does not necessarily mean that it has to be more centralised. There must continue to be robust national supervisory bodies, with relevant competencies, so that a variety of markets with a critical mass will continue to exist in Europe. This is crucial to achieving a European capital market with real penetration which helps improve the financing of our SMEs and reduce their level of dependence on bank financing.

The second one is that greater access by SMEs to capital markets is related to a structural factor – the company's size – and to cultural or mentality factors, given the personal or family nature of so many companies. It is also necessary to place emphasis on both aspects. For example, eliminating negative incentives for growth arising from tax and labour and other regulations that seek to make life easier for SMEs but in reality may work as a deterrent to their growth.

Finally, regarding the cultural factor, market operators and investment firms (and also market supervisors, given the alignment of our objective with public interests) we all have to step up our education initiatives and encourage small and medium-sized companies to access the markets. ●

Lauri Rosendahl

President, Nasdaq Nordic

The future of Europe starts by supporting growth companies with big aspirations

The European Commission's recent proposals to promote SME Growth Markets moves the Capital Markets Union (CMU) forward. Launched in 2015, the CMU has already succeeded in helping numerous private companies move onto growth markets. Over the last three years, our own growth market, First North, has grown 54%, resulting in a total of more than 330 listed companies today.

We welcome several positive steps in the proposals. And more can be done. When we established First North in 2008, we looked at our main stock market to see what could be adjusted to provide smaller growth companies with development-stage access to capital while still ensuring appropriate regulation and supervision. We concluded we needed a simplified document for admission to trading.

To this end, the Commission's proposal on a simplified prospectus when companies with at least three years of listing on a growth market switch to a main market, is constructive. In our opinion however, two years of listing is more appropriate.

We also recommend allowing any issuer on an SME Growth Market to issue a shorter "Company Description" >>>

>>> instead of a prospectus, and it should be vetted by the market operator, not the supervisory authority. Today, most issuers currently listed on First North issue such a Company Description both for the initial listing and for secondary capital raisings and the document is vetted by our surveillance department. We have found this to be a significantly less costly procedure for issuers.

Although trading systems and membership access are streamlined across the Nordics and the Baltics, our issuance rules are adapted to each local market. Stakeholders engage in a constant dialogue on ways to improve the listing rules while maintaining liquidity and market integrity. In our experience, flexible – not weaker – listing rules improve market quality. For instance, today there is no free-float requirement on MTFs, but most market operators require a minimum free-float anyway. And when a certain requirement is optional for issuers, many issuers actually opt-in anyway, as with quarterly reports.

"We call upon the EU and individual countries to join forces and lend further support to SME Growth Markets and the financial ecosystems around them."

- LAURI ROSENDAHL

Listed SMEs lack extensive coverage by research analysts. These companies need increased visibility. We are working with a news agency to cover all traded companies, and we are developing a First North 25 index. We encourage the EU to study and remedy the negative effects of MiFID II on research analyst coverage of SMEs.

Europe's forward-thinking culture drives the creativity that has put us at the forefront of digital innovation. The Nordic and Baltic countries have been the birthplace of many successful companies that are now household names worldwide – IKEA, Electrolux, Ericsson, Nokia, H&M, Novo Nordisk as well as unicorns such as Skype, Klarna, Evolution Gaming, iZettle and Mojang.

SMEs with big aspirations need a sound platform for transforming their business. We call upon the EU and individual countries to join forces and lend further support to SME Growth Markets and the financial ecosystems around them. Now is the time for us to put our foot on the accelerator and enable more SMEs to access the capital they need to start locally and then grow, regionally and globally. The European Commission has taken a positive step. Let's keep moving forward. ●

Hank Erbe III

Global Head of Strategic Relationship Management and Public Policy, Fidelity International

Global IPO market reform and the need for CMU acceleration

Historically, promising young companies and Unicorns (privately held startup companies valued at over $1B) have pursued initial public offerings (IPOs) in order to access the growth capital they need to hire new employees, develop products, drive growth and ensure governance, as well as to expand their businesses in home markets and globally.

Often the most significant step in a company's development, IPOs have enabled young companies to generate new jobs and economic growth. IPOs also provide pension funds and other institutional investors, as well as employees who receive long-term equity incentives, an opportunity to share in the upside of successful companies. It should be noted that over 90% of job and revenue growth occurs after a company's IPO.

And yet, over the past 20 years, the number of IPOs has declined significantly. From the peak issuance year of 1999 to 2017, global IPO issuance is down 70% and down 60% for the UK/EU, despite positive economic cycles. For Europe, this trend may continue following the departure of Europe's most liquid capital market, London, from the EU.

This decline in IPO activity has structural as well as regulatory reasons. While there is presently an abundance of private capital seeking investment opportunities, regulatory obligations have pushed the cost of going public higher and higher. As a result, private companies are staying private longer.

The EU Commission needs to be more ambitious and policymakers need to intervene. Inspiration could be found in initiatives launched to restore access to capital for young emerging companies e.g. in the US, Hong Kong, Australia and UK.

In the EU the idea of the Capital Markets Union (CMU) is directionally sound, but in reality not enough has been achieved in the area of capital formation. Changes to the prospectus rules and more efficient and harmonized supervision cooperation are steps in the right direction, but not sufficient. Some rules, e.g. on MIFID II research payments, may even prove to be counterproductive for the SME agenda as brokers and market makers curb research and trading for this class of issuer. What we need is a stimulatory policy and stakeholder engagement, to drive SME capital formation in the 'real economy'.

Against this background, we recommend that we restart the process and establish an "IPO Task Force" of professionals representing the entire ecosystem of SME capital formation, to come up with recommendations that can serve as a roadmap for policymakers and market participants.

"What we need is a stimulatory policy and stakeholder engagement, to drive SME capital formation in the 'real economy'."

- HANK ERBE III

In terms of timing, the work of an IPO Task Force would seem to sit naturally between the planned completion of the CMU mid-2019 and the UK's exit from the EU (if under the transition period, alternatively earlier) at the end of 2020. In order to take advantage of such a short window of opportunity we would encourage EU policymakers to begin laying the groundwork now for such task force. ●

Market infrastructure for the CMU

Markus Ferber

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

Making EU Financial Markets Infrastructure "Brexit-Ready"

The Capital Markets Union (CMU) is one of the European Commission's flagship projects. While the Commission has somewhat disappointed in terms of bringing ambitious proposals to the table, making the CMU a success is arguably more important than ever. In light of the imminent departure of the United Kingdom from the EU, getting EU financial services legislation "Brexit-ready" must be a key policy objective.

Fortunately, the process of improving the efficiency, transparency and resilience of EU financial markets had already begun long before Brexit was even thought of. The trigger for the big overhaul in EU financial services legislation was arguably the financial crisis and the realisation that the financial system as a whole was less resilient than initially thought.

The framework that was set up after the crisis did quite a lot to mitigate that problem. We managed to greatly reduce counterparty risk in the financial system by making central clearing the norm via the European Market Infrastructure Regulation (EMIR). Additionally, we introduced a whole set of new rules via the recast of the Markets in Financial Instruments Directive (MiFID II) to make European financial markets more transparent thus improving price formation and overall market efficiency. The implementation of both files will also help provide valuable reference data to competent authorities to inform better supervisory decision making. By and large, EU financial markets are far more resilient now than they were after the crisis.

In this sense, the EU's financial markets infrastructure is in a good place to face Brexit, but there are still some issues to fix and some uncertainties lie ahead. While MiFID II has overall been off to a good start, there are still some areas that need to be fixed to make the new market structure a success. After all, the share of off-venue trading remains stubbornly high and Systematic Internalisers being subject to a lighter transparency regime have captured a substantial market share over the first months of trading under the new regime. This is arguably a threat to one of MiFID II's key objective, namely to bring more trading 'into the light', i.e. onto regulated markets that are subject to strict transparency requirements.

In order to make sure that the MiFID II objectives are achieved, the European Parliament, the European Commission and ESMA are currently working on a fix to pull Systematic Internalisers into the tick size regime and thereby rid them of their key advantage >>>

>>> over regulated venues. Getting this little fix across the finishing line would do a lot to get one step closer to fulfilling the MiFID II promise of more transparent markets and more efficient price formation.

Following Brexit, further technical tweaks will be necessary in order to adjust the calibrations of some elements of MiFID II such as the tick size regime or the definition of liquid instruments that are all based on EU28 data.

In order to make the EU's financial markets infrastructure and thereby the CMU 'Brexit-ready', we will also have to give a convincing answer to the question of how to deal with the clearing of Euro-denominated derivatives contracts that currently mostly takes place in the United Kingdom. The European Parliament has recently adopted a sensible no-nonsense report that would put European supervisors firmly in charge of the supervision of Euroclearing in third countries (with the option of forced relocation on the table as a last resort). However, negotiations with Member States on the matter are still pending.

There remains still a lot to do in order to make EU financial markets infrastructure and the CMU as a whole 'Brexit-ready' and at the same time reap the benefits of the reforms already implemented. The biggest step to make the CMU a successful project, however, is not related to the implementation of existing regulation or how to tweak the details governing financial services infrastructure. On the contrary, it would be a higher level of ambition when it comes to what projects to pick. The big issues that are truly holding cross-border investment back are related to tax issues and insolvency law. Without significant progress on that front, the CMU will remain incomplete. ●

Dr. Alexandra Hachmeister

Chief Regulatory Officer, Deutsche Börse Group

Why the CMU and MiFID II are more important than ever

European capital markets have been extremely busy this year with MiFID II going live, new legislative building blocks of the Capital Markets Union (CMU) being proposed and the unpleasant task of preparing for the withdrawal of the United Kingdom from the European Union (EU). So busy, that we often tend to – and without any doubts have to – dive deeply into the nitty-gritty aspects of a great variety of regulatory dossiers, whilst putting ourselves at risk of getting lost in the details of financial regulation.

However, it is vital that we keep the bigger picture in mind: What will drive the evolution of financial markets in future? What policy goals do we want to achieve? And, in which order? Should they be based on the regulatory legacy of the past crisis, namely by enhancing safety, stability and transparency of financial markets? Can we also integrate other policy objectives, such as efficiency, growth and competitiveness?

The UK's departure makes the delivery of a fully-fledged CMU more important than ever. For the future of the EU27, there is a strong need to create an EU-wide market, which preserves and enhances its attractiveness for investments coming from abroad, whilst ensuring the stability and integrity of its financial markets from within. I am convinced that a durable and sustainable jobs and growth agenda needs a solid foundation of financial stability and market integrity – not the other way around.

Capital markets with deep pools of liquidity across different market segments can act as a strong stabilization force in times of crisis by diversifying sources of finance >>>

>>> and by ensuring a second strong leg next to bank financing. Hence, when we talk about the efficient functioning of a European CMU, this is by far a story of providing and preserving liquidity. In my view, running markets with high-quality liquidity as well as a heterogeneity of market participants are crucial components of a healthy ecosystem, as well as an important contribution to competitive European financial markets.

Consequently, it is important to ask ourselves how liquidity will evolve with MiFID II/ MiFIR provisions applying in full force, Brexit uncertainties pending and new capital requirements for banks and investment firms on the regulatory horizon. Financial market infrastructures have a pivotal role to play as they connect different market segments, trading interests and investment perspectives and bridge the gap between the need for capital-raising on primary markets and for price discovery on secondary markets. Contradicting or conflicting rules may create barriers to liquidity provision, lead to liquidity fragmentation and can substantially impair financial markets.

Therefore, one of the most important goals for the EU will be to ensure regulatory consistency across different dossiers to guarantee a coherent regulatory framework that enables the economy to deliver on the political objectives. Similarly, regulatory consistency will be necessary when it comes to our relationships with third countries. Access is beneficial, when markets are subject to similar standards of market transparency and integrity and when the home supervisor is genuinely carrying its financial stability prerogatives. The EU's equivalence decisions framework balances out the imperatives of preserving multilateral open markets, whilst promoting a case-by-base risk based approach to safeguard its stability and growth.

The global dimension of financial market regulation does not end in connecting different markets; regulatory dialogue and cooperation is essential. The EU has been quite successful in promoting its regulatory standards to become blueprints for global financial markets regulation. This only gives us a taste of what the EU can achieve together for the CMU. ●

Sébastien Raspiller

Assistant Secretary, Ministry of Economy and Finance, France

Preserving financial stability is the key objective for the EU post-trade market

Since it has attracted much public attention in the aftermath of the Lehman crisis, post-trade regulation has been front and center in the efforts by European authorities to promote a sound and efficient EU Capital Market. Many pieces of legislation such as EMIR and CSDR, but also T2S and ECMS, aim at promoting access to market infrastructures, at fostering completion and complementarity among them and at harmonizing supervision practices in the EU.

France welcomes such progress, and it is our belief that there is still room for more ambition in terms of strengthening our post-trade regulatory framework. As a result of the aforementioned regulations, and in particular the obligation of central clearing for an increasing volume of derivatives, the post market structure of euro-denominated products has reached an unprecedented degree of concentration. This in turn has made a handful of infrastructures very systemic components of the EU financial architecture. One of the best examples of this trend is the clearing market. The concentration of the business in a limited number of CCPs as a result of economies of scale has led to a build-up in the criticality inherent to clearing activities. In this light, the current regulatory framework for EU and third-country CCPs may appear as insufficient in addressing these challenges and preserving the financial stability of the EU. This is all the more relevant in the context of Brexit, since no clear direction has yet emerged as to the legislation which will be applicable in the UK for financial services.

To ensure that EU authorities have a say on decisions affecting the EU's financial stability in times of crisis, it is thus essential to review and improve the equivalence framework of third-country regimes, with a view to granting EU authorities comparable powers to what exists in other jurisdictions. This >>>

>>> approach should be incremental and proportionate to the considered activity, but it cannot exclude from the onset the possibility of non-recognition.

At EU level, the increasing cross-border dimension in the post-trade market raises the question of a more integrated supervision. The existing legislative framework has laid down the foundations for the convergence of supervisory practices. Yet they remain marred by local divergences and discrepancies that are not conducive to an even playing field among actors and across Member States. The current tools available to the EU authorities to promote convergence in the interpretation of the legislation have shown their limits and their shortcomings. Such an integration should be gradual depending on the degree of maturity of the infrastructure framework. The clearing sector has taken an early lead, with the implementation of EMIR in 2012. But it is now clear that, even though EMIR colleges may function individually, they do not as a system, and the supervisory feedback that should be mutualized at the European level is in fact lost in the process. The need for a European dimension to CCP supervision is, in that case, blatant.

An additional challenge in the coming years will be to deal with the safety and soundness of the financial markets. Further harmonization of the reporting of transactions should be promoted, in order to ensure a good monitoring of the risks. However the fragmentation of trade repositories and reporting activities leads to an increase in reporting costs, and raises questions on the efficiency of the monitoring. There is thus a need for a more consolidated landscape of the reporting infrastructures in the EU, which could even lead to a single European trade repository.

In the post-market sector, efficiency, resilience and adaptability can only derive from a greater convergence of our practices and our supervision. This does not mean piling up layers of bureaucracy, or depriving national authorities of their relation with the entities they supervise. But if regulators cannot follow inevitable trends of market concentration, they will be increasingly at risk of being blindsided by the next crisis. ●

Ilse Peeters

Head of Government Relations, Euroclear

Infrastructure at the core of driving European capital growth

As post-trade securities services providers and financial market infrastructures, Central Securities Depositories (CSDs) are essential in capital markets and therefore also core to the success of the EU Capital Markets Union (CMU). CSDs themselves contribute to the CMU objectives by continuously enhancing their service offering towards issuers and investors and by implementing the CSD Regulation ("CSDR") which will harmonise playing rules and confirm CSDs as the safest place to issue, settle and safekeep securities.

However, substantial work still needs to be done to achieve the CMU objectives. It has long been recognised that the EU needs a more integrated and harmonized post-trade securities industry, thereby reducing the cost of cross-border clearing and settlement - a cost that alas is too broadly borne by the end investors today.

Since their creation, one of the core CSD functions has been book-entry recording, regardless of whether securities are created in dematerialised form or whether physical notes or certificates still exist. This allows for efficient safekeeping and transaction settlement.

For EU and international issuers, CSDs are the entry point for making securities available to global investors, either directly – in so-called direct holding markets - or through a chain of intermediaries. Many types of capital market instruments ranging from equities, government and corporate bonds to securitisations and convertible debt, but also units of funds and ETFs can be issued and kept in CSDs. When new instrument types such as EU Sustainable Debt, STS Securitisations or EU covered bonds are issued, CSDs adapt their service offerings to support the issuance of and investment in those instruments.

As the implementation of CSDR and the related re-authorisation of CSDs in the European Union approaches, all EU-authorised CSDs will be subject to a harmonised set of requirements making those CSDs the safest place to issue, settle and safekeep assets.

"CSDs are the entry point for making securities available to global investors..."

- ILSE PEETERS

Yet, more is needed. One of the objectives underlying the implementation of Target2-Securities (T2S) is to ensure more competition between CSDs. CSDR also includes elements that are designed to make CSDs more competitive. With the launch of T2S still very recent and the implementation of CSDR still ongoing, it is too early to judge if, how and to what extent those two initiatives will effectively drive that much-wanted competition and consolidation between CSDs. Such changes in post-trade markets should be coupled with the EU efforts to work towards a complete dismantling of all barriers identified by the EPTF last year (and on which we are expecting a Commission Action Plan very soon).

Competition and consolidation between CSDs together with the removal of the identified barriers will significantly contribute to the CMU objectives and the global competitiveness of EU capital markets. ●

Verena Ross

Executive Director, European Securities and Markets Authority (ESMA)

Future of market infrastructures in the EU and beyond

The EU27 is stepping up its efforts towards a capital market union, including a strengthened trading and post trade environment, making European markets more efficient and more resilient, for the benefit of all. Indeed, with only a few months to go before Brexit, two clear conclusions can be drawn: first, Brexit increases the importance for the EU27 to strengthen further the EU internal capital market and to progress with the CMU. Second, it underlines a clear need to rethink the framework for third-countries regulation and supervision. So, strengthened EU27 markets within as well as in its relations with the outside is key.

Starting from the outside of EU27 perspective, this is certainly an area where the biggest improvements are needed. One clear example of a strengthened and better suited framework vis-à-vis third country regimes and their links with the EU27 is the EMIR 2.2 proposal. The proposal aims at improving the current recognition regime by enhancing the supervision of systemically important third-country CCPs in order to ensure that their risks to the EU financial system can be monitored and, when needed, mitigated.

This type of framework should be emulated beyond CCPs. It would be logical to apply this approach consistently for all systemically important market infrastructures, including third-country CSDs and third-country trading venues. Indeed, a similar approach should be adopted for third-country CSDs that are deemed important for the functioning of the securities markets and the protection of the investors in the EU, as well as for third-country trading venues that are considered to be of significant importance for the EU capital market. Having regard to the interlinkages between EU and third-country financial markets, it is necessary to improve the ability of the Union to identify, monitor and mitigate the potential risks related to key third-country infrastructure providers to the EU market, such as CSDs and trading venues, in a robust and consistent manner, a role which ESMA could perform, should ESMA be granted direct powers in this respect. This would be beneficial for strengthened investor protection, financial stability, and a level-playing field, as well as providing a strong single point of entry to the EU.

"It is necessary to improve the ability of the Union to identify, monitor and mitigate the potential risks related to key third-country infrastructure providers to the EU market."

- VERENA ROSS

Coming back on the first aspect of strengthening the EU27 market from within - this is no less important. We are more advanced on the completion of a robust and common regulatory framework which will continue to foster a greater integration of the EU27 financial markets. However, while huge steps have been made towards achieving a single rulebook, significant national differences remain regarding the implementation of that rulebook, and thus further supervisory convergence efforts are needed. Indeed, effective and harmonised supervision is key to deliver the benefits of a common regulatory framework. Following the decision of the United Kingdom to withdraw from the EU, the desire for a strong and closely integrated EU 27 market makes the need for supervisory convergence even stronger.

Given the importance of supervisory convergence, the Commission has assessed that ESMA's powers and instruments in this domain are currently not sufficiently strong and as part of the CMU Mid-term review has proposed to strengthen the supervisory convergence powers of ESMA in the ESAs review proposal. ESMA welcomes these proposals, as enhanced supervisory convergence is essential in achieving the CMU. ●

NEXT EUROFI EVENTS

3, 4 & 5 April 2019
Bucharest - **Romania**

11, 12 & 13 September 2019
Helsinki - **Finland**

April 2020
Zagreb - **Croatia**

Prospects of the PEPP

Martin Merlin

Director, Regulation and Prudential Supervision of Financial Institutions, Directorate General for Financial Stability, Financial Services and Capital Markets Union, European Commission

The PEPP– a flagship for a genuine European personal pension market

Over the next 50 years, the share of the population in the EU in retirement-age versus those in working-age is forecast to double. Given the demographic challenges, state-based and occupational pensions will be under increasing pressure, in spite of the reforms undertaken. Citizens will need to save more to complement their retirement income.

Despite consumers' growing needs to save and invest in retirement products, the supply of personal pension products in the EU is uneven, with wide variations between Member States. This variation is linked to the diversity of rules at national level, which prevents providers from diversifying their investments across Member States and impedes the development of a large and competitive EU market for personal pensions.

To address these concerns, the PEPP proposal aims to help create a genuine European personal pension market. The proposal will contribute to the CMU goals by mobilising savings from deposits towards long term-investments on the capital markets, contributing to the funding of the EU economy.

The proposed PEPP Regulation is supported by a wide range of market participants, given in particular the tremendous market potential for personal pensions (nowadays EU €700 billion of assets under management). According to a study[1], the personal pensions market could grow by 2030 to € 2.100 billion with the PEPP (depending on the level of tax incentives), comparing to only €1.400 billion without the PEPP. Thus, PEPP will offer significant business opportunities for all providers and notably for those that currently cannot have access to this market.

The proposal was also welcomed by consumers' organisations as an adequate response to address the concerns they voiced in the past on the insufficient supply of quality personal pension products (due in particular to locked-in effect and insufficient flexibility and transparency).

>>>

>>> This initiative has received a lot of interest from the European Parliament and the Council, who aim to adopt a Regulation before the end of the current legislative mandate. Trilogue negotiations could start in autumn 2018.

A number of market participants are carrying out preparatory work to design future PEPPs. Given this positive dynamic, it will be soon up to PEPP providers to take advantage of the new opportunities offered to them by the future Regulation and compete to offer savers high-quality PEPPs on a pan-European scale.

Over the coming years, the share of the EU citizens residing in another Member State will increase. Providers will need to prepare for this evolution and accompany their mobile customers. The compartment feature ensures that PEPP is easily portable. It also allows providers to adapt their product to the specific requirements of each Member State to enable their customers to benefit of the tax incentives of their successive Member States of residence. Some providers may be concerned about the obligation to set-up compartments, but solutions (such as partnerships with other eligible PEPP providers) can be found to facilitate compliance. ●

1. FISMA/2015/146(02)/D (June 2017) - "Study on the feasibility of a European Personal Pension Framework" https://ec.europa.eu/info/sites/info/files/170629-personal-pensions-study_en.pdf

Gabriel Bernardino

Chairman, European Insurance and Occupational Pensions Authority (EIOPA)

PEPP - The key to improve European private retirement savings

Providing for sustainable pensions in Europe and globally is a pressing challenge and one frequently debated in international economic fora. The European Commission has rightly identified vulnerabilities in national pension provisions resulting from fundamental changes and new trends in demographics and labour markets.

Unconventional career paths, mobility and digitalisation, coupled with a challenging economic environment are severely testing the sustainability of Europe's diverse pension systems. Most Member States share the view that there is a need for citizens to save more (privately) for an adequate retirement income and the need to strengthen financial markets.

Yet, in a number of Member States, personal pension products are seen as products available only to high earners and the financially literate, due to their complexity and the relatively high fees and costs associated with the products. That is why the Pan-European Personal Pension Product (PEPP) is designed to be simple and transparent in its objectives and features, whilst providing economies of scale to make it cost-efficient. In this way, PEPP can address the needs of the vast majority of European consumers, and at the same time support the goals of the Capital Markets Union and the European Commission's Action Plan for Sustainable Finance.

PEPP can make a difference to European citizens' lives if it can fully deliver on its promise: a truly pan-European, portable, cost-efficient, simple and transparent >>>

>>> pension product that is available to every consumer in the European Union (EU). That surely requires PEPP to stand out as a high-quality product that generates superior outcomes for consumers' future retirement income.

EIOPA has been advising on the key features of PEPP that can make the difference and ensure its success: a well-designed default option, linking accumulation and decumulation; standardisation to provide for economies of scale and cost-efficiencies; functioning risk mitigation techniques and effective, sustainable investment strategies, smart portability – and central authorisation.

Central authorisation of PEPPs by EIOPA is a decisive provision in the European Commission's proposal for a PEPP regulation. A central, fully consistent, authorisation at European level endorses the EU quality label and enables consumer trust, which allows for further efficiency gains and prevents potentially divergent practices. Through the authorisation process, national competent authorities and EIOPA can set clear expectations on the composition of an application for authorisation, timelines and the criteria to be used by EIOPA in approving any PEPP to be marketed throughout Europe. EIOPA believes that an EU quality label requires a strong and efficient authorization process as well as central certification of key features by a European authority.

The legislative process is approaching a critical phase. Supported by the political commitment to bring PEPP to a successful launch, the co-legislators need to strike the right balance between standardised approaches and defaults to bring transparency, to address consumers' behavioural biases, to reap efficiency gains – and to leave sufficient room for innovation and tailoring to individual needs.

PEPP and its key features – for example the decumulation phase and portability solutions – require innovative, bold and smart solutions that work in the diverse pension landscape that is the EU and that can adapt to the common challenges in the EU. In the end, the necessary political compromise should aim at simplicity, rather than over-engineering or over-regulating PEPP.

With the political will and the technically sound solutions, PEPP deserves to become a default product for the European citizens in great need of a personal pension product that will accompany them throughout their working lives, weathering job changes, mobility and economic ups and downs and by that ensure a sufficient income in retirement. ●

Brian Hayes

MEP, Committee on Economic and Monetary Affairs, European Parliament

PEPP - a new building block to tackle the EU's pension time bomb

Across Europe, people are living longer and populations are ageing. It is anticipated that there will be one worker for every two pensioners in the EU by 2060; currently there are four pensioners for every worker. These demographic trends mean that the funding gap for state budgets will be enormous if the status quo remains. The reality is simple: there is a pension time bomb coming down the tracks.

In some EU Member States a fierce pension debate has already started. In the Netherlands, pension policy is arguably the biggest political issue up for discussion. In Denmark, pension reform has been high on the agenda of almost every government since the early 1990s. Unfortunately, in many other Member States pension policy is the elephant in the room that no one wants to touch.

The idea of people relying on state pensions as their main source of retirement income will no longer be sustainable into the future. Reform of the state pension system will help. However, the main focus must be on occupational pensions and personal pensions. As we look to the future, people will have to supplement their state pensions >>>

>>> with an adequate income from occupational and/or personal pensions. The challenge is encouraging people to change their mind-set and look at supplementary ways of planning for their retirement.

The European Commission's proposal for a pan-European personal pension product (PEPP) in June 2017 was a step in the right direction. It may not be the silver bullet to Europe's oncoming pension time bomb but it could offers huge incentives for consumers that want a simple, safe and transparent product to help them save for retirement.

With several different types of pension products on the market already, many will ask: why do we need PEPP?

Essentially, PEPP stands out from the crowd because it is the first pension product to be developed through EU legislation. PEPP has a clear EU branding and backing that will give consumers confidence. It is an easily portable product that can be taken from one Member State to the next with no obstacles. And it is very much additional to what Member States already have - it is an extra encouragement to get people to contribute more to their retirement.

The portability aspect of the product is a real benefit for the modern day workforce as the product can be easily transferred from one Member State to another. It would also make sense that consumers could switch pension providers easily if they can find a cheaper offer in another Member State. Consumers should be able to shop around to get value-for-money products – that's why we have a single market.

The Parliament and Council are both working hard to ensure that we get agreement on this proposal before the end of this year. It is expected that Trilogue negotiations can commence shortly with the Austrian Presidency.

It is absolutely vital that we as legislators put a lot of effort into getting the detail right on this proposal. We need to ensure that the investment rules and the payout options strike the right balance so that PEPP can be attractive both to product providers and to consumers. I do not believe that we should be imposing strict capital guarantee rules on PEPP as this would seriously limit what types of providers can offer PEPP.

In terms of payout options, my goal is to ensure that PEPP is a genuine pension product that provides a regular income to citizens during retirement. We do have to respect individual Member State traditions but if we treat this product as a sort of investment product with lump sum payout options, it defeats the objective of PEPP, which is to offer European citizens real pension solutions.

It remains to be seen how the tax treatment of PEPP will be resolved given that there are 28 different tax regimes that apply to personal pensions in the EU. The guiding principle should be that PEPP should be treated no less favourably to national third pillar pension products when it comes to tax treatment.

Between the Parliament and Council, we have the basis for good compromise which will ensure the delivery of a new and important part of Europe's pension landscape. But this is only the start of the process in addressing Europe's pension time bomb; this will be a constantly evolving challenge. ●

Nadine Wiedermann-Ondrej

Head of Division, Legal Matters on Insurance, Legal Matters on Auditor Oversight, Beneficial Owner Registry Authority and State Guarantees, Federal Ministry of Finance, Austria

Pan-European Personal Pension Product (PEPP)

Europe's population is ageing. Due to people living longer and having fewer children, increased pressure is put on state-funded pension systems. In order to address these challenges, occupational as well as personal pension schemes are needed to complement state-based pensions. As a consequence the European Commission (EC) has published a proposal for a Regulation on a pan-European Personal Pension Product (PEPP) on 29 June 2017. The objective of the PEPP is to enhance personal pension savings, thereby creating large pools of investments being injected into capital markets. Channelling additional financing to productive long-term investments will foster the completion of the Capital Market Union (CMU).

With the PEPP proposal the EC set the cornerstones for the overall framework of PEPPs which covers key elements such as authorisation, distribution, investment policy, provider switching, or cross-border provision and portability. The PEPP proposal has been intensively examined by the Council during the Estonian and Bulgarian Presidency. The mandate for the trilogues agreed upon by the ambassadors at the COREPER on 19 June 2018 finds a well-balanced compromise, taking into account consumer protection and the flexibility for different types of PEPP providers.

"The mandate for the trilogues agreed upon by the ambassadors at the COREPER on 19 June 2018 finds a well-balanced compromise."

- NADINE WIEDERMANN-ONDREJ

One of the major policy decisions was to open the PEPP to different types of providers. This should increase competition on a pan-European basis and create economies of scale to the benefit of savers. As a result PEPP providers will be subject to the provisions in the PEPP regulation and to the relevant sectorial EU legislation (as long as the PEPP regulation does not supersede them). The compromise text of the Council clarifies where harmonisation is needed and which provisions shall be only covered by the existing horizontal frameworks.

In order to create a European-wide simple, easy to understand, largely standardised pan-European pension product it is necessary to harmonise the core >>>

>>> features of PEPP product. This is achieved in particular by the PEPP-specific rules on the accumulation phase, including a default investment option. The compromise text of the Council takes into account that different types of providers are able to offer a PEPP and leaves leeway to those providers in designing the product as long as the ultimate rational of the PEPP idea is achieved. Complemented with a uniform information regime, including a PEPP-KID (key information document) and the availability of advice, the PEPP and its distribution should be European-wide recognisable by savers.

One of the key elements of the EC proposal is the authorisation and the labelling of the PEPP as "Pan European Pension Product". Awarding the label of "PEPP" would enhance the recognisability of and the trust in the product. According to the compromise text of the Council the national competent authority of the provider will take the decision for registration because of its closer links with the PEPP provider. This solution is also intended to reduce the complexity and costs of the administration process compared to an EIOPA registration. The creation of a central public register kept by EIOPA would still reflect the pan-European character of the PEPP.

In order to allow savers changing residence to another Member State without changing PEPP providers the compromise proposal of the Council includes the possibility to continue saving in a new sub-account of the PEPP account which corresponds to the legal requirements and conditions for using possible incentives fixed at national level of the new country of residence. If the PEPP provider does not provide the sub-account for that MS, the saver can switch the PEPP provider free of charge.

A question that has attracted considerable attention is whether institutions for occupational retirement provision (IORPs) should be allowed to provide PEPPs. The compromise text of the Council includes a solution whereby IORPs which, pursuant to national law, are authorized and supervised to provide personal pension products may offer PEPPs if all PEPP-related assets and liabilities are ring-fenced.

The Austrian Presidency is ready to start trilogue negotiations and hoping to make progress on this topic. ●

Natalie Westerbarkey

Head of EU Public Policy,
Fidelity International

PEPP - The new future framework for a Pan-European Personal Pensions Product

Europe is facing a challenge regarding retirement savings and highly fragmented personal pension markets across the EU. Some of the larger EU member states may see a decline of over 20 percent in their public pension replacement rate according to the European Commission Aging Report. The PEPP - Pan-European Personal Pension Product - is designed to encourage personal retirement savings across Europe by providing greater competition, choice and scale for personal retirement solutions.

In the current low interest rate environment and increasing inflation it is important that pension savers consider options beyond just bank accounts, to better yielding products. The PEPP is designed to increase such choice for consumers and allow for greater competition across retirement products and providers. A level playing field across personal pension providers and products – and transparency on value-for-money aspects – is therefore crucial. Sound competition among providers and products will serve to foster innovation and create the necessary incentives to encourage consumers to increase their savings. This includes savers' product choice between two default options, ie capital guarantee and life-cycling strategies. Tax incentives are a key component to channel savings into PEPP pension products that generate income for retirement.

So to allow pension savers to make an informed decision with regards to their financial future, the PEPP needs to be simple, transparent and comparable. These are critical prerequisites to ensure consumers can truly choose personal retirement products and select the optimal solution for them. A standardised Key Information Document (KID) across products and providers hence is a key tool to provide the necessary data for consumers to compare products, especially at pan-European level.

Beyond the KID however, encompassing retail investor education is a major foundation to ensure consumers can adequately plan for their financial future. As societies are shifting into the digital age and the PEPP is designed to engage especially the younger generation, information should be made available in digital form. It is important to ensure that pension savers at any age have access to neutral – personal and digital – advice and a natural channel for guidance are distributers and social media.

"Tax incentives are a key component to channel savings into PEPP pension products that generate income for retirement."

- NATALIE WESTERBARKEY

As younger generations are encouraged and expected to become continuously more mobile across EU countries, the portability of personal pension savings is important. People mobility across the EU implies job mobility, not just for the younger generation. The portability of the PEPP through an EU product passport is therefore a critical feature and value-add of the PEPP to ensure consumers can efficiently accumulate pension savings also in case of a mobile life-style. A holistic personal retirement planning approach thus across state, occupational and complementary personal pension products is needed as a basis for a stronger single EU market for future generations. The PEPP, as an EU-labelled personal pension product is a key tool to increase consumer awareness that personal retirement savings is essential to secure a safe financial future. ●

Guillaume Prache

Managing Director, Better Finance

Red alert on PEPP: don't mislead EU citizens on investment and long life risks

One year ago, we highlighted the need for a Pan-European Personal Pension (PEPP) and for it to deliver decent long-term returns. Unfortunately, as discussions currently stand among the European Authorities on this key financial policy initiative, EU citizens as pension savers face two main dangers that have yet to be addressed by policy makers.

The "capital protection" scam

The first and most concerning one is the lack of any real capital protection at retirement in the default option, i.e. the one most likely to be chosen by a majority of pension savers. The current regulatory project is still proposing a highly misleading capital "protection" at retirement that is very likely to rip-off savers over the long term. Indeed, the fine print of the proposed Regulation – so far untouched by either the Council or by the ECON Committee of the Parliament - reveals that "capital" is defined:

- In nominal terms, i.e. not in real terms: the impact of inflation that eats up a large portion of the purchasing power of pension savings over time is not only ignored, but is hidden from pension savers, as if to further ensure they will still be subject to the "monetary illusion" so many times pointed out by economists. Assuming an optimistic average inflation rate of 2% over 40 years (recent history has never seen such a low long term level), it means that a capital "protection" of 100 granted by the PEPP will actually be worth only 45 in 40 years before fees.
- And after the deduction of all accumulated fees until retirement. Assuming an optimistic overall annual fee of 1% (and a zero return to simplify), the capital "protection" of 100 granted by the PEPP will be worth 60 in 40 years in nominal terms.

Therefore, in this optimistic case, the "protection" provided by the PEPP to a pension saving amount of € 100 from a 25 year old will be worth € 27 when he retires at age 65.

Worse, regulators have so far decided to hide this hideous truth from him or her, as the current proposal does not even require any prominent warning on the devastating impacts of inflation and fees over time on this highly misleadingly labelled "capital protection".

No protection against the risk of long life

As of today, the default option does not include any protection against the risk of long life. At retirement, programmed capital draw downs do allow for an optimised asset allocation after retirement - and therefore for a decent return expectation – as pensioners now tend to live 20 to 25 years after retirement on average. But what if they outlive these fixed term income flows? The default option of the PEPP (if it is not converted right away into a life annuity) must then include at retirement the purchase of a deferred life annuity kicking off at the latest when the pensioner reaches 80 to 85 years of age, i.e. the average life expectancy.

It is the only (and economical) way to cover the risk of long life and to provide very old people with a lifetime income when they need it most. In fact this option is already one of the German personal pension product (Riester Rente).

If policy makers are really serious about protecting PEPP participants, and about making its default option "safe", they must tackle these two major investor protection issues asap. ●

Xavier Larnaudie-Eiffel

Deputy General Manager, CNP Assurances

Policymakers must take time to ensure PEPPs are safe, workable pension products

The arguments for boosting individuals' saving for retirement are well rehearsed. It is pleasing, therefore, that clear progress has been made in recent months on the European Commission's proposal to create a pan-European personal pension product (PEPP) that would complement national personal pension regimes and be portable between EU member states. The Council of the EU has reached agreement on its position, ready for the trialogue discussions with the European Parliament and Commission that are expected to start later this year.

Overall, the text agreed by the member states has brought welcome clarity and has addressed issues of major importance to the insurance industry. For instance, the requirement to offer a "compartment" in each state so that customers could save throughout the EU — which would have been beyond the resources of all but the very largest pension providers — has been removed. Under the Council text, it will be

up to providers and savers to agree on the minimum number of >>>

>>> compartments when drawing up the PEPP contract.

Nevertheless, insurers still have several major concerns. First and foremost, the PEPP still does not qualify as a true pension product according to the criteria of many states. The Council text gives too little consideration to the decumulation phase — offering complete flexibility in terms of the form of pay-outs and the coverage of biometric risks — despite these being fundamental components of long-term saving products that are mandatory in some countries. Such differences between the PEPP and national definitions of pension products could lead savers to misunderstand the level of protection they have purchased.

The PEPP distribution rules, as amended by the Council, would require all providers to give mandatory advice to customers. This would require insurers to comply with two different regulatory frameworks, depending on whether they were selling a PEPP or a national insurance-based pension product, and would mean they would need to know which product was being sold before they could establish the basis on which the advice was being provided. On top of being burdensome, triggering compliance risks and confusing consumers, this would stop advice serving its primary purpose of helping individuals select products suited to their demands and needs.

"It is pleasing that clear progress has been made on the European Commission's proposal to create a PEPP that would complement national personal pension regimes."

- XAVIER LARNAUDIE-EIFFEL

Last but not least, the Council compromise text is too vague on certain crucial issues, inappropriately leaving core decisions to the Level 2 technical implementing measures or until the PEPP Regulation is reviewed. Further political guidance in the Level 1 text — such as on the definition of "risk-mitigation techniques" — is needed to frame the future technical work to be performed by EIOPA.

I strongly urge policymakers to devote the necessary time to addressing all these outstanding issues, so that individuals' savings are kept safe and the PEPP can achieve its ambitious aims by being an attractive proposition not only for savers but for providers too. ●

The Eurofi Financial Forum 2018

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Solvency II long term package review

Denis Duverne

Chairman of the Board of Directors, AXA

What measures are necessary to increase long-term investment in the EU?

Increasing investment remains a top priority in the EU. Indeed, although the EU economy has substantially recovered since the financial crisis with the unemployment rate back to its pre-crisis level (7% today according to Eurostat, the lowest rate since August 2008 although with significant disparities across countries) and a robust growth (2.4% in 2017), investment remains disappointing compared to the previous decade (20% of EU GDP in 2017 vs. 22.5% in 2007). Boosting investment is not only needed to solve the existing challenges such as unemployment, it is also key to prepare for the future and give the EU, its citizens and its companies the means to be competitive in the new economy and deliver long-term sustainable growth. This is particularly true in critical areas like infrastructure financing (only 1.8% of EU GDP today, still 20% below pre-crisis level) but also the funding of start-ups and SMEs where the share of equity should be reinforced as it is more suited for these innovative businesses which also happen to create most new jobs. Last but not least, the transition to a sustainable economy calls for large additional efforts.

Faced with these challenges, the EU is not left without any means. Abundant savings is a well-known reality in the eurozone with households' savings rate at 12% and a current account surplus of €388 billion in 2017 (3.5% of GDP). The EU can also count on large institutional investors, starting with the insurance sector which invests over €10 trillion in the EU economy (60% of GDP). Because they often hold long-term illiquid liabilities that they aim to match with long-dated assets, insurers are natural candidates when it comes to providing long-term investment and complement the financially constrained public sector. This is a key asset for Europe at a time where the EIB has shown that public investment is at a 20-year low (2.7% of EU GDP).

The needs and the means are well identified. What is missing then? Clearly, the challenge is to better match the need for long-term investment with the existing resources. There are at least 3 areas where a strong attention should be paid as to whether obstacles to the further mobilization of private long-term finance exist.

One first needs to assess whether the current regulatory regime strikes the right balance between the need for stability and the need for growth financing. This

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>>> question led the Commission to launch in 2015 a Call for Evidence. In the case of insurance, the protection of policyholders is a fundamental prudential objective. In that respect, Solvency II is presumably the most advanced prudential framework, not only in terms of capital requirements but also in terms of governance and disclosure aspects. Acknowledging and preserving the benefits of this regime should however not prevent us from addressing areas where prudence might be excessive and create unnecessary constraints, adversely affecting the economic role of insurers. For instance, the Risk Margin currently removes €200 billion from insurers' own funds, which could be further mobilized for long-term investment, including equities, in line with the CMU initiative.

A second area is to ensure certain rules do not encompass biases leading to an improper reflection of the economic model of insurance companies and hindering long-term investment. This perspective should be fully factored into the endorsement process of IFRS 17 and inform the review by EFRAG of the accounting treatment of equities under IFRS 9 as mandated by the Commission. This can decisively contribute to the rebalancing of the funding model of corporates in the EU towards less debt and more equity (the stock market represents 80% of the eurozone GDP vs. 166% in the US).

Finally, it is key to find a way to efficiently articulate public and private finance when it comes to infrastructure investment. In this area, the role of the public sector is indeed key to help unlocking projects of private investors by providing the necessary mitigation of certain risks (regulatory or political risk) without leading to the crowding-out of private actors. EU involvement is crucial to set a new momentum for infrastructure project financing by promoting a more efficient collaboration between public and private sectors to increase the deal pipe of viable projects. ●

Burkhard Balz

MEP, EPP Coordinator, Economic and Monetary Affairs Committee, European Parliament (* as of 1 September 2018 Member of the Executive Board, Deutsche Bundesbank)

Long term investment by insurers: holistic approach for the future necessary

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 one revision of the delegated acts has already been successfully completed, leading to more risk sensitive calibrations for infrastructure and European long-term investment funds. Capital charges for debt investments in qualifying infrastructure corporate were on average reduced by 25%, the alignment of the delegated act to the new STS asset class has already been advanced. The currently pending revision of parts of the standard formula should be used to further enhance the risk sensitivity of the framework, to reduce pro-cyclicality, and to avoid a distortion in asset allocations. The mandate from the co-legislators towards the Commission has been clearly set out. It is crucial that the positive efforts currently pursed are not offset by regulatory constraints, which are counterproductive to the aim of maintaining long term investments by the insurance sector and thus supporting the financing of the EU economy.

Against this background, the European Parliament encouraged the European Commission to reassess EIOPA's technical advice in order to prevent impediments for long term investments and to further create an environment that empowers insurers to act as institutional investors to the benefit of the European real economy. This also includes a critical view on some measures that EIOPA proposed on its own initiative. Thus, the Parliament supports the Commission in tackling potential recalibrations of the interest rate risk module not earlier than in the 2020 review of the long-term guarantee measures, during which a holistic approach in the revision of all LTG measures should be applied. With regard to the most immanent amendments to the delegated acts, in the light of the CMU and within the margins of the existing Directive, a more ambitious approach on the calibration of equity investment and the recalibration of the risk margin may be warranted.

An early dialogue with the co-legislators and thus an on time adoption of the revision of the delegated acts may enable the European Institutions and EIOPA to prepare already in due time for the overall assessment of the Solvency 2 framework in 2019/2020 as well as for possible improvements. This shall be done in joint consideration of the changes in the global standard-setting as well as in the accounting principles.

To sustainably enhance long term investment, we should prioritize what can be done effectively in short term, but at the same time also anticipate what can be done in the future, in a holistic approach, including as many factors as possible that shape insurers' investment policies. ●

Martin Merlin

Director, Regulation and Prudential Supervision of Financial Institutions, Directorate General for Financial Stability, Financial Services and Capital Markets Union, European Commission

The review of 2020 - bringing Solvency II into the next decade

European citizens and companies are entrusting insurers with assets worth more € 10 billion so that they are available when claims occur or when people enter retirement. To make sure that this trust is not disappointed, insurers need to hold enough capital to cover unexpected losses and need to manage their risks diligently. Solvency II, applicable since 2016, applies this fundamental principle in European law.

Solvency II is a modern system for the prudential supervision of insurers, with its three-pillar structure covering capital requirements, governance and disclosure. The major achievement in the later stages of the negotiations was a set of provisions on insurers' long-term guarantees (LTG). Transitional measures allow the phasing-in of full Solvency II requirements and adjustments to market interest rates allow that the specifics of the long-term insurance business model are taken into account.

The effort was fruitful and the introduction went relatively smoothly in spite of an unprecedented low interest rate environment. At the end of the first year of Solvency II, the sector held own funds worth more than twice the capital requirements. During 2017, insurers further increased the margin of own funds over the capital requirements even though the effect of transitional measures shrank compared to the year prior. >>>

>>> While there were no major disruptions during the introduction of Solvency II, the system brought many novelties and the final compromise on Solvency II included a clause for a review in 2020. Already in 2018 the Solvency II Delegated Act is being reviewed, with a focus on three themes: proportionality, removing unintended consequences, and fostering long-term investments (in line with the Capital Markets Union initiative). This follows targeted amendments to the Delegated Act to facilitate investments in qualifying infrastructure and in high-quality securitisations.

The 2020 review clause asks the Commission to analyse Solvency II's impact on financial stability, policy holder protection, the availability of annuity products and the role of insurers as long-term investors among others.

"The sector stands to benefit from being part of a system that invokes confidence."

- MARTIN MERLIN

During the coming months, the Commission will start reflecting on the policy areas that should be in the focus of the review. Stakeholders will also have their say when EIOPA will conduct public consultations for the preparation of its opinion on the review. The Commission will carefully look at the evidence, listen to positions and when necessary think outside the box. Facilitating long-term investments will continue to be a priority for the Commission.

The 2020 review will be about making sure that the trust that policyholders put in the insurance industry continues to be justified and that policyholders' money is wisely invested. The sector stands to benefit from being part of a system that invokes confidence. The Commission therefore encourages insurers to continue contributing to the data collections for EIOPA's annual reports on the LTG measures as well as to future consultations. ●

Clément Michaud

Chief Financial Officer,
Crédit Agricole Assurances

Solvency II review: an opportunity to address long term nature of the insurance business

The implementation of the Solvency 2 Directive has been a long, difficult, and costly exercise – it has changed the risk framework of insurance companies that have had to adapt their decisions and their investment strategies. However, companies have adapted to fit the standard and this framework is now fully integrated. It is now a decision making driver that has substantial influence on the management of insurance undertakings. This is why; we think it is essential not to substantially modify Solvency 2.

However, adjustments to the margin of Solvency 2 and in particular the LT package are necessary to fill the gaps caused by specific aspects of the standard. In this sense, we can only support a greater acknowledgement of the long-term nature of the insurance businesses. Indeed, the main flaw addressed to Solvency 2 is to impose short-term stewardship on an industry characterized by long-term management. Insurers must thus face a volatility and a pro-cyclicality of their prudential requirements disconnected from their real risks.

As a result, insurers' management decisions are influenced by their desire to reduce the exposure of their balance sheets to this volatility, which leads them to invest much less in risky assets and thus in equities. This situation weakens the equity financing of companies. In addition, it penalises the returns offered to policyholders, while they could be invested in more equity-oriented general account and improve their contribution to the financing of the European economy.

The establishment of a risk framework, which is not sufficiently linked to the economic reality of stakeholders, has some damaging consequences for the economic growth in the European Union.

To illustrate this point concretely, we witnessed that the anticipation of the new risk framework has resulted in a divestment of 50 billion in equity in France. Indeed, the prudential treatment of the equity is very penalising for insurers (the equity shock is between 39% and 49%). This treatment is therefore not consistent with the long-term vocation of these assets since they are recorded in the balance sheet of insurers whose liabilities are very long. We therefore preach the reduction of this shock for all long term held equities. This situation is all the more unfortunate as it is contrary the development of the Capital Market Union.

"The establishment of a risk framework has some damaging consequences for the economic growth in the European Union."

- CLÉMENT MICHAUD

Secondly, to address the pro-cyclicality of Solvency 2, some changes regarding the measures of the long-term package and in particular by the mechanism of the Volatility Adjustment (VA) are to be made. The aim of the VA is to stabilise the Solvency 2 balance sheet during periods of increased market volatility. This is achieved through the addition of a spread component (the VA) to the discount curve used for calculating the best estimate of liabilities (BEL). However, for insurance companies using the Standard Formula, this adjustment is incomplete because it is not allowed to apply a change in the VA under market stress. We therefore advocate changing the Volatility Adjustment by authorizing the application of a Dynamic Volatility Adjustment (DVA) in the Standard Formula, which would simply be a VA moving with the modelled credit spreads in the own funds projection over one year in the calculation of the SCR. ●

Dr. Frank Grund

Chief Executive Director Insurance and Pension Funds Supervision, Federal Financial Supervisory Authority, Germany (BaFin)

Reflecting the long-term nature of insurance business in Solvency II

Reservations with respect to the ability of the Solvency II framework to adequately reflect the long-term nature of the insurance business have accompanied the discussions since the start of the negotiations on Solvency II, thus for more than a decade now. Naturally, there is a conflict between a market value based supervisory regime and long-term insurance business mitigating risks over time. The LTG measures account for the specificities of insurance obligations with long-term guarantees and therefore were an important step forward.

This, however, has not silenced the discussions – no wonder, as there is already a trend for new products to shift risks to the customer. Especially with respect to retirement arrangements, it is still important that insurers can continue to offer long-term life insurance products with meaningful guarantees under the market-based system of Solvency II without completely shifting the asset risks to policyholders.

There is another debate coming from a different angle. Culture and society force institutional investors to align their investments to ESG-criteria and sustainability. At the same time, supervisors must face the complaint from politics, that Solvency II includes disincentives to long-term investments. In addition, long-term investments are exposed to the risk of political and social changes: Investments that are well respected today might be disliked tomorrow - an additional risk, insurance companies must thoroughly assess.

Macro-economic considerations are nearby. The prevention of pro-cyclical investment behavior has been a particular objective, which has been crucial for BaFin during the negotiations of Solvency II. Politics can also trigger pro-cyclicality, forcing the insurance industry to invest in certain asset classes. Yet, supervisors are obliged to prevent inadequate risk measurement. They have to make sure that any investments are treated according to their risk profile.

One of the objectives of the LTG measures is to mitigate incentives for a pro-cyclical investment behaviour. During the LTG-review - running until 2020 – EIOPA intends to analyze carefully the impact of the LTG measures on financial stability. The assessment will however be broader considering also the impact of the measures on policyholder protection, investments as well as product design. The question of whether undertakings will still be able to provide contracts with long-term guarantees to their customers will therefore receive particular attention.

> *"Supervisors are obliged to prevent inadequate risk measurement."*
>
> - DR. FRANK GRUND

In this context, specific consideration on the risks and illiquidity characteristics of long-term life insurance products and the corresponding ability of insurers to mitigate short-term volatility by holding assets throughout the duration of the commitments is required.

The question of how adequate capital requirements for long-term guarantee business would look like is under discussion and yet not satisfactory answered. Consequently, BaFin contributes to continue discussions in order to succeed in preserving the valuable contribution of insurance companies to old-age provision. ●

Dr. Manuela Zweimueller

Head of Policy Department, European Insurance and Occupational Pensions Authority (EIOPA)

The review of long-term guarantees measures: where do we stand?

As a risk-based regime, Solvency II includes also measures to ensure an appropriate treatment of insurance products with long-term guarantees (Long-Term Guarantees (LTG) measures) and measures to ensure an appropriate level of capital requirements for investments in equity (measures on equity risk). These measures include, inter alia, the extrapolation of risk-free interest rates towards an ultimate forward rate, the matching adjustment, the volatility adjustment, the transitional measure on technical provisions and the symmetric adjustment to the equity risk charge.

LTG measures and measures on equity risk, which relevant stakeholders debated intensively, need to be relevant and effective. The Solvency II Directive mandates EIOPA to conduct a review of these measures during the first five years of Solvency II, i.e. by 1 January 2021. As part of this review, EIOPA reports annually to the European Commission, the European

Parliament and the Council of the European Union on the impact >>>

>>> of the application of the measures and will - in 2020 - issue an opinion on the effectiveness of the measures.

Given that the measures apply to long-term business – business that may run-off over decades - five years is quite a short time over which to assess the prudential impact of the measures. Therefore, EIOPA's annual reports analyse facts and data collected over a specific year. The Authority will consider the evidence from all these reports as well as gathered through public consultation, before setting out its conclusions and recommendations in its opinion due in 2020. Half of the review period has already passed and EIOPA has published two annual reports and is currently working on its third.

"LTG measures and measures on equity risk need to be relevant and effective."

- DR. MANUELA ZWEIMUELLER

At this stage, we can confirm that the voluntary measures are widely used. According to our latest analysis, 783 insurers with a market share of 74% apply at least one of them. The volatility adjustment is the most frequently used measure, followed by the transitional measure. The measures have a significant impact on the regulatory solvency position of the companies. At the end of 2017, the insurers applying any of the voluntary measures had on average a solvency ratio of 217%. Without the measures, the regulatory capital of those insurers would decrease by EUR 166 billion and their solvency ratio would be 148%. Insurers comply with their capital requirements when the ratio is at 100% on an on-going basis.

A thematic focus of last year's report was the disclosure by insurers about the measures they use. Stakeholders suggested the disclosure of a number of additional pieces of information, such as the impact of the extrapolation of risk-free interest rates on the solvency position to better understand the use and impact of the measures.

As part of the review, EIOPA is in analysing the extent to which long-term insurance liabilities are illiquid and whether the capital requirements for investments covering such liabilities are appropriate. EIOPA is also looking into the impact of the measures from a macro-prudential perspective and whether additional measures are needed to mitigate systemic risks.

A public consultation to inform EIOPA's opinion on the LTG measures is planned for the end of 2019 and beginning of 2020. ●

Tobias Bücheler

Head of Regulatory Strategy, Allianz SE

The case for an improved volatility adjustment in the future Solvency II review

After the successful start of Solvency II in 2016, the practical experience in day-to-day application and remaining challenges is steadily growing. While stakeholders are waiting for the finalization of the 2018 Delegated Acts review, the run-up for the more comprehensive review of the Directive by 2021 has already begun. Against a background of lackluster economic growth - coupled with a high demand for infrastructure spending - but also considering the challenges with existing old age provision systems, it seems clear that the upcoming review should be ambitious in scope while avoiding to unravel the fundamentals and overall balance of the framework.

More specifically, the role of the insurance sector as a stable long-term investor should be better recognized and the recent call for information to EIOPA by the EU Commission is a first encouraging step in this direction. The (life) insurance business model is by nature long-term and related long-term insurance liabilities can ideally be covered by holding long-term assets. As such, the most prominent risk is a potential default during the asset holding period. In contrast, short-term market price fluctuations are largely irrelevant. Unfortunately, insurers are treated under the current Solvency II framework more like traders whose assets may have to be sold quickly to settle short-term liabilities. In contrast, insurers typically don't have to rely on asset sales to cover short-term liquidity needs but receive liquidity from interest and dividends on their assets and the regular premium inflows from policyholders.

"The role of the insurance sector as a stable long-term investor should be better recognized..."

- TOBIAS BÜCHELER

Solvency II acknowledged the issue above in principle with the introduction of the so-called Volatility Adjustment (VA) aiming to limit the impact of asset spread movements on the solvency situation of insurers. Unfortunately, after more than 2 years of experience with the VA under different market environments one can only describe its impact as „too little, too late„ while even introducing additional risk into the system. This is mainly driven by the lack of recognition of the actual investments made by an insurer. The current VA is based on a theoretical industry average portfolio which discriminates investment strategies that are longer term, even if such a strategy was a perfect fit for an insurer's long-term liability portfolio. We believe that an enhanced Volatility Adjustment that acknowledges the actual investment portfolio of an insurer (which is insulated from short-term liquidity needs) while related default risk is recognized in capital requirements would better reflect the underlying economic risk and at the same time promote long-term investment and good asset-liability management.

We believe that the economy and society would benefit from such thoughtful changes to Solvency II to enable the sector to invest more into long-term assets, thereby supporting growth and enhancing financial stability while enabling enhanced provision of effective old-age provisioning products at the same time. ●

Jean-Jacques Bonnaud

Member of the Board and Treasurer, EUROFI

Review of the Solvency II long-term package

The potential role that institutional investor, particularly life insurers and pension funds, can play as long-term institutional investors specially as contributors to investments in equity or infrastructures, has become a central topic of discussion in the Eurozone, given their need to match their long-term liabilities, in addition to the volume of assets they hold in their balance sheets which represents about 70 %of the EU GDP and is on average on a regular growth trend.

In fact – as shown by studies from the OECD or Insurance Europe - the structure and the allocation patterns of the portfolios in Europe, but in the US too, has not significantly evolved those last three years despite the existing major macro-economic background, and the efforts to encourage longer term investments through regulatory adaptations (specially infrastructure assets which are now considered as a separate asset class in Solvency II in the EU).

The investment decisions of insurers are governed by several factors that may seem in competition. The most driving of these factors seem to be the need to maximize the return to premium rate and also to achieve an adequate asset and liability management (ALM). In this context in principle, long-term assets are suitable for life insurers in that the inherent illiquidity of these investments fit with insurers illiquid liabilities. As writes the OECD, this creates a sort of « natural marriage ».

However, the recent asset allocation, in spite of a marked decrease in interest rates, has not witnessed a marked change towards higher yielding products such as listed equity, although pension funds and life insurers are able to minimize the liquidity risks. Long-term investments in equity or infrastructures do not significantly increase, and their level represent between 3% and 7% of total assets while fixed income and loans account for approximately 90% of the total asset portfolio.

This apparent reluctance may be due to a new and increasing demand by the market for more flexible and thus liquid life insurance products (with surrender options), combined with return guarantees. These products are not compatible with the volatility of future dividends cash flows which is much higher than bond cash flows.

Long-term direct investments in non-listed equity, have been reduced not only due to their excessive risk profile, but also to the fact that many insurance companies have been externalising certain servicing functions, including computing and customer care, which represented most of their former modest non-listed equity holdings.

"EU political authorities should not expect spectacular and sudden shifts in insurers' investment strategies..."

- JEAN-JACQUES BONNAUD

The size of the insurers' balance sheets and their ability to diversify their holdings, notably in the area of equities, should probably lead them progressively to increase such holdings.

It is clear nevertheless that prudential regulation should be adjusted to actual levels of risk. The calibration of the regulatory capital (notably Solvency II) related to the holdings of certain asset classes – equities, securitisation – should notably be based on stress situations incorporating the actual (very long) term life insurers hold these assets is necessary.

A careful review of the cost of capital approach involved in Solvency II to define the risk margin of insurance companies, could also have a positive effect by freeing large amounts of capital currently sterilised by an over conservative Solvency II, that could be invested in the real economy.

This goes in favour of the move toward a swift and efficient adaptation of legal provisions adopted by the EU. However EU political authorities should not expect spectacular and sudden shifts in insurers' investment strategies, due to their need to carefully match their risk profile with the evolving structure of their liabilities corresponding to the evolution of market's demands. ●

FOLLOWING EUROFI EVENT

The Eurofi Financial Forum 2019

11, 12 & 13 September

Helsinki - **Finland**

Financing EU infrastructure projects

Benjamin Angel

Director for Treasury and Financial Operations,
DG Economic and Financial Affairs, European Commission

What are the ambitions and specific strength of the InvestEU new initiative?

When the Juncker Commission took office in late 2014, investment had fallen by 15% as a result of the financial and economic crisis. Comprehensive action was required to tackle this investment gap and to reinstate confidence in the Union economy. The Investment Plan for Europe was the European Unions' answer to this situation.

Since then, and thanks to structural reforms carried out by the Member States, to a more a favourable economic situation and to interventions such as the European Fund for Strategic Investments (EFSI), the investment conditions in Europe have improved. However, there is still a sizeable investment gap in Europe. Therefore, the Commission has put forward for the next multiannual financial framework (MFF) a single, multi-policy investment support instrument: the InvestEU Programme, comprising the InvestEU Fund, the InvestEU Advisory Hub and the InvestEU Portal.

The InvestEU Fund will mobilise public and private investment through an EU budget guarantee of EUR 38 billion that will back the investment projects of the Commission's implementing partners, and increase their risk-bearing capacity. It should trigger at least EUR 650 billion in additional investment.

InvestEU is a major simplification compared to the current MFF
It will integrate all the support, which is now provided via 13 centrally managed financial instruments and the EFSI into one multi-policy instrument. It will also integrate 13 advisory services into one. This will avoid fragmentation, overlaps and make life easier for beneficiaries. Furthermore, it will allow us to do more with less by using a relatively small amount of the budget (EUR 15,2 bn) in the form of a guarantee.

The InvestEU Fund will also allow for seamless and easy combination with grants. When blending grants from other programmes like Horizon Europe, the Single Market Programme or the Connecting Europe Facility with support from InvestEU, InvestEU rules will apply for the entire project. No more double reporting, no more double rules. This is a major simplification compared to today.

>>>

>>> **InvestEU will be more policy-driven. This reflects the new investment environment: volumes are important but policy even more**

The EFSI's main purpose was to trigger volume and to address the investment gap in the immediate post-crisis period. InvestEU will focus more on achieving the Union's ambitious policy priorities. This new focus is reflected in the Fund's structure, with a breakdown in four policy windows: sustainable infrastructure; research, innovation and digitisation; small and medium-sized businesses; and social investment and skills.

The InvestEU Fund also opens up the possibility for Member States to emphasise investments in a specific policy area through an earmarked Member State compartment. More specifically, Member States may voluntarily contribute up to 5% of their cohesion funds to InvestEU. Like this, Member States will benefit from the EU guarantee and its high credit rating, giving national and regional investments more firepower.

InvestEU will build on all available expertise from several implementing partners, multiplying the investment and policy impact on the ground

The main partner will remain the EIB Group. The expectation is that the Bank will channel around 75% of the EU guarantees. But the Commission feels that certain geographies and specific sectors could benefit from the intervention of additional actors, such as the European Bank for Reconstruction and Development, the Council of Europe Bank and national promotional banks. The idea is to combine the strength of the EIB Group with the local knowledge and expertise of other players to do more outreach and to cover also smaller projects. This will foster innovation and new financial products for specific sectorial, regional or local needs.

The Commission hopes that the co-legislators will agree on this proposal before the next European Parliament elections so as to ensure that all preparatory work to make InvestEU operational with as many implementing partners as possible from day one of the next MFF is carried out. ●

Petr Ježek

MEP, Committee on Economic and Monetary Affairs and Chair, Special Committee on Financial Crimes, Tax Evasion and Tax Avoidance, European Parliament

Investing in the European economy for the future

The European Fund for Strategic Investments was established in June 2015, for an initial period of three years, with the goal of triggering €315bn of investment in projects of strategic importance for the EU. In July 2018 the Commission announced that the initial funding target had been surpassed, with €335bn of investment mobilized since the fund became operational. It is therefore positive that the EFSI has been prolonged until 2020, with an investment target of €500bn.

The slogan, which we heard continuously at the time of EFSI's inception, was 'Jobs and Growth'. Indeed, according to the Commission, so far the fund has supported more than 750,000 jobs, with the ambition of reaching 1.4 million jobs by 2020. Furthermore, the Commission asserts that EFSI has increased EU GDP by 0.6% and forecasts that by 2020 that figure will be 1.3%. There is no denying the fact that EFSI has so far had a positive impact in terms of reducing the investment gap in Europe. In 2018, the investment gap has returned to pre-crisis levels, and is forecast to continue narrowing.

It is particularly positive that the largest slice of investment funding under EFSI is helping small and medium sized businesses to form and expand. 700,000 small businesses have been able to tap into the EFSI so far, and it is important that this figure also continues to grow.

To take an example from the Czech Republic, a start-up business, which developed new and sustainable carrier bags for fruit and vegetables, was able to tap into the EFSI guarantee. This business would not have been able to rely on traditional financing from banks due to its lack of credit history, yet thanks to the EFSI fund the company has been able to grow, creating demand for raw materials sourced locally, as well as directly leading to the creation of more jobs. This is just one of many examples of the positive aspects of the EFSI fund. >>>

>>> Some of the deficiencies of the first EFSI were addressed in EFSI II, which will hopefully allow even more smaller projects to benefit not only from funding, but also better technical assistance from the European Investment Advisory Hub. This will be particularly beneficial for local projects, and extend EFSI support to more regions and economic sectors. Furthermore, the new EFSI should focus more strictly on those projects that would otherwise not receive financing. EFSI II should be an incentive for innovation across the EU, bringing new ideas and concepts to reality.

Within the context of the overall Investment Plan for Europe, the Commission has proposed that under the 2021-2027 EU financial framework there will be a successor programme to EFSI, in the form of InvestEU. This programme should continue the EFSI tradition of funding projects across the EU, but in this case with a particular focus on those areas of policy deemed necessary for the furthering of the objectives of the EU. These include research and innovation, sustainable infrastructure and SMEs.

"The total investment gap in Europe, while improving, is still too wide."

- PETR JEŽEK

InvestEU will have a budget guarantee from the EU of €38bn over the period 2021-2027. This compares with the combined EFSI budget guarantee of €26bn between 2015 and 2020. The Commission expects the InvestEU programme to stimulate up to €650bn of investment. This is lower than the total EFSI-related investment due to the fact that it is targeted at some higher risk projects and SMEs, as well as having a greater focus on the aforementioned EU policy objectives.

InvestEU will bring a number of investment instruments currently in force under the 2014-2020 multiannual financial framework under one roof, so to speak. This is beneficial in that it achieves greater risk diversification, has the capability to mainstream cross-sectoral policies and also will be brought under one governance structure, thereby reducing administrative duplication and excess bureaucracy.

The total investment gap in Europe, while improving, is still too wide, and therefore an expanded and simplified model of EU investment guarantees is a welcome proposal in order to reduce this gap.

With so many other issues grabbing the headlines related to the Union in recent years, it is rare that as a politician one is able to extol the virtues of the EU. In the case of EFSI and InvestEU, however, it is clear that there are many success stories as well as tangible benefits for local businesses and employment, and also for the economies across the continent. ●

Sophie Barbier

Head of European Affairs, Caisse des Dépôts (CDC)

The crucial role of NPBIs in the "InvestEU" new initiative

As the Juncker Plan is now entering into its second phase, From the very beginning, National Promotional Banks and Institutions (NPBIs) were key actors for its success. They remain extremely active in terms of financing infrastructure projects, as shown by the launch of the Marguerite II pan-European equity fund last year and by the launch of the pan-European broadband Fund earlier this year.

By doing so, NPBIs act as a catalyst for "greenfield" and "brownfield" infrastructure investments in renewables, energy, transport and digital infrastructure in line with the objectives of the Investment Plan for Europe and the European Fund for Strategic Investments (EFSI). These include cutting carbon emissions by financing energy efficiency improvements and renewable energy expansion, increased access to high-speed fiber internet, improved transport connections and strengthened energy security. Moreover, these investments support green and innovative projects which contribute to the transition towards a low-carbon economy in line with the IPE objectives and the COP 21 targets.

With the next multiannual financial framework – that is expected to be more integrated, through the "Invest EU Fund" –, NPBIs could enhance furthermore their role in the rolling-out of financial instruments. Indeed, the direct access to the EU guarantee granted to the new implementing partners can be considered as a 'game changer'. It will enable the EIB group, NPBIs and other International Financial Institutions to develop an even greater level of co-operation, thus complementing their respective actions in various ways. This will also allow for stronger synergies between the EU Commission and implementing partners and will help unlock the potential for investments in Europe.

"The direct access to the EU guarantee granted to the new implementing partners can be considered as a 'game changer'."

- SOPHIE BARBIER

NPBIs combine significant financial and project engineering expertise, together with strong financing capacities and have an in-depth knowledge of both local actors and European institutions, and of their respective political priorities. As such they do have the key assets for being enablers of investment plan, as recorded in the past with the Juncker Plan. They build bridges between public and private sectors and combine national and European funding. Never far from the local level, NBPIs such as Caisse des Dépôts are also close to the European level; so they stand as the natural partners to build the "Europe of territories" on the investment side! ●

Alexander Batchvarov

PhD, CFA, Managing Director,
BofA Merrill Lynch Global Research

Infrastructure finance optimisation starts with complimentary prudential regimes

Infrastructure financing involves a wide range of projects and financing techniques. Historically many large infrastructure undertakings, often of long-term nature and subject to informational asymmetries, were financed by the government. In the EU, sovereign budgetary and fiscal constraints, and bank constraints, are demanding the participation of the private sector, especially the large asset managers, including institutional investors, such as insurance companies and pension funds. The latter usually avoid infrastructure projects in construction phase, such financing remains the domain of the banks, while up-and-running infrastructure projects can be attractive for private investors. Given the nature of the risks in some infrastructure projects, PPP can be used to bring financing, too. In the EU an important role is played by EIB, perhaps sometimes in competition with the private sector, in financing large infrastructure projects.

"New policy measures must ensure CMU's adequate role in EU infrastructure finance."

- ALEXANDER BATCHVAROV

Infrastructure financing can be executed on different parts of the capital markets, and can use a very wide range of structures and instruments, from plain vanilla equity and bonds, through to loan syndication, project bonds and securitisations, with and without third-party guarantees, on an individual and pooled projects basis, under local or foreign law, with or without collateralisation, with or without the participation of multilateral development banks.

EU has undertaken steps to create and support infrastructure financing through the capital markets, among them the development of CMU, improved prudential treatment for high quality infrastructure projects for insurance companies, new regulatory framework for securitisation, improvements in the prudential regime for private equity and non-traded equity for insurers, etc. While the developments in the equity markets for infrastructure investments are encouraging alongside the existing market for project finance syndicated loans, we think new policy measures must ensure CMU's adequate role in EU infrastructure finance.

In our view, possible and necessary steps include the development of a project bond and municipal (revenue-based) bond markets, recalibration of regulatory capital for infrastructure and project finance under Solvency II, recalibration of capital requirements and amendments in prudential regime for securitisation to allow pooled based financing of infrastructure loans, introduction of ESN for infrastructure, etc. Regulatory capital levels for infrastructure today do not correspond to its lower default and loss history compared to similarly rated corporates. Equity finance must compliment bank finance in the early stages of project development, while securitisation, revenue bonds, ESNs and project bonds should replace banks in the post-completion phase of financing. Liquid and transparent market for project bonds and securitisation bonds should create an alternative to syndicated loans. Marrying infrastructure finance with ESG finance through fiscal, prudential and political measures can help attract more capital to address rising infrastructure needs. ●

Emmanuel Gillet-Lagarde

Global Head of Infrastructure Finance,
Natixis

Improving financing prospects of EU infrastructure projects

Infrastructure projects, with a global amount of financing of USD 293 bn in 2017 are essential to support investment and economic development. Infrastructure is mainly and best financed through project finance. Project finance is a bespoke way of financing infrastructure, with security package and structures enabling lenders to have control over the assets and the cash flows they generate and ultimately the risks taken.

Lenders have mainly been banks but the market is now evolving with insurers being increasingly active in infrastructure financing, often with the intermediation of banks at some point and mostly on the refinancing of existing assets. The top 10 of infrastructure project MLA (Mandated Lead Arranger) >>>

>>> banks do not include any US bank. As a result, Basel III (BIII) will mainly impact European banks and consequently the financing of infrastructure in Europe as it is largely financed by banks while capital markets solutions are more often available in the US.

"Improving prospects of EU infrastructure projects starts with avoiding revised Basel III dramatic impact."

- EMMANUEL GILLET-LAGARDE

This asset class shows low loss rates in average, 0.35 %, twice lower than unsecured corporate loans (0.72%). Although loss rates are low in average, these financings are sensitive to project-specific risks drivers which vary greatly from one transaction to the other and are therefore best estimated by internal models. Internal models developed by banks have proven historically to be reliable and appropriately calibrated.

The revised BIII framework would strongly affect the ability of banks to provide this type of financing with dramatic consequences on the development of infrastructure in Europe. The core issue is a strong increase of the capital requirements, uncorrelated to risks, through an unduly punitive level of Risk Weighted Assets (RWA) output floors as well as levels of Loss Given Default (LGD) input floors. Output floors consider project finance as more risky than unsecured corporate finance whereas data show they are twice less risky. LGD input floors were designed to be applied to unsecured corporate loans and are set at 2/3 of the average LGD observed on these loans; much too high for project finance as these input floors represent 100% of the average project finance observed LGD. Having a minimum LGD equal to the average observed LGD for a given asset class does not make sense. This will highly penalise the best transactions to which overstated LGDs will be applied.

The consequences we expect from the implementation of BIII are the following:

1. A strong reduction of the volumes of infrastructure project financings by banks, which may affect the development of some infrastructures on the European agenda (e.g. renewables or broadband networks);
2. An increase of prices for the borrowers and the end users (e.g. rents paid by public entities in the case of PPPs);
3. A deterioration of quality of the balance sheet of the banks as banks will be highly incentivised to choose the most risky transactions, those with sufficient margins to give an acceptable ROE;
4. Less financial stability (which is exactly the opposite to what the Basel Committee wants to achieve) with an increase of risk in banks' balance sheet and a shift of these financings from banks to shadow banking or financial institutions less experienced and skilled to understand and mitigate the risks involved.

The shift from banks to insurers for these financings will not enable to finance adequately the expected volume of infrastructure as insurers, given their constraints, will not be able to provide bespoke financings like banks do in particular for the construction of these assets and this source of liquidity will dry if banks totally withdraw from this segment as their involvement is needed in the structuring of the financing of these projects.

The supporting factor for infrastructure financing as proposed under the CRR II will not solve at all the overstated revised BIII requirements, as a discount of 25% on RWA will not compensate for an increase of roughly +150%. Moreover, as it is drafted at this stage, the scope of project finance that could benefit from the supporting factor would be very restricted, probably around 10-15% of the asset class and notably mainly for projects outside Europe.

As a solution, we propose to the EC that the EU seriously considers that LGD input floors should be more risk sensitive and set at 15%, ie at around 2/3 of the average observed project finance LGD, the same proportion as for corporate unsecured loans. Moreover, a specific lower LGD input floor should be set for the best transactions, at 10% (consistent with observed LGD for PF, as for more than half of them, observed LGD were below 10% [1]).

Finally, the Basel Committee mentioned that the "Slotting approach" would be reviewed in due course. We welcome this initiative, as long as the purpose is to get a more granular table, reflecting the low average loss rate of this specific asset class and as long as it avoids penalizing the best transactions and enables to have RWA consistent with economically reasonable margins. Calibration of the slotting approach could therefore be done on the basis of the internal models for which back testing have proved their robustness. ●

1. Source S&P Annual Global Project Finance Default and Recovery Study published in December 2015

Andrew McDowell

Vice-President,
European Investment Bank (EIB)

The EU bank will continue to support Europe's economic recovery

In 2014 Europe was still suffering from the lingering effects of the global financial crisis and the subsequent sovereign debt crisis. Levels of investments were well below historic levels, and investment gaps to achieve Europe's ambitions policy targets were widening. Compared to pre-crisis levels investment had fallen by some 15 percent.

In November, the European Commission and the European Investment Bank (EIB) Group launched the Investment Plan for Europe, also known as the Juncker Plan. Its aim: to put Europe on the path to economic recovery. The plan consists of three complementary pillars: (i) the European Fund for Strategic Investments (EFSI) to address the financing constraints facing investment projects and businesses; (ii) the >>>

>>> European Investment Advisory Hub (EIAH) to deliver technical assistance to project promoters, and the European Investment Project Portal (EIPP) to provide visibility to projects looking for finance; and (iii) regulatory and structural reforms to remove barriers and create an investment friendly environment.

"The EIB Group and the Commission are not the only ones to see EFSI as a success."

- ANDREW MCDOWELL

The project was ambitious, and many people doubted that it could be achieved. After all, the goal was to mobilise EUR 315 billion from a guarantee of only EUR 21 billion (EUR 16bn from the Commission and EUR 5bn from EIB resources).

This is a factor of 15 and it appeared to be "Juncker's pie in the sky", as one economic newspaper titled. EIB Group took on the challenge to implement the first pillar of the plan – and, three years in, it delivered on its promise. In July almost 900 operations had been approved under the Juncker Plan. They are expected to incentivise EUR 335 billion in investment across the 28 EU countries.

Thanks to the EFSI the EIB Group can finance operations that are riskier than its average investments. This translated into tangible results for Europeans: 700,000 small and medium-sized companies are set to benefit from improved access to finance; some 15 million additional households can access high-speed broadband; 30 million Europeans benefit from improved healthcare services, and 500,000 families will live in affordable, modern and energy efficient flats, to give just a few examples.

The EIB Economics department has worked closely with the European Commission's Joint Research Centre to try to assess the overall macroeconomic impact of the EFSI supported investment approved so far. Results suggest that EFSI supported operations will create 1.4 million jobs and will increase EU GDP by 1.3% in the short-term, by 2020, compared to the baseline scenario. As a long-term investor the EIB Group focusses particularly also on the longer-term structural effects that can help improve European competiveness and ultimately growth. According to the calculations by 2037 EFSI supported operations will still have created an additional 780,000 jobs and EU GDP will have increased by 0.9%. The benefits are broad-based in sector and geography, backing especially crisis hit and convergence countries when measured against GDP.

The EIB Group and the Commission are not the only ones to see EFSI as a success. In December 2017, the European Parliament and Council agreed on to extend EFSI in scope and timing – the new investment target is EUR 500 billion by the end of 2020. While the discussions about the new EU budget after 2020 are ongoing, one things is certain: The EFSI demonstrates, Europe benefits if it makes bigger use of financial instruments to support growth and competitiveness. ●

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V. FINTECH AND DIGITALISATION

Issues at stake

Technology offers new opportunities that could lead to radical change in the financial sector. All financial activities are concerned and can potentially reap the benefits of digitalisation and fintech. Although most present applications mean improvements of existing services and processes, fintech and digitalisation also facilitate the introduction of new business models and the entry of new players into the market, for example in the payments area.

These new technologies however pose challenges in terms of regulation, supervision and standardisation, which are currently being addressed by EU and global initiatives. They may also give rise to new risks and issues such as cyber-risk and data privacy. Finally the strong development of crypto-currencies could create new opportunities related e.g. to DLT but it also raises questions in terms of investor protection, AML / CFT and market integrity.

Content

Crypto-currencies policy approach

Harald Waiglein

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

What to do with Crypto Assets?

Crypto Assets (sometimes also called Crypto Currencies) have become a global phenomenon. After a sharp rise in value, market capitalization reached a record high of $835 billion in January and dropped rapidly afterwards. Many people ask themselves whether crypto assets are just another hype or, as proponents claim, the future of money.

From a technical point of view, crypto assets represent the best-known application of the blockchain technology, which means they are based on a decentralised, safe and cost-efficient transaction system. On the other hand, crypto assets entail major drawbacks. Low acceptance in the real world shows that they lack the basic characteristics of conventional money, which makes them unlikely to develop into a universal means of payment in the near future. Their decentralised nature provides for cost-efficiency, but it also means that there is no central entity which can be held accountable by users or regulators.

However, most decision-makers agree that crypto assets and their underlying technology offer a lot of potential for innovation. Therefore, we should try to create a framework which enables further development and allows us to reap the benefits.

Positives: The use of crypto assets has the potential to reduce transaction costs significantly. Whereas traditional businesses often face obstacles and bottlenecks due to the number of intermediaries, crypto asset transactions provide for a quick settlement based on peer-to-peer technology. Crypto assets and the blockchain are already used in many ways by the financial sector, for instance for the purpose of clearing, money transfers (e.g. remittances) or transactions which include smart contracts. Even central banks are looking into their potential, as the e-crown project in Sweden shows.

Moreover, initial coin offerings (ICOs) have demonstrated that crypto assets can be an effective and efficient way to raise capital. This could make markets more dynamic and provide companies with additional ways to access finance.

Negatives: However, there are also drawbacks. First, it is questionable whether crypto currencies can act as a substitute for money. To qualify as money, they need to fulfil three criteria. They have to be able to act as a store of value, a medium of exchange and as a unit of account. The high volatility of crypto currencies shows that they cannot store value. As regards the function of a medium of exchange, crypto currencies are only accepted by a handful of businesses and can therefore not be considered a universally accepted means of payment. Furthermore, there are major regulatory problems, for

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>>> instance the lack of transparency of the identity of the issuers, or of the business plans of companies using ICOs, the danger of money laundering and terrorist financing (e.g. through virtual currency exchanges and wallet providers), and problems with data protection and taxation. One of the central features of the technology may also be its major challenge: its decentralised nature and the absence of a central hub. This not only creates a problem for regulation, but also raises simple technical issues: e.g. how do you countermand or reverse a transaction that was made by mistake?

Policy Recommendations: We have to create the appropriate environment to foster financial innovation. For this, it is important to take account of the needs of all stakeholders. Consumers need to be protected, and the necessity to maintain financial stability also exists in the world of crypto assets. However, regulation should not be an end in itself, and should be technology-neutral wherever possible. Not every innovation requires new ad hoc legislation. Austria is actively addressing the issue. The Federal Minister of Finance has recently established a FinTech-Advisory Board to provide a forum of exchange for all stakeholders. We want to support start-ups and create an environment of cooperation between innovators and authorities. One example is a regulatory sandbox which may be implemented over the next year. This, we hope, will provide a space to try out new things without doing harm. After all, in one respect the crypto-world is very much like the real world: innovations may be a good thing, but it is always better to be safe than sorry. ●

Jakob von Weizsäcker

MEP, Committee on Economic and Monetary Affairs, European Parliament

What is the potential of crypto-currencies for European citizens and businesses?

In order to answer this question, it is useful to make the distinction between crypto-currencies and the underlying technology, namely the distributed ledge technology and related concepts that are able to create digital trust in a decentralised manner.

I find it implausible that privately issued crypto-currencies will be used widely as money for legitimate purposes for as long as central banks provide a currency that is eminently suitable as unit of account, as medium of exchange and for the storage of value while safeguarding financial stability and adjusting to suitable institutional and technological innovations in due course. Obviously, these preconditions may not be met in specific situations in some parts of the world where central banks fail to deliver.

By contrast, I find it highly plausible that distributed ledger technology and related concepts will be used widely as part of the ongoing digital revolution. This will be to the benefit of European citizens and its business if implemented well and also properly regulated at the right time without stifling innovation. In fact, for some applications I could very well see the EU or its member states play a leading role not only as a regulator but also as a lead user for certain applications of distributed ledger technology.

To make matters slightly more complicated, as part of the breakthrough of distributed ledger technology, some digital tokens are likely to have significant use value and also market value (not least due to network effects) just as other scarce assets. However, that does not make them better suited for the general use as money than normal currencies if the latter a run well, as argued above.

What are the key challenges and risks that they pose and questions they raise?

While many ideas on how to use distributed ledger technologies have been developed, it is still unclear which will be key breakthrough applications. For the EU, this poses a number of challenges: as a regulator, we should not regulate too early so as not to stifle innovation in the field. But we have to monitor developments very closely to be able to regulate sufficiently early. Such regulation could be designed to deal with significant risks – for example from a financial stability, a consumer protection, a regulatory fragmentation or a competition perspective.

At the same time, it could be designed to make better use of >>>

>>> the opportunities as regulatory innovation often complements technological innovation. In addition, when it comes to distributed ledger technology, the EU could not only play an important role as regulator but also by means of pioneering the use of distributed ledger technology for government applications. I am delighted that the European Commission is much aware of the opportunities and challenges and is now actively pursuing those different avenues, including by means of the recently created Blockchain Observatory.

An important test case for European Union in this policy area will be the suitable regulation of initial coin offerings (ICOs). Currently, ICOs are not properly regulated and a majority of ICOs are highly questionable in nature. At the same time, a number of national regulators are keen to help attract funding for legitimate innovative businesses by means of ICOs and aim to become ICOs hubs. However, as a result of these national activities, there is a risk of regulatory fragmentation and unhealthy downward competition in regulatory standards. Therefore, the European Union will have to become active and strike a balance between controlling the risks involved and fostering the opportunities, between preserving the single market and allowing limited national experimentation in a rapidly evolving environment. ●

Denis Beau

First Deputy Governor, Banque de France

A regulatory framework for crypto-assets to maximize the positive impact of underlying technologies

While crypto-assets can take different forms and fulfill different functions, they have in common the combination of a new asset, which is not a liability of any individual institution, a new record keeping and transfer technology and a vibrant ecosystem of entrepreneurs and investors. These commonalities and specificities have opened up the prospect of disruptive and efficiency enhancing applications for the financial system. However, as crypto-assets go through the usual hype cycle of innovations, and move beyond the peak of inflated expectations, it might be time for warning calls issued notably by the central banking community about the challenges (they do not adequately fulfill the basic functions of money) and the risks they bring to the financial system to be considered to design proportionate adhoc regulations.

Indeed, crypto-assets bear risks that need to be carefully considered and addressed. Because of their opacity maintained by the use of pseudonymity, they may serve criminal purposes, namely money laundering and terrorism financing. Second, the use of crypto-assets poses important consumer and investors protection issues, notably because of the lack of adequate cybersecurity safeguards in the overall crypto-asset ecosystem. Lastly, crypto-assets may also generate going forward financial stability risks as investors are exposed to significant financial losses because of their high volatility, even if this is not the case as of today, given their limited global outstanding amount and their weak interaction with traditional financial institutions and the real economy.

Such risks are not inherent to crypto-assets but, should they materialize, may prevent the potential benefits from an extended use of their underlying technologies in the broad area of financial services. That is why a policy response is advisable with the objective of letting the crypto-assets ecosystem developing in a safer environment, especially for the users of these instruments. Different approaches are conceivable to that end.

In France, a draft law regarding to ICOs is being examined by the Parliament. Under this proposal, an ICO issuer on the French territory would have the option to ask for a visa from the Financial Markets Authority. Such visa would inform the public that the ICO complies with basic rules regarding AML-CFT, investor/consumer protection and safekeeping of assets.

In addition, the creation of a specific status for market participants willing to engage in crypto-assets related activities, such as exchange of crypto-assets for fiat currencies or the storage of cryptographic keys, should be considered. This status would allow providers of crypto-asset services to operate in a safer environment, while being subject to rules governing operational security, customer protection and anti-money laundering, in a manner proportionate to the risks brought to the financial system.

Furthermore, financial stability concerns call for a limitation of the possibility for regulated entities (banks, insurance companies, asset management firms.) to develop activities in crypto-assets. Related constraints could entail banning such assets in investment vehicles offered to the general public and setting stringent capital requirements for the crypto-asset proprietary investments.

However, since crypto-assets make use of internet-based technologies and cross-border services, solely domestic regulatory measures will not be sufficient to mitigate potential risks at a global scale. At the international level, a consensual diagnosis has already emerged under the aegis of G20. Now, Europe needs to go a step further to maintain security while promoting innovation.

Beyond the new provisions brought by the forthcoming 5th European Anti-Money Laundering Directive, improving prudential rules applicable to crypto-asset investments and related activities by regulated entities could be considered, as well as measures regulating the provision of services at the interface between the real economy and crypto-assets and addressing consumer protection.

Strengthening the regulatory treatment of crypto-assets related risks is indeed a necessary condition to the broader dissemination of their underlying technologies, in order to support productivity gains and improve the functioning the financial system, for the benefit of the economy. ●

José Manuel González-Páramo

Member of the Board of Directors, Chief Officer, Global Economics, Regulation & Public Affairs, Banco Bilbao Vizcaya Argentaria (BBVA)

Blockchain applications vs. crypto-assets: different risk and regulation

The disruptive force of blockchain in the financial industry has focused primarily on crypto protocols as the underlying technology for building applications or redesigning processes compared to crypto-assets.

The industry is mostly following two big lines of development for blockchain-based applications. One of them is related to transformation of already existing processes as a way to improve efficiency, especially in those that are currently slow and entail multiple interactions. These cases are being usually built on private blockchains in a collaborative environment with other players in several initiatives such as R3 or Enterprise Ethereum Alliance. Some applications in this space are cross-border payments, post-trading settlement, trade finance, syndicated loans, etc.

The second line is focused on decentralization of markets and tokenization of assets. This is indeed a promising field to be explored but, as of today, crypto-assets themselves do not provide clear benefits to end-users. They are are mostly speculative products with extreme price volatility. Some crypto-tokens are created with the purpose of becoming an alternative digital currency, but so far none of them are able address in a satisfactory manner any of the three functions of money: means of payment, unit of account and store of value. Finally, so-called utility tokens, which grant certain rights to their holders, still have very limited real-world applications for financial institutions. Only certain crypto-tokens could have interest as a funding mechanism for new ventures in the form of investment coin offerings, or ICOs, but even among these there is a high level of fraud and deception.

"It is important to separate challenges and opportunities associated to private blockchain applications from those related to crypto-assets."

- JOSÉ MANUEL GONZÁLEZ-PÁRAMO

It is important to separate challenges and opportunities associated to private blockchain applications from those related to crypto-assets. The benefits offered by the first ones are huge in terms of transparency, traceability and efficiency of current processes. Conversely, doubts about the usage of crypto-assets, the lack of consumer protection protocols and AML risks, among others, are raising more questions than certainties. It is welcomed the work done by public authorities monitoring and drawing attention to the implications and vulnerabilities of the developments in crypto-asset markets, particularly warning consumers on their risks.

The introduction of digital innovations and, in particular, blockchain-based applications benefits the whole financial system. It improves the quality and variety of banking services, increase robustness, and improve allocative efficiency. However innovations do not arise in isolation; they require an appropriate environment to experiment them. Among all the deterrents to innovation, regulatory uncertainty is probably the most important one. Authorities are challenged to provide a new regulatory framework that balances the promotion of blockchain-based applications and protection against the associated risks under a neutral environment between newcomers and incumbents. ●

Harnessing the potential of fintech and digitalisation

Joachim Wuermeling

Member of the Executive Board, Deutsche Bundesbank

How to spearhead financial integration

For Europe to be economically successful in the future, two things are for sure: First, our European economy's global competitive-ness needs efficient funding. Second, we need more private cross-border risk sharing to support the euro area's stability. Against this background, European financial integration is a key requirement, reinforced by Brexit. Digitalisation can help us accomplish the task. To turn financial integration into reality, different forces are at work: politics, central banks and, above all, the market itself.

1. Political initiative: Capital Markets Union
The aim of the Capital Markets Union (CMU) project launched by the European Commission is to achieve a true single market for capital. Better integrated financial markets will facilitate cross-border investments and diversified corporate funding. The result is more support for economic growth and a better risk allocation. This would particularly benefit the euro area, where around 80% of a shock to GDP growth in a given country remains unsmoothed, affecting consumption. In the US, by comparison, with more private risk sharing across federal states, at most 40% of an economic slump is reflected in a fall in consumption growth. Therefore, strengthening cross-border private risk sharing would make euro area member states better able to absorb economic shocks.

2. The Eurosystem's contribution
Central banks have already built digital highways to more financial integration, namely TARGET2 (T2) and TARGET2 Securities (T2S). But the Eurosystem can contribute to even deeper integration and harmonisation. Three new projects have been set up. First, a project to technically consolidate T2 and T2S to increase efficiency, lower operating costs and improve cyber resilience. Second, as a result of the Eurosystem Collateral Management System (ECMS), monetary policy counterparties will benefit from a simpler and more efficient procedure for mobilising collateral across borders. Third, the TARGET Instant Payment Settlement Service (TIPS) project will ensure that instant payments can be settled immediately in secure central bank money as of November 2018. Moreo-ver, the Eurosystem has set up a task force to look at new FinTech initiatives and to explore potential use cases of Distributed Ledg-er Technology (DLT) in collateral management.

3. Market initiatives
The third and most important driver for financial integration is the market itself. The use of DLT can drive virtual value-added pro-cesses as well as digital products. >>>

>>> Virtual market places with new business models have already been launched, offering convenient and partly "one-stop solutions" for standardised products, such as savings and loans across countries. But initiatives to digitalise B2B-related products or to start business with 'new' asset classes digitally, too, such as high quality liquid assets, non-performing loans or bonded loans, can yield further benefits towards efficient cross-border funding and risk allocation. However, the potential of bringing together cross-border capital supply and demand by digitalising market places has certainly not been fully exploited as yet. We will certainly see even more business ideas. The markets will determine whether they succeed.

Outlook: Digitalisation poses new questions
More financial integration should be our objective – as politicians, as central bankers, as market participants. In this regard, digitali-sation is a facilitator.

But it can also be a game changer. Traditional market structures are breaking up, sectoral boundaries are shifting and new players, such as FinTech or Big Tech, are entering the stage. This raises new questions, especially to regulators. Do we need new rules or even a different approach to financial supervision if tech companies enter financial services? Can artificial intelligence offer efficien-cy gains, both on the regulator's and the market's side? How do we judge the importance of data security and data sovereignty when data sourcing and mining increasingly become the key economic objective?

Digitalisation fosters financial integration, but poses new questions. We need to answer them properly – and many other questions beyond our present horizon. ●

Ian Ormerod

Head of New Digital Business,
Banco Bilbao Vizcaya Argentaria (BBVA)

Opportunities and threats faced by EU FinTechs and financial institutions

In the last few years, one of the main ambitions of the EU has been the creation of a Digital Single Market (DSM), that is, a truly European market where the right conditions for innovation and growth exist and a better access to digital goods and services is granted.

Although EU economy and population is comparable in aggregated terms to that of US and China and major achievements such as the removal of roaming charges and the implementation of the Single Euro Payments Area have been made, more integration in the EU market is still needed, at least in 4 areas:

- Closing the gap in technology investment with US and China, that makes European Fintech companies more prone to be acquired by non-EU companies,
- avoiding national approaches to credit scoring, fraud identification or AML, among others so that European financial companies can launch universal solutions as US and Chinese companies,
- creating the conditions for the rise of EU champions that can compete with US and Chinese Bigtechs, companies that enjoy vast amounts of data of their large base of highly engaged users, and
- promoting the adoption and diffusion of essential technologies such as cloud computing or artificial intelligence, a field where specially the Chinese government is supporting Chinese companies.

"Trust is essential for the adoption of any technology."

- IAN ORMEROD

Cloud computing is basic for the creation of a Data Economy. It offers clear benefits such as cost efficiency, flexibility and scalability as well as eases the experimentation of new technologies that can be tested without having to make any disbursement in IT.

Artificial Intelligence is a technology that thanks to cloud computing no longer needs large investments in processing-power but that is more challenging to develop for European companies than for >>>

>>> their US or Chinese counterparts due to the requirements for gathering and processing data imposed by data protection regulations.

On the other hand, trust is essential for the adoption of any technology and regulation can have a positive effect on it. Indeed, the first European regulation on data protection, the GDPR, and all the EU measures on cybersecurity are helping to build trust and are growing the reputation of EU on this field.

Moreover, as long as Europe is taken as a reference in regulatory developments, as it is the case with the open banking regulations of Mexico and Japan or the GDPR-like requirements in Argentina and California data protection regulations, European Fintechs and Financial Institutions could leverage their expertise to enter those markets.

However, "regulatory advantages" could vanish if regulations imposed excessive compliance burdens on European companies or set conflicting requirements. Thus, if EU wants to have a prominent role or at least survive in this brave innovative world three lines or action are paramount:

- Reviewing, identifying and removing regulatory barriers to technology adoption in financial services and ensuring that any regulation is technology neutral and imposes the same requirements to any type of company offering services that pose same risks.
- Opening up data beyond just open banking and public data reuse is essential to improve both competition and the development of AI technology. In particular, data sharing obligations on platform business would reduce the current asymmetry in data access and the ability of platform owners to act as the gatekeepers of users' data would be reduced.
- Improving the ability of European companies to experiment with new technologies, raise funds and attract talent so that they enjoy a true level playing field with non- EU companies.

If all these issues are tackled properly, European financial institutions and Fintechs have the opportunity to evolve from trusted companies for securely keeping and handling money to companies with a considerable expertise in securing systems and information in which customers can entrust not only their financial assets but also their data. ●

Andreas Dombret

Member of the Executive Board, Deutsche Bundesbank (retired)

Digitalisation and fintech – not only a European way of integration

Financial technology stands for change as do EU financial markets nowadays. We are seeing change in every segment of banking and last but not least, European customers are affected by this change as well.

But although the impact of digitalisation is felt almost everywhere in the financial industry, we still do not know where it is leading us. But one thing seems quite clear: Digitalisation and new financial technologies can play a major role in further integrating EU financial markets and cross-border banking. Still, this dimension is a demanding environment for regulators and supervisors. Moreover, a variety of policy objectives are involved, such as maintaining a risk-adequate financial regulation, ensuring consumer protection and fostering innovation. In such an environment, maintaining both a general view and keeping abreast of the problems at hand is of key importance.

"Still, the digital age is likely to necessitate policy adjustments as the financial sector in Europe continues to evolve."

- ANDREAS DOMBRET

Still, the digital age is likely to necessitate policy adjustments as the financial sector in Europe continues to evolve. In that respect, an overall objective from a European point of view should be to avoid fragmentation of regulation from the start. Especially in a digital environment, where borders and long distances become less and less important, harmonisation of rules is an ongoing topic. This is an impediment to a prospering single market and the scaling of fintech. The EU needs to take a stand in favour of comparable business and innovation environments across member states. The EU Commission's Action Plan of this year addresses these concerns.

Regulating financial business in a digital era has become a topic that engages entire continents – and rightly so. Because, simply speaking, if you create a superior algorithm once, you can distribute it across the globe and scale its use at virtually no cost. And this is what is needed for fostering integration of European financial markets. But like good business ideas, there are various threats out there that may transgress borders all too easily. Therefore, we will benefit greatly from cross-border exchange in these matters.

But there are also aspects of digitalisation in the financial system we in Europe must care for: Consider, for example, the speed of transformation. In a digital world, it is likely to increase. For instance, customer fluctuation is expected to rise, as competitors are available at their fingertips. Worldwide rivalry is likely to increase through online competition. Time to market has become crucial for some business, which is again likely to influence product development. All of these dynamics may well feed into the risk landscape. There are numerous consequences that are worth pondering from a stability perspective –for instance, the threat of a rapid disruption of business models, or systemic operational risks. In that sense, in a European financial market, these are topics which must be carefully addressed. ●

Sébastien Raspiller

Assistant Secretary, Ministry of Economy and Finance, France

Harnessing the potential of digitalisation requires new regulatory approaches

Digitalisation has created a range of new services in recent years, which offer interesting opportunities for the deepening of the EU retail banking market and the capital market union (CMU). The decentralization and disintermediation implied by digitalisation are tremendous leverages to expand cross border access to financial services in the EU. Creating an effective single market lays in our ability to foster a more competitive environment, with the help of innovative players, but also to help building confidence in a cross-border digitalised market, while trimming infrastructures costs.

That said, what can be our contribution as regulators or supervisors? Reducing differences in legislation should be amongst the primary goals for us, when possible, in order to encourage cross-border activity. PSD2 has been remarkable in that regard and the challenge now lays in our ability to have all supervisors working consistently, but also to avoid open-banking fragmentation with too many APIs. Crowdfunding is another digital service which can play a significant role in deepening the EU single market for financial services by providing an alternative source of financing. The EU Fintech action plan is an interesting undertaking to identify fields of convergence, when possible and useful.

Our second goal should be to promote consumer protection, financial inclusion, but also cyber-security and data protection, to ensure collective trust in the EU single market for financial services. Digitalization implies the use of tools that not everyone is familiar or equipped with. Making the most of this opportunity means being able to take into account the specific needs of fragile customers, and to offer a protection at least as good as the one offered nationally. Cyber-security and data protection should be treated with utmost attention.

When asked which areas are likely to benefit from digitalization in the near future, saving accounts, payment accounts or mortgage credits usually come first to mind. Interest rates or fees applied to these products vary widely among EU Member States. In 2016, only 7% of consumers have purchased a financial service from another EU Member State, which leaves ample margins of progress, with business opportunities for firms as well as higher profits and reduced costs for consumers. The settlement of securities is another area where margins of improvement have been identified, especially as far as unlisted securities are concerned. We believe DLT will bring an interesting alternative to existing procedures – France allows DLT for such a purpose since 2017.

"Cyber-security and data protection should be treated with utmost attention."

- SÉBASTIEN RASPILLER

Beyond DLT itself, French authorities see ICOs as an opportunity for the financing of innovation. France has decided to offer more legal certainty to actors who are willing to comply with a proportionate set of rules, ensuring a better information and protection of investors. Regulating crypto-assets will be a major challenge in the coming years which we will have to embrace quickly, at the EU and international levels. France will gladly contribute to feeding this discussion. ●

Lauri Rosendahl

President, Nasdaq Nordic

Unleashing fintech potential by partnership

Fintech innovation is heralding a new tomorrow with huge opportunities for the broad economy. All parts of the financial ecosystem play a role: from retail investors and small tech start-ups, to big financial institutions, lawmakers and supervisors. As a market operator and technology company, we at Nasdaq are excited to be part of the fintech dialogue that is reimagining tomorrow.

From my personal Nordic perspective, it is obvious how digitalisation and fintech has since long had immense positive effects on the equity culture in especially Sweden. Online services for financial transactions, investment decisions and shareholder participation have developed fast and can now be easily done via mobile apps, for instance using Distributed Ledger Technology (DLT). The importance of investor empowerment cannot be underestimated.

One specific DLT case is the project on a blockchain-based solution for the Swedish fund market. Nasdaq, SEB (one of the largest Nordic banks) and other entities are cooperating to increase >>>

>>> efficiency in the processing of fund unit transactions and to create a single unit ledger – an area today largely characterized by manual routines and long settlement cycles.

Further, in June, Nasdaq together with EuroCCP, ABN Amro and Euroclear announced a joint project on making the use of securities when used to cover margin calls more efficient, by using blockchain technology. This solution addresses current challenges and inefficiencies in CCP clearing and has demonstrated that a shared, resilient network can be built.

Machine intelligence is also a promising technology. As an example, we have deployed machine learning across all of our Nordic market surveillance functions to assist in the ranking and scoring of trade alerts – essentially streamlining the surveillance process and helping our analysts in their decision-making. We have since commercialized this technology and now the Hong Kong Exchange is also live with this Nasdaq technology.

Further, Nasdaq continues to roll out the Nasdaq Financial Framework, which is our modular market technology architecture that provides next generation capital market capabilities. We are evolving our core services that already run at over 100 marketplaces globally into a new suite of business applications. We truly believe this new kind of architecture will be what markets are built on in the future.

The role of lawmakers and supervisors across Europe is extremely important when it comes to embracing new technologies. Facilitating innovation, enabling development of opportunities, as well as supporting risk analysis & management and providing regulatory clarity is well needed. Innovation may be driven by the private sector, but the public sector uptake and support is equally crucial in order for the whole financial ecosystem to develop and to stay competitive.

Measures such as regulatory sandboxes, harmonised supervisory approaches and ensuring technology neutral regulation, are very welcome steps. I encourage further global and EU cooperation.

I look forward to continuing our partnerships with market participants, issuers, regulators and other technology companies, and encourage even closer collaboration between all parties to support the creation of the financial ecosystem of tomorrow. ●

Mark Wetjen

Managing Director, Head of Global Public Policy, The Depository Trust & Clearing Corporation (DTCC)

Governance, standards and security: the essential mix for fintech success

Fintech innovations like distributed ledger technology (DLT), cloud computing, artificial intelligence (AI) and robotics will transform the global marketplace over time. In fact, we're already seeing the impact in certain pockets of the industry, from providing a better client experience to strengthening market infrastructure, increasing access to capital markets, realising efficiencies and reducing costs.

Currently, policymakers are pursuing various initiatives and collaborating with the industry to assess how fintech applications can fit into existing regulatory frameworks to support innovation while continuing to ensure that important policy objectives will be met. These objectives include systemic risk, investor protections, orderly financial markets as well as others.
In looking at the implementation of new technologies, the industry is increasingly realising that to ensure they can be leveraged harmoniously across borders, guidance and recommendations at both the international and EU level are essential, given that national solutions can fragment the market and lead to process inefficiencies.

In addition, the adoption of common global standards will be essential to realizing the vast potential of many new technologies. Looking specifically at DLT for example, a common set of standards across jurisdictions will be critical for successful deployment and to avoid fragmentation, inefficiency, and higher risks and costs.

Also, critical to the successful deployment of new technologies is a clear governance structure and best practice guidelines to prevent them from compromising end objectives. Industry-owned market infrastructures can play an important role in creating governance structures around future fintech applications.

EU policymakers should consider promoting an open source model where libraries of solutions are available to developers and innovators to create new products and services under specific licenses. Two examples that stand out are the Hyperledger Project and the Enterprise Ethereum Alliance – both of which are committed to the open source development of blockchains. Communities like these can help to maximise collaboration among industry participations and encourage and facilitate the adoption of global standards applicable to the technology.

Furthermore, due consideration must be given to the security of innovative technologies, particularly those developed by new entrants to the market, because these firms may not have the same level of operational controls as those of incumbents, who have operated in the financial industry and been subject to regulatory oversight for decades. The last thing we want is to increase cyber security and contagion risk in a highly interconnected marketplace. Therefore, it is imperative these firms ensure they can respond to and recover from cyber-attacks that may compromise their activities. Indeed, cross-industry coordination around response and recovery mechanisms is essential to mitigating the systemic consequences of such attacks.

Innovations in fintech have the potential to fundamentally change financial services. To realise it, the industry must make sure fintech is applied within an appropriate regulatory framework, according to standards and governance structures and encompassed by stringent cyber security measures. Failure to do so means we risk compromising the very objectives fintech set out to achieve – enhancing the provision of financial services, reducing risk, and, ultimately, promoting global economic growth. ●

Anneli Tuominen

Director General, Financial Supervisory Authority, Finland, Vice Chair, ESMA & Board Member, EBA BoS, EIOPA BoS, ESMA BoS and ECB SB

Cross-border digital retail financial services – a long road ahead

The European Commission's Fintech Action Plan is a good starting point for building up an appropriate framework for the cross-border development of fintech and digital financial services. However, it is just a starting point. The path ahead is long and will require cooperation and dialogue between several stakeholders, such as authorities, co-legislators, service providers, technical providers and standardisation bodies. Innovation should be encouraged, but not at the expense of consumer protection or operational risk management.

The development of cross-border digital retail financial services requires a framework consisting of several components to succeed. The most crucial prerequisites are enhanced digital capabilities and regulatory initiatives to support such development. Further clarity is also needed on the applicability of existing financial services legislation to innovative digital services.

There are still significant differences among Member States in terms of digital capabilities. This can be seen in the European Commission's DESI index; major efforts are needed if we want to narrow down this gap. The key building blocks for the development of retail digital services are good internet connectivity, citizens' digital skills and up-to-date devices for end-users.

Service providers and applications will have to earn end-users' trust. Due to e.g. linguistic and cultural reasons, retail clients are more likely to trust locally established service providers. The development of digital financial services is therefore likely to take place at a national level initially and only then spread across borders. Regulators should focus on removing obstacles to cross-border activities by e.g. supporting setting of standards for enhanced interoperability and facilitating online customer due diligence processes through electronic IDs. Regulators should also ensure that there are no national impediments that would restrict the free flow of digital services across borders.

"Service providers and applications will have to earn end-users' trust."

- ANNELI TUOMINEN

Consumer protection is essential in the building of trust. As supervision relies on home country supervision, the ESAs should be empowered to ensure that NCAs are up to their tasks and they should be able to tackle cases where the home country supervisor has not done enough to supervise its entities' behaviour abroad. Raising financial literacy is also an integral part of consumer protection which should start from the educational system. EU-level cooperation is needed for the sharing of information and best practices relating to financial literacy initiatives.

Trust should also be built through focusing on cyber resilience throughout the whole value chain. Digital financial services are reliant on data and IT systems. Systems and applications should be available without interruption. Firms should make every effort to ensure the robustness of IT systems and that contingency measures are in place. Cooperation is needed in sharing information on cyber risks and establishing best practices in tackling them. As cybersecurity is only as strong as its weakest link, end-users too must ensure that their devices are protected. ●

Birte Quitt

Head of Group Retail Strategy, Erste Group Bank AG

Cross-border financial services in Europe: potential and challenges

The real transformation in banking driven by digitalisation is only just at the beginning. Increasingly advanced abilities to access, analyze and apply data make it possible for consumers to gather information and make decisions about their money matters in a way that is far more immediate, transparent and personally tailored than ever before. Similarly, digitalisation allows financial services firms to provide that data and act on their clients' decisions with a speed, precision and reach that had not been possible previously.

"The speed and degree to which digital financial services continue to spread across Europe will hinge on one key factor: trust."

- BIRTE QUITT

The impact of digitalisation on financial services is apparent throughout the world, with many of the most cutting-edge advances being achieved in emerging economies. In addition to spreading new banking abilities to markets across the globe, digitalisation also makes it increasingly possible and >>>

>>> attractive to offer products and services across borders. The promise of cross-border banking is especially relevant within the European Union, where the Payment Services Directive explicitly seeks to create a more integrated and efficient European payments market. Together with SEPA, PSD2 is driving the development of cross-border offerings in the payment sector, with banks, fintechs and other third-party providers seeking to monetize the potential offered by addressing the payment needs of over 500 million Europeans.

In addition to payments, digitalisation is also promoting cross-border growth in other spheres of the financial services sector. While offerings for such comparatively big-ticket and complex products as mortgages are likely to retain their focus on local markets, simpler banking products such as some forms of consumer loans lend themselves for cross-border offerings, thanks to the advances that have been achieved in such key determinants as online authentication or KYC processing. Because clients everywhere value clear and actionable presentations of where they stand in their financial lives, convincing personal financial management solutions also find appreciative users across multiple geographies. Erste Group's deep presence in CEE, the high level of trust it enjoys among customers, and economies of scale have allowed it to capture both of these trends and successfully roll out George, its digital banking platform. Already over 2.6 million people across four CEE markets are using George as their digital banking assistant.

The cross-border trend in financial services is set to strengthen, but a number of challenges nevertheless remain in its path. The regulatory framework within which this development is taking place is generally quite standardized across Europe, particularly with regards to payments. However, some countries – especially in the CEE region -- are lagging in implementing the relevant standards into practice. Even within the EU, differing legal stipulations and practices continue to make it difficult to truly offer a uniform banking product or solution across multiple jurisdictions. To offer just one example: video legitimation of new-to-bank customers was possible in Germany years before becoming legal in Austria and it is still not authorized in many European markets.

Apart from the regulatory and legal barriers that still remain, the speed and degree to which digital financial services continue to spread across Europe will hinge on one key factor: trust. On this decisive point, banks should be able to draw on their proven track record of safeguarding the legitimate privacy interests that customers have for financial matters. Numerous surveys underline the fact that banks are by far the most trusted institution when it comes to managing personal data. Leaving aside the niche of early adopters that are the primary targets for fintechs, the overwhelming majority of the banking age public sees their personal information in safer hands with banks than with such challengers as payment providers, online retailers or social media firms. That fact should encourage banks to play to their strength as the guardians and stewards of their clients' data. ●

Andreas Ittner

Vice Governor, Financial Stability, Banking Supervision and Statistics, Oesterreichische Nationalbank

Hype or substance - Can technology support financial market integration?

The European project is currently at a crossroad. Political uncertainties and recurring nationalistic tendencies make our goal to increase the prosperity of the European people by a deeper integration of European markets even more challenging. Can new technologies and digitalization have a positive impact in integrating EU financial markets? Let us investigate some aspects that fall under this header.

Incumbent banks are currently investing heavily into new IT-systems to improve their efficiency and customer services. I am confident that these investments will pay off in the mid-term. However, modernising IT-systems alone will not be the magic bullet to drive market integration.

Having said that, we see some new developments and technological innovations currently implemented by Fintechs and incumbent banks that could facilitate further market integration in the medium-term:

- One of these areas is blockchain technology. It is still in its infancy and most applications are in an experimental stage. Still, it already shows potential, e.g. in trade finance, settlement or custody which promises more seamless integration of market participants and easier international trade.
- Another development is the new PSD2 (Payment Service Directive 2), which will facilitate new payment-services across European borders. Moreover, real time payment systems such as TIPS or potentially alternative private solutions might ease cash management and international trade.
- A further area is digital identification for streamlining KYC processes. The Nordic countries serve here as a lighthouse example of transnational cooperation.
- Also Initial Coin Offerings (ICOs) could have the mid-term potential to complement the Capital Market Union, as they make it easier for firms to address an international investor base.

"To nurture financial innovation in Europe, we must provide a level playing field."

- ANDREAS ITTNER

There are several other examples, but the most extreme and potentially disruptive would be the entry of one of the big internet incumbents. While a successful big scale market entry would certainly further integrate the European banking market, it remains uncertain to what extent and when such a market entry will happen. Still, EU banks would be well advised to prepare for such a scenario. >>>

>>> To nurture financial innovation in Europe, we must provide a level playing field. Harmonization across Europe is particularly important for innovation, since digital businesses typically need a huge market base. On our To Do list, we have first and beforehand the finalization of the Banking Union. For this, we still have to finalise the European Deposit Guarantee Scheme – provided that some necessary preconditions are satisfied beforehand. Beyond that, we need to harmonize our approach towards innovative technologies across Europe to strike the right balance between regulatory scrutiny and too restrictive constraints (think Sandboxes and Innovation Hubs). Finally, we need to make sure that cyber risks are adequately addressed as digital business models get ever more important.

The next years will shape the further path of the EU. While technology will likely not be the main driver of Financial market integration, it could contribute in selected niches. To nurture this potential, however, politics and regulation need to care for the apt environment. ●

Florence Lustman

Chief Finance and Public Affairs Officer, La Banque Postale

New entrants call on banks to question themselves

The digital revolution brings radical changes to our way of life, our consumption patterns, or our relationships with others. Power is in the hands of customers. Immediacy and easiness are becoming the minimum standards of service. This market and social disruption is experienced by all, by every company, and of course by the financial sector. Our customers expect more services offerings available on any device, more direct and customized services, smoother and more efficient processes but, above all, real time answers, as for every other area of their life.

"La Banque Postale does not consider FinTechs as a threat but as a digital transformation booster."

- FLORENCE LUSTMAN

Digitalization removes barriers to entry (technological as well as financial ones) and FinTechs use new technologies to offer innovative services on niche markets. They develop targeted services to capture a significant part of the value chain, such as payment services, loans services (for instance crowdfunding) but also more side services, like home surveillance systems or customer complaint management.

Banks have ambivalent relationships with FinTechs: they are competitors as well as a strong incentive to innovation, changing work mode and way of thinking.

FinTechs and traditional banks should be partners, complementing each other. FinTechs enable banks to propose agile, integrated and innovative products/services that can't be developed elsewhere and meet people new expectations.

La Banque Postale, as a young Bank set up in 2006, has a strong experience of partnerships. Its growth has deeply relied on joint ventures with business partners. Building partnerships is indeed the most efficient way to acquire expertise on new markets, like non-life insurance, or consumer loans. Today, La Banque Postale develops a similar approach with FinTechs.

Therefore, La Banque Postale does not consider FinTechs as a threat but as a digital transformation booster, offering innovative solutions on market segments, in a win/win agreement.

In this fast changing landscape, a new regulation develops over time. Regulator encourage the emergence of new technological solutions, while setting up the adequate regulatory framework. Banks point out the necessity of a fair level playing field for all actors, traditional and new entrants. Fair competitive conditions are essential to provide every actor with the same opportunities.

Digitalization and FinTechs could play a key role in further integrating EU financial markets and activities, provided that securitized framework be in place: La Banque Postale believes that every innovation should be analyzed from a security standpoint.

This should apply to all actors, not only financial ones. Since banking relationships are built on trust, operators have a duty to provide their customers with a secured environment for data. ●

Cătălin-Sorin Ivan

MEP, Committee on Economic and Monetary Affairs, European Parliament

The EU could overcome the challenges lying ahead

We are in the midst of a digital transformation of financial services that might offer new solutions to many existing challenges, and give European citizens greater opportunities, more transparency and lower prices. Although this transformation has many implications, I would like to underline its social aspects. Financial services could be widely >>>

>>> available and help in the fight against poverty, for example by offering banking for the unbanked and by accelerating financial inclusion. For all that, we still have a long way to go. By means of firm principles, clear goals, and cooperation, the EU could overcome challenges lying ahead such as fragmentation and lack of trust.

When we talk about FinTech, we think of innovation. FinTech companies are trying to make the financial markets and systems more efficient. The payment industry was among the first to be disrupted and it could be a catalyzer for further integrating EU financial markets.

When we think of innovation, we talk about regulation. The digital transformation meant a new experience for industry, consumers, as well as a new challenge for regulators. This type of financial services should be available across the EU by encouraging convergence and harmonization of regulatory approaches that should be principle-based. There is a need for a true 'passporting' regime in which financial services should be available throughout the EU. Moreover, the EU should try to identify the best practices by having common guidelines for regulatory sandboxes or innovation hubs. Every day, we see start-ups and big companies coming with innovative ideas, and sandboxes offer a safe place for testing and experimentation.

We have to think of potential risks and how to address them. A focus on cybersecurity, a high level of consumer protection, and transparency are key issues in the development of a single market in financial services. Protecting vulnerable customers should be one of the main priorities of all proposals. New tools should be easy to use in order to improve access to financial services for everyone, no matter the condition and age. Financial and digital literacy programs in the EU should be encouraged. We should see technological solutions being developed, providing consumers with guidance on accessing financial services.

The proposals advanced by the Commission this year, including the FinTech action plan and the crowdfunding regulation, are a good step in the right direction. Among many others, cybersecurity is at the forefront, and there is also a focus on the development of best practices on sandboxes, the establishment of EU Blockchain Observatory and Forum. This is just the beginning since there are other issues that shall be addressed in the near future.

Overall, we should be optimistic about the future of the financial industry. The European Commission is working on its proposals. The European Parliament tries to be as involved as possible. The anticipation of new developments, linked to the principle-based regulation in an evolving technology environment, is the way forward. We should envisage Europe capable of competing with the US and Asia. Despite that fact that Europe missed the start, it is now steadily catching up. ●

NEXT EUROFI EVENTS

3, 4 & 5 April 2019
Bucharest - **Romania**

11, 12 & 13 September 2019
Helsinki - **Finland**

April 2020
Zagreb - **Croatia**

Disruption in EU retail payments

Madis Müller

Deputy Governor, Eesti Pank

Instant payments and open banking increase competition and cooperation

Technological advances and the broad availability of mobile digital communication channels have changed customer behaviour and expectations for payment solutions a great deal. The basic need to send and receive funds safely has evolved through the ongoing digital transformation of our lives. Today, the demand is for instant and secure payments that at the same time are wrapped into digital and mobile solutions that provide a seamless user experience. Meeting such expectations in a short timeframe can be a challenge for many incumbent banks, and so new digital payment service providers and Fintech firms have aimed to fill this gap. This has fuelled innovation in the European retail payments market, through both competition and cooperation with incumbents.

Implementing SEPA instant payments as the new norm and making it available through mobile banking will help banks compete with the new, innovative solutions of non-banks. Reliable payment solutions that function well are becoming hygiene factors that are necessary for customers' loyalty to be retained. Customers do not want to think or worry about the time it takes to transfer funds between payment accounts. They increasingly expect transferring money to resemble messaging a friend on their phone in its speed and convenience. It is easy for them to try out new payment solutions or even to switch payment service provider completely. As payment transactions provide insight into the customer, the new provider could complement its value proposition with other retail banking services, such as personal loans, car leases or mortgages. Consequently, this may affect the revenues of incumbents beyond the mere provision of payment services.

It should be recognised when speaking of convenient payments that the customer experience is made of more than just an immediate transfer of funds. Strong customer authentication and one-click instant payments are part of it, but digital transformation of the pre and post-payment processes are additional opportunities that could be worth considering as well. The banking industry is currently looking into making e-invoice presentment and payment, and other in-store request-to-pay solutions work at the pan-European level. The introduction of e-receipts would be a natural next step that we need to pay attention to. The question all providers of payment services should be asking is how to combine all these different endeavours into one seamless user experience.

Open banking increases competition and cooperation at the same time, as both incumbent banks and new PSPs want to provide added value for their customers. Standardised API-based (Application Programming Interface) connections

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>>> between account servicing banks and third-party payment service providers promise to make open banking happen. Banks in Europe are obliged to allow third party PSPs to use their online banking infrastructure to provide payment initiation and account information services. This can be seen as a threat to revenues, but also as an opportunity to cooperate. Banks have the option of outsourcing the provision of innovative payment solutions to Fintech-based newcomers so that they themselves could focus on delivering other retail banking services, thereby creating more value for their customers.

So the future promises to be even more integrated, as end-users could choose the most suitable financial services from anywhere in the Digital Single Market through one-stop-apps or platforms. API-based connections, if implemented on common standards, will facilitate such new digital platform-based marketplaces for retail payment solutions and for other financial services. ●

Laureen Seeger

Executive Vice President and General Counsel, American Express

Disruption in EU retail payments: how smart regulation can enable opportunities

Digitalization has transformed retail financial services over the last two decades. Consumers have seen the way they can interact with their finances move from branch, to online and now to mobile. And yet, so much has remained the same. Consumers tend to stay with the same institutions with whom they have always banked, and their data remains largely siloed within those institutions.

Not for much longer. In the era of "open banking", real change is in the air. Traditional players and, critically, regulators need to gear up for the revolution that's coming.

The revised Payment Services Directive ('PSD2'), which came into effect in January of this year, requires banks to open their systems to allow third parties to access data and transaction history. But success isn't guaranteed: consumers have to trust that their data isn't being misused, and genuine needs have to be met. Established players will need to collaborate with new entrants, and regulators will need to play a key role to enable this to happen in the most seamless and efficient way.

It's all a bit of a worry for some traditional players, who see this new world of 'open banking' ushering in significant disruption. Third parties will offer new products and services in the more profitable areas of retail payments, but won't have to carry the cost of the infrastructure or legacy systems. Banks also fear losing elements of their direct relationship with the consumer, becoming providers of basic current accounts where consumers pick and choose the third party solutions that they want to 'plug-in.'

This is why we believe financial institutions should not fear, but embrace the possibilities offered by this disruption. Most significantly, established institutions have trusted reputations, with security built into their DNA, which can provide real confidence for consumers who are taking their first steps into open banking. Those long-standing relationships with consumers will also allow established players to collaborate with new entrants, providing them with opportunities to scale up.

EU regulators can play a vital role in fostering this collaboration, by designing a legislative framework that is technologically neutral, and in so doing leveraging the agility and flexibility of new entrants. That in turn will allow incumbents to focus on what they know best: building trust with customers, managing risk and providing scalability. Regulators can also play an important role in facilitating dialogue between all stakeholders. The Euro Retail Payments Board, for instance, is a good example of bringing supply and demand side stakeholders together around the table. Forums such as these that focus specifically on open banking regulation will go a long way toward consolidating mutual trust, clarifying and aligning the rules of the game, and helping to protect and promote incentives for different players to work together.

Disruption is coming, but we all have an interest in ensuring the revolution succeeds. Collaboration across the whole ecosystem, fostered and nurtured by regulation and regulators, is an essential pre-requisite to ensure consumers' needs are truly met. ●

Massimiliano Alvisini

Senior Vice President & General Manager, Europe and CIS, Western Union

It is time for the EU's coming of age on anti-money laundering

Fighting financial crime is rightly one of the European Union's key policy initiatives in the area of financial services.

Over the last decades the EU has adopted no less than five Anti-Money Laundering Directives. This is complemented with numerous initiatives on cash control, terrorism financing and the prevention of payment fraud. Despite all of this the European Commission is, we understand, exploring further action at European level even before this legislative term is over.

There are invariably many reasons for these legislative initiatives. Financial services, technology and criminal activity evolve, as do the means for tracking and fighting financial crime. At Western Union more than 2500 of our colleagues are directly and indirectly involved in anti-money laundering activities. That is over 20% percent of our total workforce. Fighting financial crime is a very significant element of our cost base. Each new rule adds costs to doing business - at a time when the payments industry is under continued pressure to reduce its fees.

Does this mean we should compromise on AML requirements? Of course the answer is no. Nonetheless the raft of legislation in this area suggests that the current rules are not as effective and efficient as they could possibly be.

I would argue the answer does not lie in introducing yet new rules but to focus on how Europe is enforcing them. The key to success rests in better and importantly more consistent enforcement.

The European AML Directives are a minimum harmonisation framework. Each Member State can add-on requirements and can impose different reporting requirements. This not only requires companies to de facto comply with 28 regimes in the EU but it also hampers the cross-border cooperation between European law enforcement agencies.

"The EU must now move towards a maximum harmonisation regime for AML."

- MASSIMILIANO ALVISINI

The current patchwork of national rules fragments the Single Market and disincentivises investment in Europe-wide AML technologies. It prevents authorities from having comprehensive access to the universe of suspicious transaction reporting the financial services industry already produces on a daily basis.

The solution is simple though ambitious. The EU must now move towards a maximum harmonisation regime for AML. This should be accompanied by common reporting templates and effective cooperation arrangements between law enforcement agencies.

Industry is fully supportive of effective anti-money laundering. It is now up to the EU and Member States to make it happen and deliver on its promise for true European action. ●

Marc Bayle de Jessé

Director General, Market Infrastructure and Payments, European Central Bank (ECB)

TIPS: ushering in the future of payments

Today, the way payments are made around the world is changing dramatically and will affect the way individuals and businesses interact for many years to come. Instant payments lie at the heart of this shift, which has largely been brought about by the widespread use of smartphone technology and the increasing digitalisation of services. While heightened demand for real-time payments is affecting various domestic markets, the Eurosystem remains focused on working towards broader integration and addressing emerging needs at the European level.

"TIPS offers the banking industry a unique opportunity to gain access to a future proof infrastructure for instant payments that is competitive and efficient."

- MARC BAYLE DE JESSÉ

In this vein, the Eurosystem will launch the TARGET Instant Payment Settlement (TIPS) service, which will offer settlement of instant payments in central bank money from 30 November 2018. Supported by the Eurosystem's

solid infrastructure, TIPS will help ensure that credit risk is eliminated for all parties involved. >>>

>>> TIPS will adhere to the latest ISO 20022 messaging standards and the pan-European SEPA Instant Credit Transfer (SCT Inst) scheme. With fewer processing steps and a sophisticated settlement engine in place, TIPS will enable funds to be received and transferred in a few seconds and around the clock, 365 days a year. Payments will be irrevocable and processed individually, linking payer and payee directly. This means both parties can be certain about the status of a transaction within a few seconds of it being made.

The service has a flexible structure and can accommodate multiple currencies, which will help it to establish a broad network of participants. Designed as an extension to the TARGET2 real-time gross settlement system, TIPS has a consolidated liquidity management feature that will optimise participants' liquidity. This feature will be available for all transactions made in euro using TARGET Services.

The new service is both easy to access and attractively priced; TARGET2 account holders won't need to pay any entry or maintenance fees for TIPS. Each payment sent will be set at a price of 0.2 euro cents for at least the first two years of operation.

TIPS offers the banking industry a unique opportunity to gain access to a future proof infrastructure for instant payments that is competitive and efficient. Banks should capitalise on this momentum and connect directly to TIPS. By doing so, they will be in the best possible position to provide their customers – be they large companies, small and medium-sized enterprises or consumers – with instant payment solutions that are supported by a reliable and comprehensive service.

As a promoter of European financial integration, I hope that TIPS can help ensure that Europe's single payments area will benefit from innovative instant payment solutions that have a pan-European reach. The ECB is committed to forging ahead by introducing consolidated services that are safe, high-quality and low-cost. ●

Livio Tornetta

Deputy Director General for Markers and Payment System, Banca d'Italia

Two case studies on the impact of PSD2 and IFR on retail payment services in Italy

The main objectives of IFR are to reduce market fragmentation, enhance transparency and promote the use of payment cards by increasing competition and reducing costs. Banca d'Italia colleagues made an empirical assessment of the impact of the IFR in Italy on the acquiring side using a panel of Italian banks (www.bancaditalia.it/pubblicazioni/qef/2018-0434/QEF_434_18.pdf).

The econometric analysis is focused on two specific policy questions: 1) did the cap on interchange fees result in lower merchant fees? 2) Is there a positive impact on card acceptance at the point of sale? They find that between 2015 and 2017, interchange fees dropped by 37 per cent while merchant fees, which include the acquirer's margin, dropped by 22 per cent. This led to an increase in merchant acceptance (the number of card transactions per POS terminal) of approximately 8 to 11 per cent, and explained 30 to 40 per cent of the increase in merchant acceptance observed between 2015 and 2017. In sum, in line with the regulatory intent, the ceiling imposed on interchange fees has led to a sizeable drop in merchant fees and to an increase in the acceptance of card payments.

In order to facilitate the development of an "open" banking business environment, PSD2 recognizes a new category of payment services based on the access of third party providers (TPPs) to users' bank accounts. PSD2 also requires banks to set up dedicated interfaces in order to communicate with TPPs. Each European bank is free to implement its own interface with different technical standards, but also with the risk of a costly migration process. As a result, some cooperative initiatives have been started, in order to exploit possible scale and scope economies. In Italy, the most relevant initiative is the "Consorzio CBI", a service consortium under the aegis of ABI (Italian Banking Association). This Consortium is developing a common infrastructure to allow adhering banks – both domestic and foreign - to communicate with TPPs through a single "gateway" where shared services will be centralized. The Consortium estimated that a common solution can produce savings of up to 40% compared to the total investment required by individual banks. Positive returns are estimated also for TPPs, through the reduction of the burden in accessing the Italian user payment accounts domain. A common solution can also reduce the supervisory effort necessary by National Competent Authorities in their task to evaluate and monitor the interface adopted by banks, to ask for recovery solutions and to solve possible disputes between TPPs and banks.

"A sound development of the open banking environment is a challenge for financial authorities..."

- LIVIO TORNETTA

In conclusion, a sound development of the open banking environment is a challenge for financial authorities since the regulation gives them concrete responsibilities in terms of monitoring the compliance of payment service providers with the new security and functional requirements. These authorities will therefore have to strike a balance between various objectives: allow innovation, preserve the level playing field, protect final users and their trust on digital services. Due to strong market integration, these objectives cannot be achieved in isolation and require a harmonized supervisory approach at EU level. ●

Kim Laustsen

Chief Analyst, Regulatory Affairs, Nykredit

Open banking creates new opportunities – but also new challenges

Although the new Payment Service Directive (PSD2) forces European banks to open their systems to third parties which can retrieve data and conduct payments or other transactions on behalf of the banks' customers, many banks also voluntarily grant access to a number of external digital partners.

This so-called open banking means that, together with financial technology developers (FinTechs), banks can create new and innovative products and services to customers at a much faster pace than previously reflecting the growing demand for digital solutions in payment services or other products and services tailored customers' individual needs.

"Open banking is already a success."

- KIM LAUSTSEN

A challenge lies in providing functional and well-documented technical interfaces that do not jeopardize the protection of the customer data or the banks' cyber security in general. The latter must be core features of banks' operations. However once established, such customer-authorized secured access to the bank provides innovative FinTechs the ability to create solutions and value-added services beyond the banks' own solutions and data.

Another challenge lies in the limitations in the use of customer data that potentially prevent banks and FinTechs from developing new attractive solutions and services beneficial for the consumers and businesses. Often, differences in consumer protection regulation between jurisdictions makes it impossible to create cross-border solutions. In essence, all customer-authorized transfer of data should be allowed in order to ensure level playing field among different players in the market and enhance competition between different solutions.

Nevertheless, open banking is already a success. We have never seen such a flow of new and innovative partnership-driven services and products that we see now. Everything from investment robots to pocket money for children. But ultimately, it is up to consumers and businesses to choose the best solutions.

One thing is certain: the open approach to innovation and the understanding of the necessity and benefit of the open ecosystem has come to stay. Challenges with cyber security, data protection and cross-border level playing field, however, are also issues that need to be addressed continuously. ●

NEXT EUROFI EVENT

The Eurofi High Level Seminar 2019

3, 4 & 5 April

Seminar organised in association
with the incoming Romanian EU Council Presidency

Bucharest - **Romania**

Data privacy implications and challenges

Eva Kaili

MEP, Committee on Industry, Research and Energy, European Parliament

Privacy as a prerequisite and a catalyst for innovation

The EU, through its privacy reform, is trying to update the definition and the global standards of privacy and data protection during a turning point in tech.

Such an action has effects that transcend the EU territory, given the importance of European legislation globally, and especially as the EU plans to include privacy adequacy clauses in free trade and even development aid agreements. A global legal definition of data privacy creates a much needed balance as data privacy and data protection become exponentially important: in the era of companies that operate on a global scale, like Facebook, Google and Amazon, we need global definitions, regulations and standards so that we all enjoy the same respect of our rights and privacy.

However, privacy is a term that is used differently depending on cultural and ideological frameworks alike. As a result, nuances are created that focus on different aspects of privacy and prioritize differently, at times favoring innovation and entrepreneurship or privacy. That poses restraints in creating legal frameworks that are interoperable and establish a legal continuity regardless of geography, without creating political friction. The example of the US-EU agreements (Safe Harbour, Privacy Shield) are quite typical and showcase how cultural and ideological differences affect such relations. The situation worsens when addressing the developing world as the legal framework and societal understanding of privacy is different. That is a significant barrier to internet services (incumbents, big tech or startups) that aim to reach a global audience and for citizens that lack serious protection.

The EU has been pushing the global standards for privacy for the last decades, even before the GDPR, and continues to do so, even more effectively than before. The most recent example, the trade agreement with Japan, covering one-third of the global economy, offers robust privacy protection, aligning the EU with the Japanese legal framework and allowing at the same time free flows of data between the two parties. On the other hand, one could claim that such strict privacy rules mean that fewer data sets are available and more administrative work is needed to obtain the necessary consent, resulting in hindering and stalling of scientific research, from the medical field and climate change to artificial intelligence development because of the EU's data protectionism.

Dismissing data privacy as an obstacle to innovation and science is a mistake. Obstacles to research are mitigated in the GDPR as specific articles allow for the processing of data >>>

>>> for scientific purposes, under certain circumstances without the explicit consent of the data subjects. At the same time, privacy laws allow for AI to be controlled, while creating efficient ways to use data, pushing data science innovation.

This global shift towards privacy reshapes the corporate map of the world creating the conditions for disruption by the next big thing. While it is a burden to comply with stricter privacy provisions, companies that view this new era of data privacy and protection as an opportunity to deepen digital trust, rather than a burden, will position themselves for a larger share of data, value and continued loyalty from their customers.

At the same time, lawmakers are focusing their attention at the smaller players, like SMEs and startups, so that they facilitate compliance and provide with the necessary incentives for companies to be immersed into the digital sector.

Concluding, the consensus that privacy is a key aspect of our digital presence makes clear that privacy is and will be a prerequisite and a catalyst for innovation. The legal community has been leaning towards that direction for years and GDPR formalized that privacy is the new default for Europe with the whole world. ●

Erlend Engh Brekke

Corporate Responsibility
& Public Affairs Advisor, DNB

Retaining customer loyalty in an age of data portability

The ability of financial institutions to deliver phenomenal user experiences while respecting our customers' privacy will determine whether we earn and retain their trust – and their business.

The industrial revolution left us with a surplus of carbon dioxide that poses a generational threat to our societies. In a similar way, the ICT revolution risks leaving us with a surplus of data which may threaten basic tenents of modern society like the expectation of privacy.

Since the invention of banking, banks have been trusted with some of their customers' most sensitive data, and have developed sophisticated mechanisms for doing so. What we have not always been terribly good at, is utilizing the data we sit on to deliver tailored, personalized services to our customers. A bank might, for instance, market an insurance product to a customer who has already bought it, or offer a petrol discount to credit card users wouldn't even think of owning a car.

New competitors are forcing banks to step up their customer-insight game. With major tech platforms and fintech startups alike entering the market with data-driven business models, customers' expectations change. If Facebook, Amazon and Netflix can offer customized newsfeeds and recommendations that are unique to each customer, why shouldn't banks? Our customers will increasingly expect us not only to draw on our knowledge of them to offer more relevant, tailored experiences, but also to help them to leverage their data to their own benefit.

As Big Tech enters the financial services market, will customers vote with their feet and turn to Silicon Valley for their banking needs? GDPR and PSD2 in hand, are customers ready to take their business elsewhere?

That is certainly not what they are telling us. DNB's own surveys show some 78 percent believe they will still get their banking services from a bank in five years. A full 53 percent of Norwegians claim they "will never" change their existing banking habits. And it is not just Norwegians: A 2017 study by Accenture found 69 percent of UK customers are reluctant to share financial data with third parties.

"If customers can't trust us with their data, why should they trust with their money? "

- ERLEND ENGH BREKKE

A survey by the Norwegian data protection supervisor of people's trust in financial institutions and tech companies respectively, points in the same direction: A full 79 percent would not be interested in "financial services from Google or Facebook". Some 87 percent would consider sharing their banking data with Google or Facebook "problematic". >>>

>>> Perhaps tellingly, five percent of those would choose to do so nevertheless.

Financial institutions have one important comparative advantage over the new guys: for the time being, our customers trust us more than they do the platform companies.

In a world where customers are increasingly sophisticated in their understanding of the value of their own data, and with the Oxford Analytica scandal having illustrated the risks of being nonchalant about privacy, an important challenge for banks becomes: How can financial institutions move closer do data-driven business models without loosing their "trust lead" over tech firms? After all, if customers can't trust us with their data, why should they trust us with their money? ●

Joe Cassidy

Partner, KPMG in the UK

If data is the new oil, it's just as dirty

Data is the new oil, we are now told almost constantly – a priceless source of actionable insight that will propel businesses into a new growth paradigm. Well, that may be so, but as the oil industry discovered long ago (think environmental damage and health and safety), your greatest asset can also be your greatest liability. Any organisation that did not previously recognise the dangers lurking in their data management must surely do so now. The European Union's General Data Protection Regulation (GDPR), which came into effect on 25 May, has crystallised the risks for all to see.

Those risks carry clear and quantifiable costs. There is the significant cost of complying with GDPR; there is the increasing cost of running the organisation's data estate, spanning collection, storage, processing and management; and there are the huge costs of non-compliance, with potential fines for GDPR failures of up to 4% of annual global revenues. The £500,000 fine imposed on Facebook for data failures relating to the Cambridge Analytica affair, imposed under the pre-GDPR regime, looks small change by comparison.

Even for a modestly sized financial services business, the cost of GDPR compliance could be as high as $100m. For a large and global player, the cost of putting their house in order will have topped $250m. Such costs have been a wake-up call. GDPR is prompting financial services organisations to look beyond the hype around data, tempering their excitement about the potential for analytics technologies with a realism about the difficulties of privacy and transparency.

"Risks carry clear and quantifiable costs."

- JOE CASSIDY

Finding the balance will now require businesses to think again about their data activities. For example, organisations are beginning to sift through their data with a view to identifying much more clearly where the greatest value lies. They are thinking harder about which data should be retained and which should now be decommissioned, either through deletion or anonymisation. And they are focusing anew on the data that financial services regulators insist they maintain.

This is a work in progress. The reality of GDPR is that only a tiny handful of organisations were fully compliant in advance of the 25 May deadline. For the rest, the process of compliance is continuing, in tandem with the broader effort to understand how they should proceed in the new regime.

Moreover, the views of the industry will evolve as GDPR beds in. The first large fine under the new rules – a high profile case is inevitable sooner or later – will concentrate minds. The number of subject access requests that organisations receive will also influence thinking.

Nevertheless, it is important to recognise that GDPR is a watershed moment – for all businesses, but particularly in the financial services sector, where the promises made for the value of data have been so extravagant. If data really is the new oil, extracting and processing it looks to be just as dirty and dangerous as with the black stuff itself. ●

Charlotte Paterson

Head of Regulatory Risk Management EMEA, Swiss Re

Preventing misguided regulatory restrictions on data use – GDPR and beyond

The EU's General Data Protection Regulation (GDPR) became applicable on 25 May 2018 introducing far reaching requirements in respect of the processing of personal data of EU residents. It provides a world leading framework for data protection and several multinational companies are adopting GDPR standards across their worldwide operations. >>>

>>> Whilst one of the key objectives of the GDPR is the harmonisation of data protection within the EU, the existence of "flexibility clauses" leaves scope for Member States to adopt different approaches. This creates the risk of fragmentation which presents a real challenge for multinational companies. One example relates to insurers' processing of sensitive data without consent – in a complex value chain it is difficult to obtain fully informed, specific and freely given consent from consumers. Some Member States have recognized the importance of this in the fulfillment of insurance contracts and regulated nationally to allow it. However, others are yet to do so creating uncertainty.

GDPR also raises other sector-specific challenges. The application of concepts such as "legitimate interest" will require (re)insurers to carefully evaluate whether someone could reasonably expect, at the time and in the context of the collection of their personal data, that processing for that specific purpose may take place. GDPR should not de facto prohibit the use of certain data sources for example in product development provided appropriate measures are taken to protect personal data and respect privacy rights. Such narrow interpretations may limit opportunities for consumers and society to benefit from new technologies.

"GDPR should not de facto prohibit the use of certain data sources."

- CHARLOTTE PATERSON

Given the emerging fragmented regulatory landscape and lack of clarity with regards to the GDPR's application, the new European Data Protection Board (EDPB) will need to play a crucial role in providing guidance and ensuring a consistent approach. For example, with regards to reinsurance, the EDPB's confirmation that the reinsurer and its reinsured should be treated as separate controllers would assist all parties in being accountable for their processing operations and give more clarity to consumers regarding who is responsible for protecting their personal data. The EDPB is best placed to provide such clarifications as the experts in data protection legislation and those with the best overview across sectors.

In the era of an increased use of Big Data and Artificial Intelligence (AI), it is reasonable that the European Supervisory Authorities (ESAs) try to understand how (re)insurers use data and examine the potential risks this poses to consumer protection and financial stability. (Re) insurers must be transparent and explain what data are used, how and why, as well as how that data are protected. This will help to give consumers confidence in the benefits of data use and build and maintain trust that data is managed responsibly with clear accountability for any breach of privacy.

Careful consideration of the balance between data access and privacy will be vital for the provision of effective new products by (re)insurers. Big Data and AI have tremendous potential to improve the affordability and access to (re)insurance, and regulation should facilitate this process so that society can reap the benefits. ●

Cyber-resilience priorities

Marc Bayle de Jessé

Director General, Market Infrastructure and Payments, European Central Bank (ECB)

Market infrastructure in the cyber era

Financial market infrastructures (FMIs) are constantly being modernised in an effort to both anticipate and meet market needs. The financial sector has been able to keep up with developments in technology by embracing digitalisation, but this has also exposed entities to greater cyber risks. The number of cyber incidents has increased in recent years and they have also become more sophisticated, leaving the door open for disruptions to the broader economy.

The European Central Bank (ECB) and the international community are committed to addressing these challenges head-on. In June 2016 the Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO) published the CPMI-IOSCO Guidance on cyber resilience for FMIs. The Guidance sets out measures that FMIs should take to anticipate, withstand, contain and rapidly recover from cyberattacks.

One year later, the ECB introduced the Eurosystem's cyber resilience strategy for FMIs to ensure that the CPMI-IOSCO Guidance would be implemented consistently across Europe. The strategy is based on three pillars: FMI readiness, sector resilience and regulator-industry engagement. Since 2017 the ECB has been using this strategy as a springboard to develop various tools aimed at enhancing the cyber resilience of FMIs.

First, a cyber survey of European FMIs was carried out to help overseers assess the level of cyber resilience of the FMIs under their watch. Furthermore, the Cyber Resilience Oversight Expectations (CROE) were developed to provide FMIs with detailed steps on how to implement the CPMI-IOSCO Guidance. The ECB then developed a European Framework for Threat Intelligence-based Ethical Red Teaming (TIBER-EU). TIBER-EU enables financial entities to conduct the highest level of red-team testing across more than one jurisdiction. The framework can be applied to many different types of entity and is specifically designed to be applied across borders, with a view to harmonising processes across the European Union and internationally.

The Eurosystem's cyber resilience strategy is based on information-sharing and collaboration between FMIs and relevant authorities. In that vein, Eurosystem overseers carry out sector mapping and market-wide simulations to gain a better understanding of the operational interdependencies that make up the financial >>>

>>> ecosystem. In June 2018 the Eurosystem carried out the UNITAS crisis communication exercise, which was based on a cyber incident related to data integrity issues. Participants included representatives from large-value and retail payment systems, central securities depositories and critical service providers.

Identifying common cyber challenges and initiating joint initiatives with financial infrastructures and other authorities is crucial to the ECB. In March 2018 ECB Executive Board member Benoît Cœuré chaired the first meeting of the the Euro Cyber Resilience Board for pan-European Financial Infrastructures, a public-private forum which will help to raise awareness about cyber resilience issues and foster a spirit of cooperation among stakeholders.

The Eurosystem has taken these steps under its oversight mandate. At the same time, it has been strengthening the cyber resilience of market infrastructures in its role as an operator by expanding security operations centres and intensifying activities to test the security of its TARGET Services.

As digital innovation continues to direct the financial sector towards a new cyber era, the Eurosystem will continue to focus on cyber resilience. But in the long term, if the integrity of the financial sector is to be preserved as systems become increasingly interconnected, the people who run those systems will need to work much more closely together. ●

Morten Linnemann Bech

Head of Secretariat, Committee on Payments and Market Infrastructures, Bank for International Settlements (BIS)

Cyber-resilience: priorities for Financial Market Infrastructures at the global level

Wholesale payment systems are critical to the smooth functioning of the financial system. They handle payments worth trillions of euros on a daily basis, and disruptions can have system-wide implications. Central banks have a special interest in this ecosystem, not only as owners and operators but also as overseers and users. For example, central banks rely on these systems to implement monetary policy.

Unfortunately, nefarious individuals have discovered the systemic importance of wholesale payment systems and the large money flows they handle. They are increasingly targeting this ecosystem, and their methods are becoming alarmingly ever more sophisticated. The 2016 heist at Bangladesh's central bank is a case in point. Weak cyber-security allowed hackers to transmit fraudulent SWIFT messages and divert $81 million from the bank's account with the New York Fed. Only a combination of diligence, luck and identification of spelling errors allegedly prevented a further loss of up to $1 billion.[1] More recently, criminals have targeted the wholesale systems in Chile and Mexico.[2]

As an international standard setter that promotes the safety and efficiency of payment, clearing and settlement arrangements, the Committee on Payments and Market Infrastructure (CPMI) continues to play an active role in improving cyber-security on two fronts: protecting the core of the ecosystem and securing its periphery.

To protect the core, the CPMI is – together with the International Organization of Securities Commissions (IOSCO) – pushing for broad adoption of our joint Guidance on cyber resilience for financial market infrastructures (FMI)[3]. As the first internationally agreed guidance on cyber-security for the financial industry, the Cyber Guidance complements industry efforts to improve FMIs' ability to pre-empt cyber-attacks, respond rapidly and effectively to them, and achieve fast and safe recovery following an attack.

To secure the periphery, the CPMI recently published a strategy for Reducing the risk of wholesale payments fraud[4] related to endpoint security. The strategy seeks to encourage industry-wide efforts to reduce the risk of wholesale payments fraud. It is designed >>>

>>> to address all areas relevant to preventing, detecting, responding to and communicating about fraud. The CPMI and its members are committed to acting as a catalyst for effective and coherent operationalisation of the strategy within and across jurisdictions and systems. As the CPMI Chair recently said: "[W]e should see the global payment system for what it really is: an essential global public good whose integrity is increasingly being challenged by malicious cyber-attacks and fraud attempts."[5]

The CPMI will monitor progress throughout 2018 and 2019 to determine the need for further action. ●

1. See Joshua Hammer, "The billion dollar bank job", New York Times Magazine, 3 May 2018.
2. See Bloomberg, "Mexico says possible bank hack led to large cash withdrawals", 13 May 2018; and Reuters, "Bank of Chile trading down after hackers rob millions in cyberattack", 11 June 2018.
3. https://www.bis.org/cpmi/publ/d146.htm
4. https://www.bis.org/cpmi/publ/d178.htm
5. Benoît Cœuré, Member of the Executive Board of the ECB, speech, 26 June 2018.

Daniel Barriuso

Global Chief Information Security Officer, Grupo Santander

Key areas to improve global cyber resilience

One of the key priorites of Santander and of the financial industry in general is on improving cyber resilience – understood as a business's ability to identify, prevent, detect and respond to process or technology failures and recover, minimizing customer harm, reputational damage and financial loss.

Cyberattacks can affect institutions, systems and infrastructures in different jurisdictions. Therefore, we support a holistic approach to cyber resilience based on international cooperation with the aim of promoting harmonization. In our opinion, striving towards a global cyber jurisdiction is the best solution to regulatory fragmentation.

To advance towards this goal, and based on our experience as a global financial group, we think progress is needed in a number of relevant areas:

Firstly, regulatory fragmentation of cyber risks increases costs for all companies, in particular for international ones, such as Santander. We need a globally accepted risk-based, principles-based framework for cyber risks, that could be based on the NIST framework and the CPMI-IOSCO principles for financial infrastructures.

A specific feature of the financial industry is that cyber risk is different from financial risks, therefore our supervisors and regulators should apply proportionality in a way that maintains a level playing field for banks and Fintechs. The same activity posing the same risk should be subject to the same rules and requirements. Cybersecurity measures should not depend on the company's size or the complexity of their business model; all types of companies must commit to identify, protect, detect, respond and recover from cyberattacks.

Often the biggest threat comes from the weakest link in the chain, in this case, the financial systems ecosystem.

An important element of this global framework should be a coherent cyber threat testing framework for significant market participants and infrastructures, jointly developed with the industry, that would ensure a harmonized approach to penetration-testing and red teaming testing.

A second key area where progress is needed is information sharing. Here a crucial aspect is incident reporting, due to its mandatory nature and timeliness. In particular, harmonization of incident reporting requirements and processes would be highly beneficial to reduce complexity, increase agility and maximize value added.

We support the setup of one-stop-shop mechanisms that allow firms to report incidents only to one "home" or "leading" supervisor/authority, which will then coordinate with other relevant supervisors/authorities. In general, information sharing on cybersecurity with supervisors and authorities should be a two-way communication process: companies and institutions report incidents, but information also flows in the other direction, alerting companies to emerging issues, threats, or counter-threat measures as soon as possible.

Special attention should be payed to the promotion of incident-sharing networks among financial institutions and other critical operators or strategic industries, helping to address legal obstacles to information-sharing.

In summary, we support working at a global level to reduce as much as possible regulatory fragmentation and its negative effects, while increasing international cooperation as a crucial step to manage the increasing cyber threat. ●

Nausicaa Delfas

Executive Director of International, Financial Conduct Authority (FCA)

Cyber-security: building financial sector operational resilience

In July, the UK Financial Conduct Authority (FCA), jointly with the Bank of England and the Prudential Regulation Authority, published a Discussion Paper on suggested approaches to improving the operational resilience of firms and financial market infrastructures. Comments are still welcome by 5 October. The Paper consolidates many of the themes that UK authorities - and others around the globe – have been stressing over recent months. Operational resilience is not just about cyber-risks, but cyber is an important element. Driving our proposed approach are a number of important concepts, including:

- The need for firms to focus on the continuity of the most important business services as an essential component of managing operational resilience. Firms need to protect their critical information, detect attempts to breach protective controls, and respond quickly and effectively (including communicating with those most affected). Attacks often exploit well-known vulnerabilities. >>>

- Boards and senior management in firms could set standards of operational resilience which define the amount of disruption that could be tolerated, and ensure an increased focus on setting, monitoring and testing key services. Business leaders need to understand what a cyber-attack, technology failure, or wider operational failure could do, and how to respond and recover.
- Firms, markets and regulators need to plan on the assumption that disruption will occur as well as seeking to prevent it. We do not operate in a zero-failure environment and cyber-attacks will actively adapt to defensive controls. All stakeholders need to consider the impacts of operational disruption, the implications for financial stability and supply of vital services, the viability of individual firms, and potential detriment to consumers and other market participants.

Technological innovations transform how we live. But with innovation comes new risks. In 2017, the UK's National Cyber Security Centre recorded over 1100 reported cyber-attacks, with 590 regarded as significant. The UK deals with more than 10 significant attacks every week across all sectors. The FCA has assessed sectors we regulate and identified areas where firms could improve: focusing on basic cyber/IT hygiene; better identifying their critical assets, including data; and improving detection of attacks (e.g. using monitoring software). There also needs to be a focus on raising awareness of security issues for all staff, and raising understanding at Board level.

We continue to work very closely with other financial authorities in the UK and beyond. We have also introduced 'cyber co-ordination groups' across different financial sectors, with firms participating to share information about their experiences to help promote understanding, increase awareness, and share thoughts and ideas.

The cyber landscape is complex and unpredictable. And when attacks happen, they happen fast. That means response and

recovery are just as important as protection and detection. The FCA wants firms to be resilient and robust - understanding what to protect, how to swiftly detect an attack, and how to respond and recover to continue operating their most important business services. ●

Saskia Devolder

Managing Director, Head of Western and Central Europe, SWIFT

Legal certainty: key to effective information sharing

The financial industry's cyber-resilience will undoubtedly be improved by all the public sector initiatives underway – whether they relate to improving information sharing and disseminating best practices; or to increasing awareness and standardising regulatory approaches to cyber-security. We have already seen how initiatives like these have helped the industry protect against present threats – whether through private sector action, or private-public action.

Based on its own experience in developing an information sharing framework for the SWIFT community, one particular area that SWIFT would single out for public sector action is information sharing. As our community's efforts have evidenced within the international payments sphere, well-implemented information sharing helps raise awareness, leads naturally to best practice sharing, and demonstrably helps to prevent and detect attempted attacks.

Crafting a prescriptive approach to information sharing will, however, be challenging at best – counterproductive at worst; information sharing relies on trust and understanding – neither of which can be legislated into existence. Where policymakers can make a real difference, however, is in ensuring the right climate and conditions for information sharing; removing evident barriers to information sharing – particularly across borders – and by ensuring legal certainty. This second point is key.

Doubts regarding what information can be shared, with whom and under what conditions are hindering efforts to effective information sharing. Doubts still linger – whether over liability exposures and protections; whether over confidentiality and data privacy; over personal information or over competition issues. Can information be shared in the case only of a suspected cyber fraud, or can the information only be shared where there is certainty? Do AML or CTF-related information sharing provisions allow for cyber-fraud related information sharing? The doubts are plentiful. Moreover, in many areas there is still uncertainty over what must, can or should be shared between private sector peers, with government or with law enforcement.

Nowhere are these uncertainties more evident than at a cross-border level. Because of the interplay between different domestic laws it can be very difficult for private sector entities to accurately gauge what they can share with whom, when – even within the same group entities. And yet, one of the most significant challenges in facing the cyber security threat is the cross-border nature of the threat – particularly in the international financial sector where the combination of interconnectivity and money, makes for rich pickings.

As long as legal issues related to information remain clouded in uncertainty, the international financial sector's ability to mount an effective and timely response to the cyber threat will be compromised. Ensuring the development of an efficient, legally certain and clear framework for information sharing across borders is absolutely pivotal to the industry's ability to respond to this growing threat. ●

INDEX OF CONTRIBUTORS

About EUROFI

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 Andres** and **Marc Truchet**, Senior Fellows:

Events and meetings:

- **Eurofi organizes annually two major international events (the High Level Seminar in April and the Financial Forum in September)** gathering industry leaders and EU and international public decision makers. The aim of these events is to facilitate open discussions on the main developments of EU and global financial regulation, the measures needed for facilitating the financing of the EU economy and enhancing financial stability and the way forward for strengthening and further integrating the EU financial sector.
- 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 meetings** involving the members of Eurofi are set up to exchange views on specific regulatory issues.

Research and documentation:

Assessments and proposals taking into account economic, risk and end-user impacts are prepared with the support of cross-sectoral working groups comprising members of Eurofi. Bilateral meetings are also organised with representatives of the public authorities and other stakeholders to complete assessments and proposals.

Topics addressed include prospective and on-going regulatory proposals at the EU and global levels, industry trends as well as the impacts of economic and monetary policies on the financial sector.

MAIN TOPICS CURRENTLY ADDRESSED

- **Measures and instruments needed to ensure an appropriate financing of the EU economy:** impact of Brexit on the financing of the EU, impact of on-going monetary policies, measures to support bank financing (e.g. securitisation), diversification of the financing of SMEs and infrastructure projects, proposals for developing a long term investment perspective, sustainable and green finance.
- **Prospects of digitalisation and fintech:** digital transformation in the banking, insurance and payments industries, fintech and blockchain applications in the capital markets area and related regulatory challenges, crypto-currencies and ICOs, cyber-resilience.
- **Prospects of further EU and Eurozone integration:** optimizing and completing the Banking Union, priorities for implementing the Capital Markets Union, prospects of a deepening of the EMU, review of the operation of the European Supervisory Authorities.
- **Evolutions of the prudential and regulatory framework of banks and non-banks:** fine-tuning and implementation of banking and insurance prudential frameworks, mitigation of the systemic risks associated with insurance and market-based finance activities, recovery and resolution of banks and nonbanks, culture and conduct measures.
- **Capital market and investment product regulations:** implementation of the Capital Markets Union action plan, regulation of securities, derivatives and commodities markets and infrastructures, CCP supervision and recovery and resolution, SFT and collateral regulation, asset management regulations, distribution and investor protection regulations (PRIIPs, MiFID, IMD…).
- **Financial regulation at the global level:** resolution of banking groups at the global level, coordination of financial regulation at the global level, systemicity of non-banks non-insurers, availability of data to assess systemic risks.

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