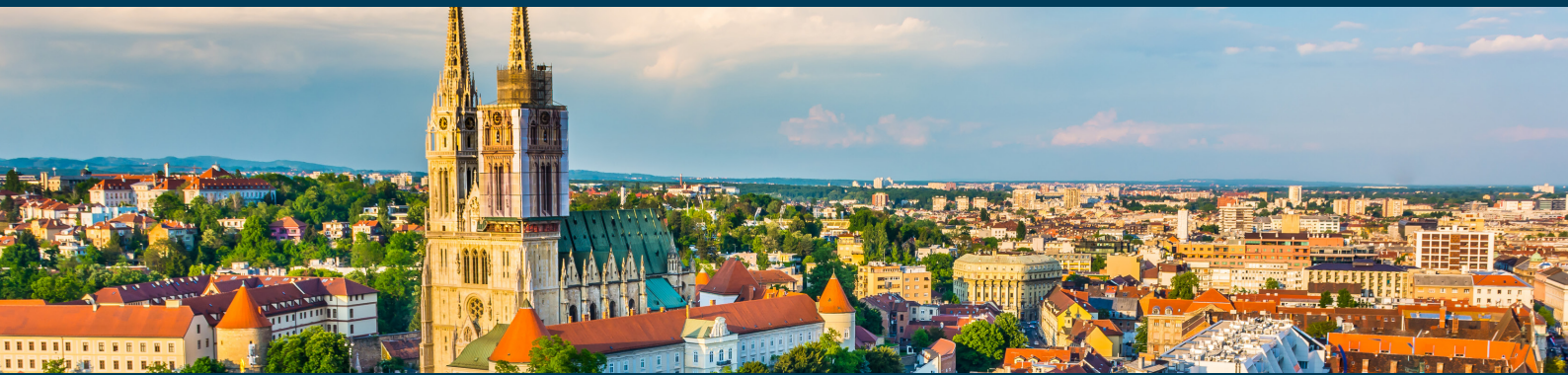


# REGULATORY UPDATE



A P R I L 2 0 2 0

***europfi***

The policy notes in the following pages were drafted by Didier Cahen, Marc Truchet and Jean-Marie Andrès from Eurofi and also include contributions from Jacques de Larosière, Honorary Chairman of Eurofi.

Reproduction in whole or in part of this regulatory update is permitted, provided that full attribution is made to Eurofi and to the source(s) quoted, and provided that such elements, whether in whole or in part, are not sold unless they are incorporated in other works.

# CONTENT

---

## COVID-19 CRISIS IMPACTS AND POLICY RESPONSES 4

Reflections on the health and financial crisis

Views on the responses to the Covid-19 crisis

## DEVELOPMENT OF EU CAPITAL MARKETS 12

CMU 2.0: what is needed, by whom and when?

Enhancing transparency in EU securities markets

Relaunching securitisation in the EU

Are the powers of ESMA sufficient for CMU?

Capital market development in CEE

## SUSTAINABLE FINANCE 32

The financial and non-financial challenges of the Green Deal

Sustainability Transition challenges for Small and Mid-Caps

## ON-GOING POLICY DEVELOPMENTS 38

Optimizing third-country approaches: the challenges of Brexit

The protection of deposits in the EU

Stablecoins, digital assets and electronic payment prospects and challenges

Ensuring operational resilience in the Covid-19 crisis context

# COVID-19 CRISIS IMPACTS AND POLICY RESPONSES

---

Reflections on the health and financial crisis	5
Views on the responses to the Covid-19 crisis	8

# Reflections on the health and financial crisis

Jacques de Larosière, Honorary Chairman, Eurofi  
30 March 2020

## 1. Why has the emergence of this virus caused economic and social unrest on the scale we are seeing today?

There is, of course, the novelty of this extremely virulent disease and the fact that it has spread very rapidly, first in China and then to all other regions of the world. Most hospitals are simply not equipped to receive the “peak” of new cases and this is why the hospitalisation curve must be “flattened” by limiting it to the most serious cases requiring resuscitation.

In the absence of a vaccine which some experts feel could take up to one year to develop and deploy and of sufficient screening capacity - which is absolutely essential but lacking in many countries -, it is necessary to use population containment to try to stop the contagion. However, this containment is the most disruptive aspect of the situation. It causes many segments of the economic machine to grind to a halt and acute drops in turnover in fundamental sectors of the economy: air transport, automobiles, tourism, catering trade, even threatening supply chains.

The extent of uncertainty about this exogenous shock to economic activity is evident across all financial asset classes worldwide.

However, what is said less is perhaps just as worrying.

## 2. The coronavirus is not the cause of what is happening to us financially, but it is a powerful amplification factor on ground already heavily mined

For the first time in a long time, the announcement of interest rate cuts and massive bailout plans did not, initially, automatically calm the markets. It took promises of hundreds of billions of fiscal dollars and euros, whipped up by many impecunious governments, to start dissipating the widespread scepticism and concern, bordering on panic from swathes of investors. In Q1 the major stock markets have fallen by at least 20%, most of this fall in the last few weeks.

Why? It is because the economic territory - the “mine field” in which we live and work - is in a far worse position than we have been prepared hitherto to acknowledge.

As a result of monetary policies that have been accommodating for too long, the debt ratio of states and societies has surpassed all peacetime records. We witness that the growth in overall debt has been 50% since the last crisis. The asset bubble that was favoured by cheap debt - including the so-called risk-free government bond bubble - is now abating. We had become accustomed to a situation where the announcement of money creation through massive purchases of sovereign securities by central banks was welcomed by the markets as a source of comfort and a sign of commitment by public authorities. In fact, for quite some time, the value of securities rose as their rates fell below zero, thus favouring borrowers.

However now the rot has set in. Risk premiums had virtually disappeared in this environment of low or negative rates and we lived with an illusion that seemed limitless. As long as growth lasted, mediocre - or even downright bad - signatures of all forms and supposedly adequate ratings were considered by investors to be of sufficient quality and the search for a little yield pushed them to take unwise risks which are concurrently, undervalued by financial markets.

In this context, the risk of a serious crisis was dangerously close even before the virus struck; the slightest sign of economic slowdown

was enough to instil fear in the market that the “good times” were over and the storm was beginning. In fact, the first defaults were already appearing among the most vulnerable borrowers (e.g. issuers of high-yield securities and BBB-rated companies, which account for more than half of investment grade corporate debt, companies whose financial cost/income ratio has deteriorated considerably).

To cope with these defaults, fund managers had to sell liquid assets; hence the decline in gold and sovereign securities seen some time ago. There are fears that these movements will be amplified by the rapid deterioration in economic conditions and the huge asset bubbles that have been allowed to swell indiscriminately.

## 3. The seriousness of the situation requires action despite the weak financial environment

Given the gravity of the situation (there is talk of negative growth of 5 GDP points or more in 2020) and the uncertainty as to its duration (the most common assumption being that the spread of the virus will be reversed in the second quarter of 2020, but this seems increasingly less certain), we must be prepared for a very large economic shock.

Immediate resources are rightly beginning to be deployed: increased bank liquidity, almost unlimited absorption of sovereign securities by central bank purchases, government guarantees granted - in France, Germany, UK, Spain and others in particular - for loans to affected companies, deferred payment for loans, social security contributions, taxes, etc., facilities granted for short-time working, use by banks of their counter-cyclical cushions, etc and most recently strong pressure on banks to jettison dividends and variable pay bonuses this year so as to increase credit supply.

Some of these schemes will be very costly for public finances, notably the financing of short-time working. And this at a time when budgetary and monetary room for manoeuvre is very limited due to the inadequate management of the post-financial crisis of 2008 by a number of States.

But the present hour leaves no choice. It requires action to be taken in spite of the weak financial environment, which is bound to deteriorate further.

All the pins are getting pulled one after the other: in the United States, the monetary financing of the Treasury has become unlimited and private securities are accepted as collateral by the FED. In Europe, the European Central Bank has potential purchases of securities worth 1,000 billion euros. The rules of the European Stability Pact are suspended and, in fact, the national support and recovery plans (Germany 750 billion euros, France 350 billion, Spain 200 billion) are incompatible with these standards.

## 4. Still, it is necessary to keep reason

So the valves are open. But we must keep and stick to clear principles. The severity of the crisis requires providing the economy with the necessary liquidity to allow the granting of credit, which is essential for economic survival.

On the other hand, the suspension of the rules governing the budgets of the Eurozone Members, compliance with which is the very basis of the viability of the Single Currency, is a decision of major importance. Member States will have to return to this in a

coordinated manner based on a more effective fiscal framework if the Monetary Union is to be maintained.

The present situation does not justify helicopter money. In a health crisis such as the one we are going through with the confinement of populations, the priority does not seem to be to give monetary subsidies to consumers who are having a hard time buying anything, but to enable businesses to survive by means of credit. If the poorest and most affected households are to be helped, this should be done through social benefits; in a democracy, money should not be the agent of social policy.

The top priority is to enable companies to continue their business. This may require the use of direct loans from financial institutions, public guarantees for bank loans, extension of maturities and even, where necessary, conversion of non repayable loans into capital subscribed by public authorities. This would be a more efficient way than using helicopter money and could contribute to a healthier and swifter recovery for companies with a sufficient equity base.

The idea that states can compensate for everything by exposing their balance sheets is unfortunately, in part, an illusion. Indeed, most States have fragile balance sheets with monumental debts and the extension - which some would like to see unlimited - of these financial capacities obviously raises the essential issue of the sustainability of deficits - except if one agreed that all incremental expenses were to end up for ever on central banks' balance sheets. However, such an approach would ultimately lead to the systematic monetisation of all deficits, which would affect stability and confidence in the currency. Given the heterogeneity of fiscal performance across euro-area Member States, this approach would most probably be incompatible with the functioning of monetary union. In the longer turn, such a result would mean that the market economy would eventually become an economy largely directed and owned by the central bank, which poses an existential problem.

### 5. The truth is dark

Of course, the public authorities are once again seeking salvation in an "easing" of monetary and fiscal policy, even if it means increasing the leverage of an already overexposed financial system. Hence the key rate cuts announced by some central banks and the use of new quantitative easing (QE) programmes.

However, given the existence of already very low rates that make these cuts ineffective - in a context where it is less a question of benefiting from lower rates than of surviving the closure of companies - and given the lack of margins for raising taxes, these promises of massive bailouts are tantamount to announcing new issues of debt securities. Central banks can certainly be expected to ensure the success of these issues through their purchases of securities. This, in fact, would be tantamount to wanting to compensate for the real losses caused by the recession (or depression?) through money creation.

Is such a headlong rush viable? Won't the markets one day worry about the inflationary consequences of a new full monetary "put"? Admittedly, inflation is still low and the markets do not expect it to ratchet upwards, but after an accumulation of money creation in the face of reviving consumption, future inflationary pressures seem possible, leading to greater social inequality.

### 6. Post-COVID19 questions

We must think now about the post-crisis period. A few orders of magnitude on the eve of the crisis provide food for thought:

- World GDP: \$85,000 Billion
- Global Market Capitalisation: \$20,000 Billion
- Balance sheets of the largest central banks: \$18,000 Billion

If we were to assume that governments decided to "compensate" by additional public spending for let us assume a 3 to 5 percentage point decline in world GDP and that they undertook to counter the stock market crash "à la japonaise", this would result in central banks' balance sheets being increased by about half. Certainly, this

has already been done in 2008. Can this be repeated over and over again, and what kind of future is there for us?

Can we pretend that money creation can exempt our societies indefinitely from having to face the question: "who will pay?" Can moral hazard be institutionalised and perpetuated as many reckless actors wish? Guaranteeing to any market player that they will never make a loss and that the result of their investments, however imprudent, will always be favourable would be a dangerous solution to the problems.

Do we seriously believe that unlimited issuance of sovereign securities will never come up against fundamental questioning of the markets as to the solvency of States? Some say so, but who will believe them? One of the consequences of this exacerbation of public debt is obviously the increase in taxes with the problems of tax competition between states, competitiveness of companies and saturation of fiscal capacity in many states.

How can we encourage a return to healthy growth in a zero-rate environment that encourages the hoarding of liquidity to the detriment of productive investment, in economies that are often over-indebted and where populations are demanding more protection from the State? Is capitalism at the end of its tether, and how will we face growing calls for the universally protective state?

What is going to happen to the euro zone, where the heterogeneity of deficits and public debt, and therefore of tax margins, is particularly marked and where the sense of solidarity that should prevail in the Union seems once again to have evaporated?

When we think of the complexity of the challenges: normalisation of a monetary policy in deadlock, response to the climate danger, the need to re-establish an international monetary order to avoid competitive devaluations, teaching our fellow citizens that structural reforms cannot be indefinitely postponed through monetary creation etc, one wonders with real concern whether our methods of government and cooperation will be able to rise to the challenge. We are witnessing the self-isolation of States, the random, uncoordinated closing of borders. EU Single Market rules being switched off at will. This is reminiscent of the inter-war period when states engaged in competitive devaluations and tariff protectionism.

### 7. Outline of initial responses concerning Europe

Interest rate differentials in the euro zone widened with the crisis until the ECB intervened, exposing the fragilities that remain due to the still incomplete European architecture of the Economic and Monetary Union, be it the failure to comply with the criteria of the Stability and Growth Pact since the early 2000s, the lack of symmetry in current account adjustments, or the still incomplete banking and capital market unions etc.

Today we should start with a simple political and ethical principle: EVERYTHING must be done to stop the spread of the virus. Other considerations should be put on the backburner until the health situation has been restored.

It follows from this principle that a number of initiatives should be taken urgently in a spirit of solidarity. For example:

- Finalisation of the agreement - pending for 2 years - on the European Union's budget (with sufficient resources to deal with the epidemic)
- Issuance of a token amount of corona bonds with European signature to finance exclusively the additional health expenditure due to the virus
- Use of the European Stability Mechanisms for a specific financing of Member States centred on the virus
- Finalisation of the Banking Union and of a real resolution system, making it less vulnerable to economic shocks
- Political agreement on the principles governing "re-entry" after the crisis: implementation of structural reforms which are the only way to increase the growth of our economies, conditional restructuring of public debts which have become



unsustainable, restoration of a renewed and finally effective Stability and Growth Pact which should be based on the area's debt capacity and on effective discipline being practised by the member countries, etc.

### 8. And after the pandemic, what societies will we have?

We must not believe that, once the epidemic is over, everything will return to the old order.

We must prepare for a paradigm shift, and it is better to organise this change on a negotiated and cooperative basis than to allow it to be imposed. This was the case with the unfortunate "Washington consensus" that shaped the world from the 1980s onwards and whose dogmatism contributed to the disaster.

#### 8.1 The pandemic will leave traces that cannot be ignored

- The size of public credits and guarantees offered to enable companies to get through the economic downturn will pose the following problem: a substantial part of these debts will not be able to be repaid at least in the medium term since part of the activities maintained by these credits inevitably will result in unrecoverable losses.
- As a result, treasuries will become capital investors. They will therefore have to answer the question: what type of shareholders will they be? Passive and non-voting or inclusive and willing to play a strategic role at the corporate level?
- The importance of the answer to this question should not be concealed. It is in fact a matter of choosing between a return to traditional liberal capitalism or an active state that would play a decisive role in industrial strategy.

#### 8.2 The overhang of certain public debts will also have to be addressed.

Public debt will, in a number of cases, exceed the limits of sustainability. Some restructuring will therefore be necessary to avoid the growth brakes and market disruptions that come from this excessive debt.

This will require a pragmatic restructuring process that should be de-dramatised and carried out in close cooperation with the markets. But if the governance of the restructurings that have become inevitable is similar to the one that brought us to where we are now, the results will be painful.

We no longer have the luxury of pretending that this problem does not exist. However, this restructuring process can only succeed if debtors commit to more prudent financial management.

#### 8.3 The question of globalisation must also be addressed.

Without denying the benefits of an open trading world, the WTO will have to be rethought to enable it to effectively combat the abuses of certain players in world trade, abuses that we have suffered almost without protest for years. World trade needs a binding dispute settlement body that is efficient and fair to all. Otherwise it is the law of the jungle, dominated by the biggest to the detriment of all others.

Relations between Europe and China will have to be rethought by a Europe that has become less tolerant but more aware of its own interests.

#### 8.4 If genuine global cooperation is to be achieved, the international monetary system must also be reorganised.

Indeed, the "non-system" in which we live has a great disadvantage: the absolute freedom that reigns in exchange rate matters raises suspicion.

The easing of monetary policies by some countries is often seen as a disguised way of depreciating their exchange rates. This provokes accusations of exchange rate manipulation and encourages trade wars.

In fact, since the end of the war, we have never been so close to the situation of the thirties ("beggar thy neighbour").

Everything leads one to ask a number of questions that had been lucidly addressed by Robert Triffin:

- How to introduce some stability and order into exchange rate movements (anchoring on a basket of major currencies or on a sample of raw materials)?
- How can we avoid the drawbacks of a system whose supply of international liquidity depends exclusively on a national currency, the dollar?
- How can effective surveillance of the new system be organised around the IMF?
- How can we ensure that the international monetary system is more symmetrical and does not rely exclusively on debtor countries for the adjustment effort?

It is high time to start discussing these issues. So far we have accepted the "non-system"; because the dollar's hegemony has been relatively benevolent.

But now that the world is becoming multi-polar and less consensual and that the United States is increasingly using the dollar for diplomatic and political purposes, an agreement between the United States, China and Europe seems essential for the future.

#### 8.5. Nor will we escape an even more fundamental question: that of the model of growth and society that will have to be developed after the crisis.

Is economic nationalism the way forward? Two factors contribute to this:

- The search for social protection which has manifested itself during the pandemic. Public opinion clearly wants hospital services that are better adapted to major pandemics which, according to many forecasts, will multiply in the coming decades.
- De facto nationalisation implies surreptitiously a monetary policy that would continue to insure all economic actors against the risk of failure. Unlimited repurchase programmes by central banks of securities depreciated by the markets amount to a form of collectivisation of individual companies, and therefore of the risks involved.

These two factors cannot work concurrently. Indeed, if we consider the percentage of public expenditure in relation to GDP reached by a country like France (53% before the pandemic), we may wonder what margin will be available for large additional social infrastructure programmes.

The answer is that if we want to return to a normal situation where interest rates are positive in real terms to ensure productive investment, we will have to proceed "à la Suédoise" in some countries such as France. The Swedish authorities have radically changed, by reducing public expenditure, to eliminate everything that is not essential.

If countries do not undertake these reforms with a minimum of coordination and discipline, the future of the euro will be jeopardised.

&&  
&

Why this article?

Because, even if the "over-financing" of the system leaves us with little choice today, it is essential that we ask ourselves, this time at least, the questions about the "post-crisis". We can no longer afford the luxury, once the shock of the pandemic has passed, of falling back into the same rut of ease, postponing indefinitely the real issues.

Not to think about it now would be tantamount to de facto accepting as a principle - which has led us to disaster - that unlimited money creation is the only way to respond to the fundamental problems, to those of future generations. Otherwise, we will face one recurring crisis after another. After the war, the first thing to do is to clear the landmines.

# Views on the responses to the Covid-19 crisis

Interview with Jacques de Larosière conducted by Didier Cahen on 14 April 2020

## How different is this sanitary crisis from the previous financial and sovereign debt crises of the years 2000?

The present crisis is far worse than the one of 2007 – 2008 because, this time, it threatens the lives of citizens worldwide. Covid-19 has disrupted our social and economic order at lightning speed and on a scale unseen in living memory, and the lockdown needed to contain it has affected billions of people. The common trait between the two crises is the unpreparedness of governments:

In 2007-2008, they underestimated the lack of sufficient equity in the banking sector and the vulnerability on the financial system in the face of huge asset bubbles

This time we are, except for a few countries, unprepared to cope with this massive pandemic because of:

- insufficient preventive and diagnosis devices, which are crucial to limit the confinement measures to people that are affected by the virus,
- insufficient availability of masks and the absence of an effective vaccine, or other medical treatments and
- the very limited capacity in terms of life saving respiratory units.

So, the difference is this: in 2008, the authorities swamped financial markets with liquidity in order to avoid total collapse of the banks and financial markets. This time, governments are closing very significant parts of economic activity because health services are not able to distinguish healthy and non-healthy individuals and therefore have to lock-in most sectors of the economy in order to avoid any contacts between people.

This method is very inefficient compared to the practice of a few countries that have established systematic testing of all individuals and have kept most of their economies functioning. This time it is the public authorities that have decided, given their unpreparedness, to create the conditions for a major depression unseen for 90 years.

## How to assess the economic impacts of coronavirus?

The consequence of this global crisis and the lock down measures taken will be huge. Their magnitude will depend on how long it will take to overcome the health problems.

As a very approximative yardstick, if you assume that advanced economies are mandatorily closed at a level of 50%, that means that two months of confinement entails a loss of 8% of GDP. 4 months would amount to 16% of GDP.... Some countries will be far worse hit than others.

The collapse of economic output in the second quarter of this year will be the biggest in modern peacetime history. The impact of a gradual exit from confinement is not yet forecastable. But the social and economic consequences of the pandemic are extremely serious and will be with us for many years to come.

## The coronavirus crisis is developing at a time when the financial system appears weakened. Does monetary policy have a responsibility in this regard?

The minefield of the world economic and financial system is in a far worse state than we have been prepared to admit.

As a result of monetary policies that have been accommodating for too long, the debt ratio of states and corporates compared to GDP has surpassed all peacetime records. We witness that the growth in overall debt has been 50% since the last 2008 crisis. The asset bubble that was favoured by cheap debt - including the so-called risk-free government bond bubble - is now abating.

However, the rot has set in. Risk premiums had virtually disappeared in this environment of low or negative interest rates and we have lived with an illusion that assumed this situation would be timeless. As long as some growth was maintained, mediocre - or even downright bad - signatures of all forms and supposedly adequate ratings were considered by investors to be of sufficient quality and the search for a little yield pushed them to take unwise risks which are concurrently, undervalued by financial markets.

In this context, the risk of a serious crisis was dangerously close even before the virus struck; the slightest sign of economic slowdown was enough to instil fear in the markets that the “good times” were over and the storm was beginning. In fact, the first defaults were already appearing among the most vulnerable borrowers (e.g. issuers of high-yield securities and BBB-rated companies, which account for more than half of investment grade corporate debt - companies whose financial cost/income ratio has deteriorated considerably).

## You have been warning of the dangers of monetary policies that have been accommodative for too long. Can you remind us of those dangers?

The impact of excessively accommodative monetary policy - with interest rates at zero or even negative for a long time - on the stability of the financial system is unfortunately too well documented: incentives to borrow more; weakening of the banking system; deterioration of the accounts of pension institutions whose liabilities remain subject to contractual obligations but whose fixed-income assets no longer yield anything; proliferation of zombie companies in an environment where interest rates no longer play their discriminating “quality signal” role that should be theirs; strong disincentive for governments not to undertake structural reforms since borrowing “no longer costs anything”;

Let us not underestimate the importance of this loss of benchmarks - zero interest rates blur risk premiums (one of the characteristics of the 2008 crisis).

## What are the potential economic and financial stability consequences of the massive purchases of securities decided by the ECB and the Fed? Do the issues raise similar risks in the Eurozone and US?

The huge increase in public expenditures to maintain economies during this pandemic crisis will create a massive increase in public debts. This will inevitably raise questions on the sustainability of public debt levels of those countries whose figures are already very high.

The solution to the problem would normally be to raise more taxes and reduce less essential public expenditure. But given the monumental amounts in question, there may well be a temptation to expect central banks to hold them on their balance sheets thereby monetising public debt by monetary policies.

This is a new source of vulnerability and instability of the financial system.



Business survival justifies the central banks' role as lender of last resort during the crisis. Central banks must do everything to support the needs of the people. But doing so should not be in conflict with the core purposes of monetary and financial stability. Increasingly using monetary financing will damage credibility and the role of money as well as weakening future control of inflation.

So the future looks very dark.

Both the US and Europe are pursuing the same policies. But the US has an advantage: they issue the international currency. It is less immediately exposed than other countries who do not benefit from this privilege. But, of course, in the very long run, even that US advantage will tend to dissipate, and the question of the fiscal sustainability of debt will arise even for the dollar.

**Can this ocean of public debt on the balance sheets of central banks be reduced over time or are we entering an era of perpetual public debt, with maybe even further demands for State protection?**

The answer will depend on the outcome of economic behaviour. If central banks and governments continue to forecast a very long period of low growth and zero or even negative interest rates, I do not see how central banks could start selling their accumulated bonds on the markets. The probability of even an increase for a very long time on central banks' balance sheets looks pretty high.

Consequently, a situation of persistently low interest rate will be very disturbing: in such a monetary environment, the market is no longer in a position to discriminate among different types of assets due to the asset purchase of the central bank. Indeed, the universal buying of sovereign securities eliminates the normal functioning of market forces between savings and investment and brings interest rates to levels close to zero which, as we have already seen, encourages the holding of liquidity to the detriment of productive investment.

How can free markets assess value in these conditions? How do productive economic projects distinguish themselves from sheer financial profit opportunities in the search for investment capital?

Ultimately, by taking things to extremes, central banks would eventually hold most of the debt and even shares. But, by dint of being taxed, household savings could decline and central banks could become the main actors in the savings/investment equation.

Continuing such monetary policies is a cause of great concern for the future of our economies and our societies.

**Are you concerned that this ocean of debt on the balance sheets of central banks will be a brake on the recovery of investment at the end of the economic depression we are experiencing?**

Absolutely. The increase in public debt and unlimited money creation are a dangerous spiral for our economies. They will not only act as a brake on the recovery of investment but can also undermine the confidence of economic agents in the currency and the value of money.

The core problem of loose monetary policies is that it drives a preference for liquidity. Since investment by purchasing securities is taxed, investors tend to forgo illusory remuneration and retain liquid instruments which, at least, are not affected by the application of negative rates. But such a preference for liquidity (Keynes' "haunting") diverts savers away from long-term investment. They would be taxed if they invested long-term.

In the traditional investor trade-off between return, risk and liquidity, the notion of return loses its importance with low interest rates. The arbitrage is only between liquidity and risk.

Moreover, with lasting and huge asset purchase programmes, central banks are anchoring in the minds of the markets the idea that interest rates will remain low for an indefinite period. The expectation of

low rates for a very long period has a "depressing" effect: economic agents conclude that the growth horizon will be low for a long time and therefore will refrain from making long-term investments.

The accumulation of very high public debt, negative interest rates and massive repurchases of public and private securities against the backdrop of an accelerating ageing population has been experienced for many years by Japan (47% of outstanding public debt is held by the BOJ), which shows that it is inseparable from a sharp fall in potential growth.

**What do you think of the Eurogroup European agreement of 7 April?**

I think this is an excellent and fair agreement that provides for concrete actions. More than half a trillion Euros are now available to shield European Union countries, workers and businesses.

The European Stability Mechanism, the safety net for countries, will provide pandemic crisis support, in the form of precautionary credit lines not subject to macroeconomic policy conditionality. A member state that draws under these Enhanced Conditions Credit Line (ECCL) will commit to using the money only to cover corona-related costs. Each member state could benefit from this support up to the benchmark amount of 2 percent of GDP.

Second, a temporary solidarity instrument (SURE) will be established to support member states to protect workers and jobs in the current crisis. Loans will be provided to member states up to €100bn, building on the EU budget as much as possible and on guarantees from the member states

And thirdly, the European Investment Bank will implement its proposal to create a pan-European guarantee fund of €25bn to support €200bn of EU businesses, in particular SME's, throughout this crisis.

It has also been agreed to explore the setting up of a temporary Recovery Fund to facilitate a robust European economic recovery in all Member States. There was broad agreement to disagree on the financing of the fund, with mutualized debt issuance being favored by some and strongly opposed by others.

All this is still pending the agreement of the European Council.

**Could the monetisation of public spending by central banks, if not accompanied by control of public spending by Member States, lead to a break-up of the euro zone?**

What threatens the break-up of the zone is the disparity of the economic policies of the Member States and their lack of coordination. This heterogeneity is bound to increase with the further increases in public spending in this crisis.

If Member States whose public debts are already excessive do not make a more serious effort to reduce public expenditure not justified by imperative and urgent needs, the problem of the Eurozone' centrifugal forces will only worsen. We can see how much the policy, particularly in Germany, of reducing the public debt-to-GDP ratio to the level prescribed by the Maastricht rules, has paid off. Starting with 60% of public debt, compared to more than 100% in other countries, Germany has been able to embark on a massive programme of aid to the economy while its neighbours do not have the same margin for manoeuvre.

Moreover, the EU countries that have best managed the 2008 crash and the coronavirus epidemic are not those that have accumulated public expenditure and debt - like France, which is enduring a major shortage of gel, masks, screening tests and fans - but those like Germany - that have a modern state, healthy public finances, a powerful and reactive industry, a sustained research effort and strong social cohesion.

Furthermore, those countries that have controlled best their public finances are also those where research and reactivity have been better in terms of responding to the virus crisis.

### **How can public debt of the most indebted European states be reduced after the crisis? Is it possible to achieve primary budget surpluses?**

Primary fiscal surpluses can be achieved to the extent that the debt-servicing burden would continue to be zero. Still, an effort must be made to reduce the least indispensable public expenditure.

Germany has reduced its public debt in relation to GDP from 80% in 2008 to 60% in 2019 (while Italy's has jumped from 126% to 136% and France's from 90% to 99% over the same period).

Countries that are still in primary deficit must take advantage of low interest rates to achieve a primary surplus to public debt over time.

### **What should be the characteristics of a renewed and effective Stability and Growth Pact once the crisis is over? Should new rules be added?**

The first recommendation would be to apply the rules of the Stability and Growth Pact as they exist and as they were modified with more structural objectives after the 2008 crisis. We can always envisage improvements but the reality is unfortunately very simple: when the percentage of GDP devoted to public expenditure is too high, it must be reduced and brought closer to the average for the euro zone if we want to achieve a degree of homogeneity in budgetary performance, which is essential for the proper functioning of any monetary union.

It is all the more important to strengthen the common discipline that the system has put on the backburner during the crisis. Those rules are the cement that keeps together the Eurozone.

On the institutional front, since national budgets are vetted at the Union level, at one point, it would make sense to move toward a politically binding decision-making process with a more substantial federal budget and tougher sanctions for non-compliance.

### **How can we encourage a return to healthy growth in a zero-rate environment, in economies that are often over-indebted, with populations, most of them ageing, asking for more protection from the State?**

The first priority is to re-establish financial markets that function on the basis of market forces and not according to the prescription of zero-interest rates. The latter method, which has been practised unsuccessfully for the past decade or so, only encourages savers to hold liquid instruments such as bank accounts and to turn away from long-term securities with negative returns. This liquidity trap, feared by Keynes, largely explains the reduction in productive investment observed in recent years.

The national budget can also be used to promote infrastructure programmes, but to do so, it is necessary to have the means to do so, i. e. to reduce non-productive current public expenditure.

We must stop this psychodrama of so-called austerity, which is said to have weakened certain States of the Union. In fact, it is the fiscally virtuous countries that have best prepared their economies for the challenges of the crisis.

In countries with too much debt, decisions must now be made to stop "walking on their heads"; and to reduce unproductive and inefficient public spending. This is the only way to release the necessary resources to the productive sector. Such a fiscal policy requires a spirit of cooperation among the different political parties and on a bi-partisan basis, examples abound in the Northern European Member States.

### **Is this Europe's 'Hamiltonian moment'? What is your feeling about 'corona bonds' and /or a separate fund for dealing with the pandemic as suggested by the French government?**

Alexander Hamilton understood that a nascent federal state needed a federal budget. Given the heterogeneity of economic performance among the 13 States of the Union, it is understandable that he had great difficulty in imposing this idea. But his vision was that of a federal state in the long term and not that of a group of individual states only weakly bound together only by legal concepts and human rights.

Is it possible to envisage that this American-style late 18th century vision could be born today in Europe?

One possible, Hamiltonian-inspired progress that is not revolutionary, would be to strengthen the Community budget. But the vision of the mutualisation of past or future national debts is of a different nature and is difficult to establish in a political system not united in fiscal terms.

Indeed without a fiscal Federation, it is very difficult to ask the best performers to guarantee the debt of the weakest members because this would be equivalent to a discretionary transfer of resources from some countries to others without the guarantors being able to influence politically the policies of separate states. This is fundamentally different from a fiscal authority. Moreover, Hamilton laid down the principle that the Federation was not responsible for the failure of the States.

Finally a Fiscal Union would be a major political leap that must be explained to the public and which requires democratic accountability and the consent of citizens....

### **Given the critical situation we face, do you not think that some common, limited financial instrument issued by the Eurozone or the EU as a whole, would be beneficial to the Union?**

What could be envisaged in these exceptional times with this huge, exogenous universal shock, is to mutualise exclusively the incremental part of public debt that has to be issued to fight against the pandemic. Indeed, this would not entail a transfer of resources from good performers to more problematic ones. It would just say that to fight this war all countries are in the same boat and that "l'appartenance européenne" counts.

In this regard, the Commission's proposal of the very significantly enlarged common budget is welcome. It entails a borrowing capability in the hands of the European Executive. This would be a "Hamiltonian" step forward. For the first time, such a major budgetary plan would imply a fiscal common entity in charge of issuing euro denominated debt.

# VISIT THE NEW “CURRENT TOPICS” SECTION OF OUR WEBSITE

[www.eurofi.net](http://www.eurofi.net)

Latest Eurofi policy notes  
and contributions from public and private representatives  
on a selection of key topics on the EU agenda

## **ECONOMIC AND STABILITY CHALLENGES**

Covid-19 crisis impacts  
Economic and Monetary Union (EMU)  
Monetary policy impacts  
International role of the Euro

---

## **FINANCIAL POLICIES**

CMU 2.0  
Securities trading and post-trading  
Relaunching securitisation in the EU  
Banking Union  
Brexit & Third-country arrangements  
CEE region funding challenges

---

## **NEW TRENDS**

Sustainability investment challenges  
Small & Midcap ESG challenges  
New technologies (cloud, AI, DLT...)  
Crypto-assets and payments  
Operational resilience

# DEVELOPMENT OF EU CAPITAL MARKETS

---

CMU 2.0: what is needed, by whom and when?	13
Enhancing transparency in EU securities markets	16
Relaunching securitisation in the EU	20
Are the powers of ESMA sufficient for CMU?	28
Capital market development in CEE	30

# CMU 2.0: what is needed, by whom and when?

## 1. The EU capital market legislative framework has been significantly enriched with CMU 1.0, but concrete impacts are still limited

Launched in 2015, the Capital Markets Union initiative (CMU) aims to develop and further integrate capital markets in the EU in order to diversify the financing of EU enterprises - particularly the most innovative and fastest growing ones - and better connect savings to investment across the Union, providing savers with improved long-term investment opportunities. An additional more macro-level objective is to enhance the resilience of the EU economy with a diversification of funding sources and a development of cross-border capital markets (contributing to private risk sharing across the EU).

The Commission proposed two action plans including legislative and non-legislative measures aiming to bring more investors to the market, facilitate access to capital markets for issuers and improve the functioning of EU markets notably on a cross-border basis, which have now been mostly implemented. The initial CMU Action Plan published in September 2015 set out 33 actions concerning securitisation, investment funds, prudential calibrations, prospectuses, etc.<sup>1</sup> Following the mid-term review of the CMU, an additional set of measures was proposed by the Commission in 2017, covering different objectives such as the strengthening of the powers of the ESAs, the development of fintech, the promotion of sustainable finance, the facilitation of SME listing, private pensions (with the PEPP framework<sup>2</sup>) and support for the growth of local capital markets. With these two action plans, the Commission has chosen an evolutionary approach to the CMU addressing a broad range of drivers and building on the pre-existing EU securities legislations such as MiFID, EMIR, CSDR, UCITS, etc.<sup>3</sup>, rather than a more radical plan addressing market fundamentals such as, insolvency, tax and securities ownership laws, common infrastructure, etc.

Despite this improvement of the EU capital market framework, the general feeling is that much remains to be done to achieve the CMU. A first reason is that EU capital markets have not significantly grown over the last few years, except non-bank funding through debt securities, and they remain quite under-developed compared to the US or UK for example. In addition, there is persistent fragmentation in the EU, with limited cross-border flows and fragmented infrastructure (see Annex 1). Secondly there is frustration with CMU 1.0 among many stakeholders due to the protracted negotiation process and also the lowering of the initial ambitions of certain proposals such as the ESAs review, in order to enable the co-legislators to reach an agreement. The piecemeal fashion in which the proposals were made, the lack

of ex-ante political agreement on the main components of the CMU action plan and the absence of an overall implementation timetable, beyond the adoption of the legislative texts are additional issues that have also been put forward.

## 2. Completing the CMU remains a priority of the Commission and the Council

Completing the CMU was reasserted as a centrepiece of the legislative agenda by the new Commission, in particular to ensure SMEs have access to the financing they need to grow, innovate and scale up. The Council also reaffirmed at the Ecofin of 5 December 2019 the need to further intensify policy efforts for deepening the CMU and set 5 main objectives: (i) enhanced access to finance for EU businesses, especially SMEs; (ii) removal of structural and legal barriers for increased cross border capital flows; (iii) provision of incentives and removal of obstacles for well-informed retail savers to invest; (iv) support the transition to sustainable economies; (v) embrace technological progress and digitalization, and a sixth objective of strengthening the global competitiveness of EU capital markets building on local markets and ecosystems.

Several reports on the CMU published in the last months of 2019<sup>4</sup> recommend similar areas of work. There are however some nuances in their approaches. Some focus more on building the fundamentals of an integrated EU capital market. This is the case of the IMF staff paper published in September 2019 which recommends the central provision of issuer information (an "EU EDGAR"<sup>5</sup>), streamlined withholding tax procedures, improved insolvency procedures, enhanced supervision and a new portable pension product. Others, such as the Next CMU report, recommend a very wide list of objectives ranging from specific regulatory measures to improve the financing of SMEs and investment conditions for retail and institutional investors to broader policy recommendations such as strengthening the international role of the euro or increasing financial flow fluidity between EU financial market places. While all these themes seem relevant in theory, the challenge now is to identify the priorities to start with, likely to have the strongest impact in the short and medium term and to define a clear sequence of action to relaunch the CMU project.

The High Level Forum (HLF) set up in November 2019 by the Commission aims to propose by the summer of 2020<sup>6</sup> a set of concrete and targeted policy actions, likely to be "game-changers" for the CMU, together with the method and process needed to see them through.

<sup>1</sup> These include measures to develop securitization and covered bonds, improve Solvency II calibrations, prospectus and investment fund rules, facilitate the cross-border distribution of funds and also some non-binding measures regarding withholding tax and insolvency proceedings.

<sup>2</sup> Pan European Pension Product framework.

<sup>3</sup> Capital market regulations and directives including: MiFID / MiFIR, EMIR, CSDR, SFTR, MAR, UCITS, AIFM, etc.

<sup>4</sup> Including: CEPS "Rebranding the CMU" (June 2019); IMF staff discussion paper "A Capital Market Union for Europe" (Sept 2019); the Next CMU high-level group (Oct 2019); S&P The EU CMU: turning the tide (Feb 2020).

<sup>5</sup> EDGAR is the Electronic Data Gathering, Analysis, and Retrieval system used at the U.S. Securities and Exchange Commission (SEC). EDGAR is the primary system for submissions by companies and others who are required by law to file information with the SEC. EDGAR performs automated collection, validation, indexing, acceptance, and forwarding of submissions by companies and others who are required by law to file forms with the US SEC. All companies, foreign and domestic, are required to file registration statements, periodic reports, and other forms electronically through EDGAR. Anyone can access and download this information for free.

<sup>6</sup> The initial deadline was May 2020 but it may be postponed because of the Covid-19 crisis.



So far, the HLF has highlighted in its February 2020 interim report a number of areas of improvement on the basis of which these key measures will be identified<sup>7</sup>: (i) The financing of businesses; (ii) The strengthening of market infrastructure; (iii) Retail investment; (iv) Cross-cutting issues related to tax, insolvency procedures and supervision.

Two main factors of success of the CMU were also emphasized by the HLF. One is the need to have a clear delivery timetable that can be rigorously monitored over time by the EU institutions against a set of indicators. The second factor is the need for clear political backing with an “upfront commitment” from the Commission, the Council and the EU Parliament on a precise package of reforms.

### 3. Challenges and opportunities going forward: Brexit and Covid-19

In defining the priorities and course of action for CMU 2.0, two main challenges that have appeared or gained in importance since the publication of the recommendations above need to be considered.

#### Brexit is a first challenge

Although the terms of a potential trade deal are still to be defined, it is now almost certain that future EU-UK relations in the financial sector will be based on bilateral equivalence. This may have major impacts on EU-27 capital markets, since at present the UK acts as a hub for many activities and UK and EU financial markets are highly integrated<sup>8</sup>. Many capital market activities can potentially benefit from equivalence arrangements<sup>9</sup>, but it is likely that costs and frictions will increase after the transition period<sup>10</sup>, particularly if UK rules diverge over time. How these changes may affect the future dynamics of EU capital markets and CMU objectives still needs to be clearly evaluated. Developing capital market activities on the continent could be an opportunity for the EU-27 to further increase its financial independence, but so far transfers of activities from the City have been limited and on-going trends point towards a multi-polar EU capital market, requiring stronger regulatory and supervisory convergence and interconnecting market ecosystems<sup>11</sup>.

#### The Covid-19 crisis is another potential game changer for the CMU

Although it is still early to evaluate the full implications of this crisis at the time this paper is written, it is likely that it will perpetuate a macro-economic context in the EU that is not particularly favourable to the growth of capital markets. Very low interest rates used to fight recession should continue to favour debt over equity financing and encourage risk-free savings offering returns that are only slightly lower than balanced-risk securities portfolios. Secondly this crisis will probably increase macro-economic imbalances between Member States, hindering the further integration of capital and banking markets, unless some decisive steps can be made towards enhancing EU governance and some form of fiscal integration. Thirdly, at the more micro level, although financing needs will increase for all businesses, bank financing (partly supported by State guarantees) will presumably be given the priority, as the most accessible source of financing in the short-term.

There may be a temptation to de-prioritize CMU in this context, but this would be a mistake, because some issues such as the funding of innovative and growing SMEs that are not adequately served by banks or the need to provide savers with investment solutions delivering higher returns in the long term will remain crucial (despite questions that the recent equity market crash may raise). In addition the need to rebalance debt with longer term equity funding and investment will become even more important in an environment where debt levels will have significantly increased. The Covid-19 crisis may however justify in the short term a clearer focus on these latter priorities, as well as on trends such as digitalisation and sustainable finance that remain relevant in this crisis - rather than on the realisation of a fully integrated EU capital market or on broader objectives related to the strengthening of the role of the euro.

<sup>7</sup> 1) the financing of businesses: (i) fostering single pan-European access by investors to comparable company data; (ii) widening capital supply for businesses through adequate long-term investment vehicles; (iii) increasing the risk appetite of institutional investors; (iv) facilitating the listing of companies; (v) strengthening the range of tools available to financial intermediaries including securitisation. 2) the strengthening of market infrastructure with (i) a better integration and efficiency of trading and post-trading and (ii) measures for improving the liquidity of secondary markets. 3) retail investment with (i) measures to provide adequate occupational and personal pension products and (ii) measures to improve financial literacy, equity culture and access to high-quality advice. 4) cross-cutting issues requiring further work: (i) tax related obstacles to cross-border investment notably concerning withholding tax; (ii) the legal certainty of outcomes notably concerning national insolvency proceedings and (iii) the convergence of supervisory outcomes across Europe in order to remove regulatory arbitrage. Some other cross-cutting issues were identified relating to financial innovation, the transition towards sustainable investment and possible synergies between public and private instruments.

<sup>8</sup> In particular for certain financial services linked to derivatives markets and investment banking activities. For example, between 2012 and 2018, almost half of all debt and equity issuance for euro area non-financial corporations was carried out by global banks based in London. Almost 90% of all over-the-counter (OTC) derivatives positions taken by euro area institutions were cleared at UK global clearing houses in December 2019. In August last year, over a quarter of uncleared OTC derivatives held by euro area institutions were sourced from the United Kingdom. In some cases, the City represents a gateway to global financial markets for euro area financial and non-financial firms, allowing them to tap into global capital and liquidity pools. The growth of non-bank financing in the euro area is also driven mostly by entities based in the UK. In other areas, however, reliance on London is quite limited. For instance, UK-domiciled banks only play a marginal role in direct lending to euro area households and non-financial companies. (Source L. de Guindos, ECB speech January 2020).

<sup>9</sup> Equivalence regimes exist for financial services related to securities and derivatives transactions (MiFID, EMIR, CSDR, SFTR) and for services and products targeting professional customers and eligible counterparties (investment services under MiFIR, AIFMD) and reinsurance activities. There is also an EU equivalence regime for credit rating agencies and financial benchmarks. However, most core banking and financial activities are not subject to an equivalence regime providing access to the single market. This includes deposit-taking and lending in accordance with the Capital Requirements Directive; payment services in accordance with the Payment Services Directive; and investment services for retail clients. In addition there is no third-country regime for investment funds targeting retail clients (UCITS and AIFs) and most insurance activities except reinsurance.

<sup>10</sup> The transition period is due to end in December 2020, unless it is extended because of the Covid-19 crisis

<sup>11</sup> For example a sizeable fraction of asset management firms and insurance companies that are relocating activities from the UK as a result of Brexit have moved to either Ireland or Luxembourg and the Netherlands is attracting a substantial amount of trading platforms, exchanges and fintech companies.

## ANNEX 1

**EU capital markets remain under-developed and fragmented despite recent progress in non-bank funding**

Capital markets, particularly related to tradable instruments, have not significantly developed across the EU over the last few years and still lack liquidity and depth from a global standpoint.

The EU-27 average stock market capitalisation is still much lower than that of the US and UK (58% of GDP in EU-27 with many countries having practically inexistent capital markets, compared to 115% in the UK and close to 150% in the US)<sup>12</sup> and the share of listed securities remains limited in the funding structure of EU non-financial companies (28% compared to 47% in the UK and 69% in the US)<sup>13</sup>.

There are however some positive evolutions in terms of funding diversification outside the banking sector, with for example a significant growth of financing provided by non-banks to companies in the EU through the purchase of debt securities, a significant part of which however originates from London<sup>14</sup>. In addition there are no major funding problems in the EU for businesses, except for innovative and growing SMEs that may not have access to sufficient venture capital in the EU or may be rationed out of funding because of a lack of tangible collateral such as machinery or a plant that banks usually require.

On the investor side, issues are two-fold. The share of savings held in shares or investment funds by EU households is limited<sup>15</sup> and only a small proportion of households invest in capital market instruments<sup>16</sup>. As for EU institutional investors, many of them continue to invest predominantly in assets outside the EU in search of yield<sup>17</sup>.

EU capital markets are also still highly fragmented, with a persistent home bias in investments<sup>18</sup>, and cross-border capital flows have not recovered pre-2008 crisis levels. The market infrastructure also remains fragmented<sup>19</sup>, although efforts have been made to unify regulation and lift the Giovannini cross-border barriers with the European Post-Trading Forum (EPTF) group. This notably leads to differences in the cost of funding and in the access to capital market instruments (e.g. venture capital) across EU Member States<sup>20</sup>.

<sup>12</sup> Source The EU Capital Markets Union : Turning the tide – S&P Global – February 2020

<sup>13</sup> Source IMF staff discussion note “A Capital Market Union for Europe” September 2019.

<sup>14</sup> The balance between banks and non-bank financial institutions in the EU has been evolving in recent years: although still very much bank-based, our economy is increasingly financed by non-bank institutions. In the euro area, total assets held by non-banks have almost doubled over the last ten years, growing from €23 trillion in 2008 to €45 trillion in June 2019. Non-banks currently account for around 55% of the euro area financial sector. Their fast growth reflects their expanding role in financing the euro area real economy. Whereas in 2008 non-banks accounted for 14% of the euro area financial sector's loans to non-financial corporations, that share roughly doubled in a decade. Non-banks provide a steady net flow of financing to non-financial corporations through the purchase of debt securities. (Source L. de Guindos, ECB speech January 2020).

<sup>15</sup> Cash and bank deposits amount to 30% of the total assets of EU households, compared to 12.3% in the US and equity and debt securities represent 21% of total savings in Europe, compared to 41% in the US (End 2017 - Source CEPS – Rebranding Capital Markets Union – June 2019)

<sup>16</sup> Moreover only 20% of euro area households hold stocks or investment fund units, and only 1/3 invest in voluntary pension and insurance schemes (Source IMF staff discussion note “A Capital Market Union for Europe” September 2019).

<sup>17</sup> Source The EU Capital Markets Union : Turning the tide – S&P Global – February 2020

<sup>18</sup> Almost half of EU insurers' equity holdings are in firms based in the insurer's home country, rising to 60% in Spain, 70-75% in Germany, the NL and Austria, and 80% in France. The pattern for debt holdings is similar. For pension funds equity home bias is highest in France, Portugal and Spain. (Source IMF staff discussion paper referenced further up)

<sup>19</sup> with 25 exchanges, 17 clearing houses and 19 central securities depositories across the EU

<sup>20</sup> The IMF paper referenced further up shows that typical non-financial companies in Spain for example will pay 60 bp more on debt funding than its peers in Germany and 40 bp more in Italy.

# Enhancing transparency in EU securities markets

## 1. Assessments underway regarding MiFID II / MiFIR transparency measures

Improving the transparency of equity and non-equity markets is one of the key objectives of MiFID II / MiFIR. Transparency is considered as a key driver of the efficiency and integrity of equity and non-equity markets and also of its resilience in times of stress, in a context where the number of venues and venue types has significantly increased in the EU. Appropriate trading data supports price formation processes, which are essential for informing investor decisions and allowing an efficient allocation of assets. Transparency also helps to narrow bid-ask spreads and enhances liquidity. Furthermore, appropriate post-trade market data is essential for market participants to comply with MiFID II provisions such as best execution.

MiFID II and MiFIR mandate that ESMA should submit a report on the impact of the transparency obligations put in place since 2018, as an input to the upcoming review of these legislations by the European Commission (EC). ESMA is currently leading several consultations, aiming to assess how transparency has evolved in EU securities and derivative markets and whether MiFID II / MiFIR provisions need adjusting or completing. The implications of Brexit in this area also need to be considered, since many of the requirements and thresholds in the current framework (including the double volume cap<sup>1</sup> (DVC) or requirements applying to systematic internalisers<sup>2</sup> (SIs)) were calibrated to include UK data. ESMA's objective is to send final recommendations to the Commission in Q3 2020. One general improvement that has been observed, is that MiFID II / MiFIR have enabled to improve the data at the disposal of the public authorities to monitor market developments.

Regarding equity instruments and other related instruments such as ETFs, ESMA published in December 2019 a report on the development in prices for pre- and post-trade data and on the objective of setting up a consolidated tape for equity and launched a consultation in January 2020 on MiFID II / MiFIR transparency measures for equity and equity-like instruments<sup>3</sup>. For non-equity instruments a first consultation was launched in January 2020 on SIs (systematic internalisers) in non-equity instruments<sup>4</sup>.

A second consultation paper on the transparency regime for non-equity instruments and the trading obligation for derivatives was also published in March 2020<sup>5</sup>. In these consultation papers ESMA assesses the impacts of MiFID II / MiFIR so far in terms of transparency and proposes a certain number of recalibrations or amendments to the existing requirements.

## 2. Equity and equity-like instruments: issues under review and proposals

### 2.1. Transparency regime of equity instruments

MiFIR mandates ESMA to submit a report on the impact of the newly established pre-trade transparency obligations and waivers of MiFIR and in particular the double volume cap<sup>6</sup> (DVC) for equities and equity-like instruments. ESMA has decided to broaden the assessment and include other key transparency provisions such as the share trading obligation and the transparency provisions applicable to SIs. The objective of the review is indeed to simplify the current complex trade reporting regime while trying to improve the overall trade transparency available to market participants. Initial assessments generally show that MiFIR requirements are complex and have not yet achieved their objectives.

ESMA's data analysis since 2018 has revealed that a significant margin for improvement remains in many areas:

- There has not been a significant change in the share of trading volume executed OTC for equity and equity-like instruments, which still represents around 1/3 of the overall volume
- A majority of trading is not subject to pre-trade transparency (between 50 and 70% of trading in turnover). This includes on-venue execution for which a large share of the total turnover is traded under pre-trade transparency waivers (approximately 30% of turnover for shares and 50% for ETFs<sup>7</sup>)
- The use of waivers from pre-trade transparency has changed due to the application of the double volume cap (DVC), which limits the amount of trading under the reference price (RP) and negotiated transaction (NT) waivers<sup>8</sup>, resulting in a significant increase in the percentage of trading under the LIS waiver (+56%)<sup>9</sup>.

<sup>1</sup> The purpose of the DVC is to ensure that the use of certain waivers does not unduly harm price formation by limiting the trading under the RP waiver and the NT waiver for liquid instruments. In particular, Article 5 of MiFIR provides that the trading volume under the waivers against the total volume traded on EU trading venues over the last 12 months for a specific instrument should not be higher than 4% at the level of a single trading venue, or higher than 8% for all the venues combined. In such cases NCAs have to suspend the use of the authorised waivers for the relevant instruments for a period of 6 months.

<sup>2</sup> SIs, as defined in MiFID II, are investment firms which on an organised, frequent, systematic and substantial basis, deal on own account when executing client orders outside a trading venue (i.e. a regulated market, a multilateral trading facility or an organised trading facility) without operating a multilateral system. In other words, a SI is an investment firm which is a counterparty dealing with its proprietary capital and is not a trading venue.

<sup>3</sup> With a deadline for feedback postponed to 14 April 2020.

<sup>4</sup> Deadline for feedback 14 April.

<sup>5</sup> With a deadline for feedback postponed to 14 June 2020.

<sup>6</sup> The purpose of the DVC is to ensure that the use of certain waivers does not unduly harm price formation by limiting the trading under the RP waiver and the NT waiver for liquid instruments. In particular, Article 5 of MiFIR provides that the trading volume under the waivers against the total volume traded on EU trading venues over the last 12 months for a specific instrument should not be higher than 4% at the level of a single trading venue, or higher than 8% for all the venues combined. In such cases NCAs have to suspend the use of the authorised waivers for the relevant instruments for a period of 6 months.

<sup>7</sup> See Eurofi Views Magazine article – V. Ross “Less complexity, more transparency” – April 2020.

<sup>8</sup> The reference price (RP) waiver: for systems that match orders based on a trading methodology by which the price of the financial instrument referred is derived from the trading venue where that financial instrument was first admitted to trading or the most relevant market in terms of liquidity. Negotiated transactions (NT) are made within the current volume weighted spread reflected on the order book or the quotes of the market makers of the trading venue operating that system (liquid equity instruments); dealt within a percentage of a suitable reference price (illiquid equity instruments); or, subject to conditions other than the current market price of that financial instrument.

<sup>9</sup> The LIS waiver is for orders that are large in scale compared with normal market size and aims to protect investors from market impact.

ESMA proposes to reduce the complexity of the regime and further clarify it:

- The DVC mechanism – if maintained, ESMA is proposing to simplify the DVC regime, using a single cap (e.g. eliminating the 4% threshold concerning the use of waivers at a single trading venue) and the applicable liquidity tests and also to apply DVC in a wider and stricter way to further curb dark trading (e.g. applying thresholds even if there is not a period of 12 months of available data);
- Pre-trade transparency and waivers – to address the ongoing high volume of dark trading ESMA proposes to either reduce the number of waivers available to market participants (suppressing the RP and NT waivers) or to make the use of waivers, notably the RP waiver, subject to stricter requirements in terms of size (on the grounds that there seems to be little justification for trading small orders via reference price facilities and there may be scope for increasing the LIS threshold);
- The trading obligation for shares – ESMA is proposing to clarify the scope of the trading obligation specifically in relation to third-country shares (i.e. those for which the main pool of liquidity is located outside the EU), given the current challenges in this area (i.e. the low liquidity of these shares on EU exchanges, the overlap with equivalent trading obligations applicable in third countries and the difficulty of implementing an equivalence regime in this area).

## 2.2. Prices of pre-and post-trade transparency data for equity and equity-like instruments

MiFID II / MiFIR provide obligations to make pre and post-trade data available separately, on a reasonable commercial basis (RCB)<sup>10</sup>, to ensure non-discriminatory access to that data and to make it available free of charge 15 minutes after publication and also an obligation for systematic internalisers (SI) to make quotes public to other market participants on a RCB.

Following a consultation led during the second semester of 2019 notably on the variation of data prices, ESMA considered that the input provided by market participants shows that MiFID II has so far not delivered on its objective to reduce the price of market data. In their replies to the ESMA consultation, data users generally considered that market data prices have on the contrary increased significantly since the application of MiFID II / MiFIR, albeit with some variations across trading venues, based on observations of costs paid by individual companies. These increases concern notably the price of data for non-display usage or data used by SIs and are also due to the introduction of fees for some services that were previously provided free of charge. Data providers such as trading venues and approved publication arrangements<sup>11</sup> (APA) disagreed with these observations, arguing that the overall prices of market data have been stable since the application of MiFID II / MiFIR. According to them, while the price of some services has increased (e.g. data for non-display usage), others have gone down and the application of disaggregated prices means that users can select the data they purchase.

A second question was whether market data is provided on a reasonable commercial basis (RCB). When considering how RCB

could be enforced, ESMA advised on choosing a “transparency-plus” approach aiming to enhance the public transparency of the policies related to pricing and market data<sup>12</sup>, rather than other possible systems such as imposing a revenue share limitation or applying a cost-plus methodology. Evidence gathered during the consultation showed that while trade information is generally made available with respect to the RCB provisions, data users feel that there are significant shortcomings regarding the quality, comparability and usability of the information provided and the current RCB information provided does not enable users to understand how data prices are set or to compare the information provided. This has led ESMA to propose measures to improve the current “transparency-plus” approach: development of standards to further specify RCB requirements<sup>13</sup>, move to Level 1 of the requirement that market data should be provided on the basis of costs<sup>14</sup> and additional requirements for venues and APAs to share information on the actual costs for producing and disseminating market data. These assessments and proposals were however not supported by regulated markets who consider that much progress has been made towards delivering good quality information and that further significant clarifications are not needed.

A third issue covered during the ESMA consultation was the MiFIR provision on data disaggregation aiming at ensuring that users only pay for data they are interested in, rather than being forced to buy bundled data. So far only limited demand has appeared for data disaggregation, which has not contributed to reducing the cost of market data so far, according to the feedback generally received. ESMA however considered that further guidance on the provision of market data on an RCB basis combined with a stronger focus on the enforcement of data disaggregation requirements should address these concerns.

Finally the ESMA consultation noted some improvements in terms of access to data regarding the MiFID II / MiFIR objective of making data available free of charge 15 minutes after publication by the trading venues and APAs. However, data users complain that data is often not provided in a user-friendly way or in a machine-readable format and also that accessing it may require agreeing to restrictive terms of use. Trading venues and APAs for their part disagree with the requirement to provide data free of charge to all users, notably commercial users who may be competing with the business of venues. At this stage ESMA recommended clarifying in legislation the obligation for trading venues to provide market data in easily accessible and usable formats in order to remove any doubt about this requirement.

## 2.3. Implementation of an EU wide consolidated tape for equity and equity-like instruments

MiFID II sets out the regulatory framework for DRSPs (Data Reporting Service Providers), which include APAs (Approved Publication Arrangements) and CTPs (Consolidated Tape Providers). CTPs are entities authorized to collect post-trade reports for equity and non-equity financial instruments and consolidate them in a continuous electronic live data stream (the CT) providing price and volume data per financial instrument. The objective of a CT is to contribute to remedying the fragmentation of markets by providing a reliable view of liquidity and trading data across the EU;

<sup>10</sup> The RCB concept requires that prices for market data should be fair and non-discriminatory i.e. prices should be based on costs of producing and disseminating data including a “reasonable” margin and should be charged according to the use made by the individual end-user, data should be offered on a non-discriminatory basis to all clients and should be available without being bundled with other services.

<sup>11</sup> Approved Publication Arrangements (APAs) are entities created by MiFID II / MiFIR responsible for publishing details of executed trades to the market on behalf of firms as close to real time as possible, on a reasonable commercial basis. The data should be made available free of charge 15 minutes after publication. APAs must disseminate information in a manner that ensures fast market-wide access on a non-discriminatory basis. They must also check a firm’s trade messages for accuracy and completeness (requesting the resubmission of any identified erroneous messages).

<sup>12</sup> The objective of this solution is to provide more information on the pricing of market data, which should enable data users and supervisors to effectively compare the offerings, spot best practices as well as monitor compliance.

<sup>13</sup> Standardised publication format to be used by all providers, standardization of the key terminology used.

<sup>14</sup> And delete articles allowing trading venues and APAs to charge for market data proportionate to the value it represents to users.



support the creation of a single market for equity trading; ensure the provision of real-time data at a fair cost and help to establish a level playing field among users of data; and supplement best execution policies notably for retail investors.

While MiFID II defines the requirements applicable to CTPs, potentially established on a commercial and voluntary basis, it does not mandate the establishment of a CT in the EU and does not oblige trading venues and APAs to submit transaction data to a CTP for consolidation, as is the case in the US. MiFID II nevertheless indicates that a CT for equity and equity-like instruments may be appointed through a public procurement process if the initial commercial solution does not lead to an effective and comprehensive CT. Nearly two years following the application of MiFID II a CTP for equities is yet to emerge. While post-trade information is available from trading venues and APAs and also offered by data vendors, there is currently no data source consolidating 100% of the market.

The main obstacles to the implementation of a CT identified by ESMA are: the limited commercial rewards for operating an equity CT; strict regulatory requirements for providing an equity CT; competition by non-regulated entities such as data vendors; and the lack of sufficient data quality in particular for OTC and SI-transactions. In their input to the consultation some market stakeholders also highlighted significant shortcomings associated with a CT (such as the negative cost/benefit of setting up a CT, the lack of funding of the project) and pre-requisites (e.g. improvement of the quality and consistency of data notably for non-trading venues such as SIs and OTC). The difficulty and cost of implementing a real-time CT was also stressed due to the challenge of consolidating data feeds provided by about 170 trading venues in the EU.

Following the consultation, ESMA nevertheless recommended the implementation of a real-time CT for equity instruments, while recognizing that this would be a complex and long process that may take at least 5 years to go live. Several key factors of success to the implementation of a CT were identified, as well as conditions including a further specification of requirements that would require Level 1 amendments and Level 2 measures in most cases, in addition to supervisory guidance (e.g. concerning the area of data quality):

- A high level of data quality;
- Mandatory contribution of post-trade data to the CT by trading venues and APAs free of charge;
- Contribution of the users to funding of the CT e.g. via mandatory consumption and possibly with a proportionate fee key depending on the extent of consumption;
- Full coverage with a CT consolidating 100% of transactions across all equity and equity-like instruments, except in certain pre-specified conditions;
- Publication in real-time;
- Operation of the CT on an exclusive basis providing the most cost efficient solution. ESMA recommended the appointment of the provider for 5 to 7 years following a structured and fully competitive appointment process;
- Strong governance framework in order to ensure the neutrality of the CTP, a high level of transparency and accountability and provisions ensuring the continuity of service.

In addition some stakeholders have questioned the scope of the CT: whether it should include pre-trade as well as post-trade data<sup>15</sup> and

whether the project of developing a CT for non-equities (and notably bonds) should be conducted in parallel with the equity CT, rather than sequentially, given that it may not be suitable to use the equity CT as a template for a bond or derivative CT<sup>16</sup>. MiFID II indeed provides an additional 21 month delay for the implementation of a non-equity CT, recognizing the greater difficulty of establishing it. The parallel is often made with the US also, where post-trade consolidated tapes exist in each of the corporate bond, municipal bond, mortgage-backed securities, and OTC derivatives markets. These CTs are each comprehensive, require mandatory contribution, disseminate information immediately upon receipt (both freely to the public via websites and via real-time data feeds at a reasonable cost), and feature targeted and limited deferral regimes for larger size block trades.

#### 2.4. Review of the SI regime for equities and equity-like instruments

ESMA is also consulting on the review of the SI regime for equities. The objective of this review is to address concerns about the SI regime and perceived lower transparency requirements compared to other venues.

The number of SIs and their share of equity trading has significantly grown since the implementation of MiFID II / MiFIR with above 70 SIs operating in the EU and a share of turnover between 20 and 25%. ESMA's assessments show that most of SI trading is not subject to pre-trade transparency requirements for two main reasons: the absence of requirements for illiquid instruments (which represent the vast majority of shares<sup>17</sup>) and transparency requirements only apply to transactions below the standard market size (SMS), which is equal to 10,000€ for most shares<sup>18</sup>. ESMA proposes an increase of minimum quoting obligations related to SMS subject to pre-trade transparency, a revised methodology for determining quoting sizes and/or an extension of the SI obligations to illiquid instruments.

#### 3. Non-equities: issues under review and proposals

In response to the financial crisis and the weaknesses identified regarding the provision of information on non-equity transactions and positions to market participants, MiFIR and MiFID II introduced a pre-trade and a post-trade trade transparency regime for non-equity instruments (bonds, structured finance products, emission allowances and derivatives). MiFID II / MiFIR also introduced a new trading venue category of OTFs (Organised Trading Facilities), that complements regulated markets and Multilateral Trading Facilities (MTFs) for non-equity trading with the purpose of having more non-equity trading taking place on trading venues and therefore being subject to pre-trade transparency.

In line with MiFIR review requirements, ESMA has undertaken a technical review of the effects of the MiFIR transparency regime for non-equity instruments since January 2018 with the aim of (i) assessing whether the provisions have delivered on their objectives and (ii) where possible, proposing legislative amendments to ensure a more effective application of the rules while simplifying a regime that has proved to be rather complex to apply and supervise in practice.

According to ESMA, these assessments show that generally the level of pre and post-trade transparency for non-equity transactions remains limited, which means that one of the main objectives of MiFIR following the G20 commitments is not yet fulfilled. This is due in part to market structures but also to the way the MiFIR transparency

<sup>15</sup> Some have pointed out that pre- and post-trade data may correspond to different needs i.e. trading information for the former and mainly compliance on best execution for the latter

<sup>16</sup> While equity and bond markets share a few challenges such as the fragmentation of infrastructure and an unlevel playing field in the access to data, the bond and equity market ecosystems are largely different. The drivers of a CT in these markets also differ due to differing market structures (e.g. the presence of equity exchanges). A CT for equities addresses speed and the prevention of arbitrage opportunities, while in fixed income a CT would provide transparency and an overview of the market. Source ICMA Quarterly review – October 2019.

<sup>17</sup> The latest transparency calculations resulted in just over 1,500 liquid shares in the EU and over 20,000 illiquid instruments

<sup>18</sup> MiFIR requires SIs to comply with pre-trade transparency requirements when dealing in sizes up to the SMS and to make public quotes for sizes of at least 10% of the SMS for equity instruments for which they are SIs. Statistics gathered by ESMA show that 70% of shares have a SMS equal to 10,000€.



provisions are designed, which results in the exemption through waivers and deferrals of many OTC derivatives from the MiFIR transparency and transaction reporting requirements.

### 3.1. Pre-trade transparency of non-equity transactions

According to ESMA's assessments, the overall level of pre-trade transparency appears to be limited due to the high share of financial instruments benefitting from a waiver, in particular the illiquidity (ILQ) waiver<sup>19</sup>, which means that real time transparency is the exception rather than the norm. While most waiver notifications received by ESMA were for large in scale (LIS) waivers, more than 75% of the notional trading volume concluded under a waiver benefitted from an illiquidity waiver. In addition, there is a high proportion of transactions concluded OTC or on SIs (in particular in terms of notional amount, close to 30%). However the situation varies across asset classes. For commodity derivatives or interest rate derivatives for example, a significant amount of trading is executed on trading venues, whereas for other asset classes such as bonds and credit derivatives, the trading activity on trading venues is limited.

In terms of possible improvements, ESMA mentions several options in its consultation paper that need to be further assessed. One is deleting the SSTI (size specific to the financial instrument) waiver, which is only marginally used (6% of waiver requests) and lowering the pre-trade LIS threshold in order to simplify the pre-trade transparency regime. A second option is clarifying the use of the hedging exemption, mainly used for commodity derivatives. A third proposal relates to the calibration of pre-trading requirements applying to different types of trading venues. A fourth improvement area concerns the quality, consistency and completeness of the pre-trade transparency information published, which varies significantly across venues and the availability of real-time data on an RCB basis which is not always ensured.

### 3.2. Post-trade transparency of non-equity transactions

The overall level of real-time post-trade transparency also appears to be very limited according to ESMA<sup>20</sup>, due in particular to the available deferral options used notably for bonds and illiquid instruments and also the complexity of the deferral regime that is subject to national discretion. ESMA's assessments show that an excessive amount of transactions benefit from waivers and the 4-week deferral period from public reporting which is relatively frequently used<sup>21</sup> means that the information provided is of very limited use. The reporting environment is also very fragmented and complex with more than 279 trading venues and APAs operating in the EU, which hinders the emergence of a consolidated tape provider (CTP) for non-equity transactions, due to the high cost of implementation with different rules and post-trade transparency regimes across the EU. Moreover some market participants stress that in many cases post-trade transparency data is not published free of charge 15 minutes after, as is required.

ESMA therefore proposes in its consultation paper that more real-time post-trade transparency should be made available to enhance competition among market participants, reduce asymmetries of information and deliver high quality information to market users.

A first option would be to simplify waivers, deleting the SSTI concept for the deferral regime (as for pre-trade requirements) and lowering the post-trade LIS threshold, possibly to different levels depending on the asset class. This would leave two main waivers for real-time publication: LIS and illiquid instruments. In addition, ESMA proposes to create one single regime for post-trade deferrals across the EU, removing the current discretionary regime, in order to avoid the current patchwork of rules. This new regime would require that for transactions benefitting from the LIS or the illiquidity waiver, post-trade information would be published as close to real time as possible but with the volume being masked.

In order to increase the transparency of OTC derivative transactions, ESMA is also assessing how transparency requirements may apply to derivative contracts traded OTC but that share many characteristics with those traded on trading venues such as MTFs or OTFs, either using a broader approach to the present concept of TOTV<sup>22</sup> (traded on a trading venue, which currently means that MiFIR transparency requirements apply to instruments that are traded on-venue), or abandoning the concept of TOTV, which would mean that any OTC-derivative would be subject to post-trade transparency and transaction reporting, whether executed on-venue or OTC. This second option would be closer to the situation in the US where real-time reporting and public dissemination requirements apply to all publicly reportable swap transactions (interest rate, credit, equity, foreign exchange, and other commodity), including swaps executed on-venue as well as OTC. Finally ESMA proposes removing the possibility for a National Competent Authority (NCA) to temporarily suspend transparency obligations where the liquidity of a class of financial instruments falls below a certain threshold, which has never been used so far, or alternatively to put in place a mechanism whereby the suspension would apply across the EU temporarily, if a threshold is met.

### 3.3. Monitoring of the application of pre-trade transparency obligations to SIs for non-equities

SIs are subject to the obligation to make firm quotes public under certain conditions for equity and non-equity instruments. While for equity instruments this obligation is specified in MiFIR delegated acts, there are no equivalent Level 2 measures for non-equity instruments. ESMA and the NCAs are however responsible for monitoring the application of these pre-trade transparency obligations<sup>23</sup>. The focus of the monitoring is on the sizes at which quotes are made available to clients of an investment firm and to other market participants relative to other trading activity of the firm, and the degree to which the quotes reflect prevailing market conditions. Based on this monitoring, ESMA is due to submit a report to the European Commission by July 2020.

In its preliminary recommendations, ESMA proposes several measures aiming to improve the effectiveness of SI requirements and their consistent application. These include simplifying certain requirements for SI quotes in liquid and illiquid instruments, clarifying the definition of exceptional market circumstances under which SIs may withdraw quotes and further specifying the content and format of pre-trade transparency information that should be made public.

<sup>19</sup> The non-equity transparency regime allows Competent Authorities to waive the obligation for trading venues to make pre-trade information public in certain instances including: Illiquidity (instruments which are not deemed to have a liquid market by ESMA); LIS (orders that are large in scale compared with normal market size); SSTI (actionable indications of interest in request-for-quote and voice trading systems that are above a size specific to the financial instrument, which would expose liquidity providers to undue risk and takes into account whether the relevant market participants are retail or wholesale investors); OMF (orders in an orders management facility of a trading venue pending disclosure as per MiFIR Article 9(1a), such as iceberg orders); Package orders (specific orders that meet certain conditions).

<sup>20</sup> It is estimated that approximately only 5% of off-venue trading activity in OTC derivatives is currently subject to post-trade transparency requirements.

<sup>21</sup> This is mainly due to inaccurate liquidity assessments or excessively low size thresholds for trade deferrals – see article by S. Berger, Citadel in Eurofi Views Magazine – April 2020.

<sup>22</sup> The concept of 'traded on a trading venue (TOTV)' applies to a number of provisions in MiFID II and MiFIR, and in particular the pre- and post-trade transparency requirements for trading venues and investment firms (including SIs) trading OTC, the obligations to report transaction data and the requirement to submit reference data. MiFIR does not provide for a definition of TOTV.

<sup>23</sup> MiFIR SI pre-trade transparency requirements for non-equities differ substantially from those to be met by SIs in respect of equity instruments. Investment firms have to make public firm quotes in respect of non-equity instruments traded on a trading venue for which they are SIs and for which there is a liquid market when they are prompted for a quote by the client of the systematic internaliser; and they agree to provide a quote. When the non-equity instrument does not have a liquid market, SIs are required to disclose quotes to their clients on request if they agree to provide a quote, unless the SI can benefit from a waiver for this obligation.

# Relaunching securitisation in the EU

## EXECUTIVE SUMMARY

- Securitisation is a financial technique which allows lenders to refinance their loans in the capital markets by turning them into securities.<sup>1</sup>
- Securitisation, well executed, has a number of advantages:
  - Allowing non-bank capital market investors (eg insurance companies and pension funds) to invest directly in sectors of the economy otherwise closed to them;
  - Creating very safe bonds in which risk averse capital market investors can invest their money for the benefit of their stakeholders;
  - Allowing banks and other financial institutions to manage risk and capital on their balance sheet thus contributing to financial resilience.
- In 2019, the STS Securitisation reforms came into force in Europe. They were designed to implement the lessons of the crisis of 2007/2008 in penalising opaque and badly structured securitisations whilst recognising safe one.
- To recognise safe and socially useful securitisations, the STS Regulation created the most detailed and comprehensive securitisation standard in the world – the STS standard.
- Despite the STS Reforms, the European securitisation market (€106bn in 2019) is stagnating at a minimal level.
- A strong and large European securitisation market is vital for the future of the continent. It is needed:
  - To prevent the new Basel rules from contracting available finance for the economy.
  - To power the Capital Markets Union and reduce Europe's dependence on banks.
  - To assist in funding Europe's green ambitions.
- For these to occur, an increase of €235bn in annual issuance would be the smallest meaningful amount.
- A number of key measures need to be taken to make this a reality. These measures are no more, in most cases, than the completion of the STS reforms. They involve drawing the logical conclusions from the creation of such a comprehensive standard into attendant legislation (i.e. incorporate in capital requirement's formulae e.g. floors, p factor, etc., the removal by the STS framework of all the former causes of non-neutrality, the elimination of agency risks and eventually acknowledge the actual performance through the crisis, of EU securitisations, which would have met the STS standards had it then been in existence, that have were never), as well as the equally logical extension of this standard to similar financial tools (synthetic securitisations).
- In practice this would mean
  - Rectifying the CRR and Solvency II capital calibrations.
  - Amending appropriately the LCR eligibility criteria.
  - Extending the STS standard and its benefits to synthetic securitisations.
  - Introducing a simple, streamlined and workable regime for significant credit risk transfer.

## Introduction

Securitisation is a financial tool whereby a lender (usually a bank but sometimes an non-bank finance house or a non-financial corporation) is able to refinance a pool of loans by turning them into securities and placing these with capital market investors.

There are a number of advantages to securitisation. One is that the investors can take the risk of the assets themselves (e.g. residential mortgages, consumer loans) without taking the risk of the financial institution which originated them. It is a way for capital market investors to invest into direct lending to the economy which would not otherwise be open to them.

Another advantage is that securitisation includes "tranching" where the risk of the securitised assets is bundled into tranches of risk which are more or less risky. Any losses on the securitised assets are first taken by the most junior tranches whereas the investors in the senior tranches are only at risk if losses are greater than a pre-set amount. Properly executed, this enables the creation of very safe bonds and the allocation of different risks to different types of capital market investors depending on their risk appetite.

A further advantage of securitisation is turning illiquid bank type assets into liquid capital market instruments, thereby providing attractive investment opportunities to pension funds, insurance companies and other funds.

Finally, if the securitisation meets certain rules, it allows banks to rebalance their balance sheet by removing risk and freeing up their capital for new lending to the economy.

However, despite the positive potential of securitisation, one of the clearest triggers of the financial crisis of 2007/2008 was the devastation inflicted on the world's financial system by opaque and badly structured securitisation products coming out of the United States. During the first phase of crisis management, the reaction of most European public institutions towards securitisation generally was extremely negative and the regulatory measures proposed for dealing with this finance tool were punitive.

However, as the management of the crisis progressed, data emerged that began to inflect policy makers' views.

First, European securitisations in the basic and simplest asset classes displayed spectacularly good credit performance through the severe economic downturn triggered by both GFC and the subsequent Eurozone crisis. To this day, twelve years on, AAA to single-A rated senior tranches of traditional asset class securitisations in Europe have still not suffered a single euro of loss. This includes securitisations in what became at times highly stressed economies such as Spain, Greece and Italy. It became clear that properly structured transparent securitisations, such as Europe had been issuing, were a safe and resilient financing tool.

<sup>1</sup> For a very basic introduction to securitisation please see PCS' "Basic Overview" ([https://pcsmarket.org/wp-content/uploads/publications/5f1b5/Basic\\_Overview\\_.pdf](https://pcsmarket.org/wp-content/uploads/publications/5f1b5/Basic_Overview_.pdf)) and the European Commission's press release ([https://ec.europa.eu/commission/presscorner/detail/en/MEMO\\_15\\_5733](https://ec.europa.eu/commission/presscorner/detail/en/MEMO_15_5733)).

Secondly, institutions such as the European Central Bank, the Bank of England and the European Banking Authority began to point out that well-structured securitisations could play a very positive role in shifting risk in the financial system in systemically positive ways<sup>2</sup>. Good securitisation could play a role in increasing banking resilience.

Thirdly, a key lesson of the crisis was that Europe was too dependent on banks to finance its economy and it was therefore vital, to ensure future stability and protect European citizens from a repeat of the 2011/2012 crisis, to boost the role and size of the capital markets. Hence the Capital Markets Union project.

All this led the Commission in 2014 to seek to create a differentiated regulatory system for securitisations which, grounded in what was learned during the crisis, could define and identify safe, simple and transparent securitisations. This was done with the explicit aim to increase meaningfully the volume of issuance of such instruments. Such increase would allow the reduction of systemic risk in the European banking system whilst, simultaneously increasing the size of the European capital markets – in line with the CMU project – and avoid the reduction in the financing of the economy that could result from additional capital requirements for banks.

The STS Securitisation Regulation<sup>3</sup>, incorporating these policy aims, was passed in December 2017 and came into effect on January 1, 2019, even though some key pieces of secondary legislation did not fall into place until the end of the first quarter of that year.

However, it did not result in the hoped-for increase in issuance. This paper will try to analyse why this may be the case, why this matters and what could be done to improve the situation.

(For obvious reasons, most of the figures and analysis in this paper are from the pre-COVID19 lock down period, so as not to allow the impact of events of an exceptional nature to confuse the analysis. It should also be noted that, so far, the securitisation market is weathering the storm no worse than capital market instruments generally and better than some – including covered bonds – a fact that is relevant, for example, in analysing some proposals in this paper on LCR – as to which more later).

## State of play

### The STS regime

The STS Regulation created a new European framework for securitisation. This regulation was drafted very much with the lessons of the crisis of 2007/2008 in mind and is designed to prevent any repetition of the weaknesses that were displayed in the US securitisation market. In particular, it:

- Banned re-securitisations;
- Mandatorily imposed the most extensive transparency and disclosure requirements in the world
- Codified extensive due diligence requirements which must be complied with by all European investors
- Created new categories capital market actors (data repositories and third party verification agents) designed to increase the robustness of the European securitisation market and subjected them to regulation to ensure their independence and integrity.

- Set up a severe sanctions' regime for any breaches by market participants of the new rules.

Most innovative of all, European policy makers, advised by the European Banking Authority, created a new regulated definition of “simple, transparent and standardised securitisations” (“STS securitisations”). To meet this new and exacting standard, a securitisation must meet each and everyone of 102 separate criteria. These criteria were designed to capture all the aspects of securitisations which had been an issue during the crisis as well as additional elements deemed by regulators and the legislators to be important aspects of safe and transparent securitisations. This standard is the highest, most comprehensive and most demanding regulatory securitisation standard in the world.

All this was designed to restart a strong but also safe and socially useful securitisation market.

### STS is successful, but only on its own terms

Despite misgivings by some stakeholders that the definition of STS securitisations was overcomplex and the Regulation's requirements for data disclosure overburdensome, for securitisations that are able to achieve the standard, it has become the norm.

In 2019, 143 securitisations were notified to ESMA as meeting the STS standard<sup>4</sup>. By 8th April 2020 that number reached 234. Effectively, almost all transactions publicly placed with investors since March 2019 and which may achieve the STS standard have elected to do so<sup>5</sup>.

The STS standard is being used extensively and is therefore a workable standard.

### Securitisation issuance is stagnating

What the STS regulation has not been able to achieve though is to increase the use of securitisation as a financing channel. Even though this was explicitly the purpose of the Regulation, issuance – in fact – decreased in 2019.

In 2019, issuance of European securitisations placed with investors was €108bn. That is a 10% fall on 2018. In the securitisation of residential mortgages – the backbone of any securitisation market – the numbers are even starker. In the EU27, placed issuance in 2019 fell to €7bn. This is the lowest post-crisis issuance.

Part of that fall was the delay in the passing of key legislative provisions leading to almost no STS securitisation issuance in the first quarter. Disturbances in the sterling market due to Brexit also weighed on UK issuance which is always the largest securitisation jurisdiction in Europe.

If you remove these negative factors though, it would be fair to say that 2019 was a repeat of 2018. With a very few exceptions, in 2019 the same issuers came to market issuing the same transactions as they would have issued if the STS Regulation had not passed. Of new investors there were few signs.

Some of that continues to be the impact of the ECB's monetary policy. But not, by far, all of it. For example, retained securitisation issuance (in other words, securitisations issued solely to be used as collateral for the ECB Eurosystem or the Bank of England's equivalent) in 2019 were down to €97 bn. That is the lowest number in a very long time.

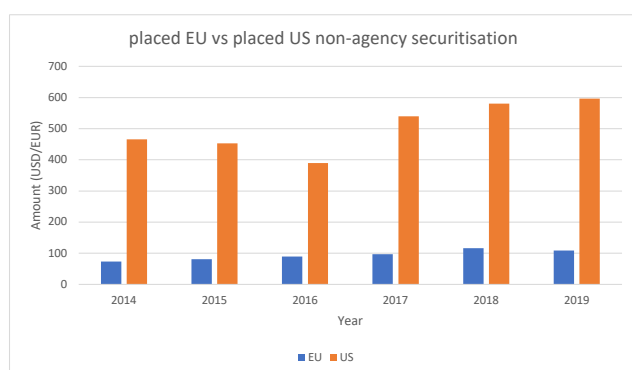
<sup>2</sup> Joint ECB/BoE discussion paper: “the case for a better functioning securitisation in the European Union” (2014) - <https://www.bankofengland.co.uk/-/media/boe/files/news/2014/may/case-for-a-better-functioning-securitisation-market-discussion-paper.pdf?la=en&hash=3AC4F391CB45870260134F53BCB67BEE587CC856> and EBA discussion paper: “Simple, standard and transparent securitisations” (2014) - <https://eba.europa.eu/sites/default/documents/files/documents/10180/846157/ceefdf3f-58ea-452f-a924-2563410d1705/EBA-DP-2014-02%20Discussion%20Paper%20on%20simple%20standard%20and%20transparent%20securitisations.pdf?retry=1>

<sup>3</sup> <https://eur-lex.europa.eu/legal-content/EN/TEXT/PDF/?uri=CELEX:32017R2402&from=enf>.

<sup>4</sup> <https://www.esma.europa.eu/policy-activities/securitisation/simple-transparent-and-standardised-sts-securitisation>

<sup>5</sup> The one area of exception is UK buy-to-let mortgage transactions for highly technical reasons. The number of transactions retained by banks for use as collateral with ECB which are STS is much lower as a result of the ECB not using the standard in its own rules.

Comparisons with earlier years and with the United States are telling.

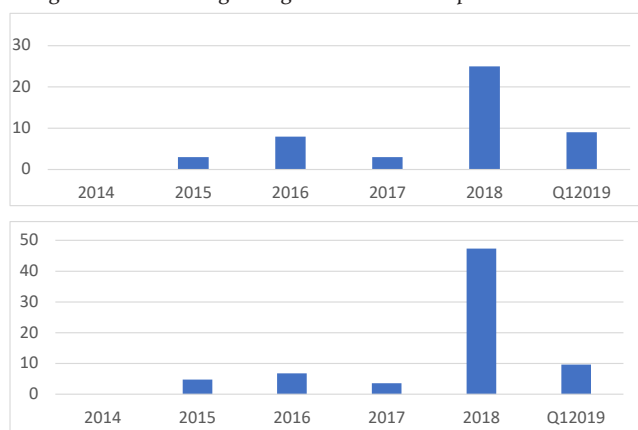


Source: BAML Global Research

### Growing importance of SRT

Another key trend in recent years has been the growing importance of securitisations used by European banks to remove risk from their balance sheet and thus free some capital for further lending. Technically, this may be achieved when a bank demonstrates to its prudential regulator that it has met the “significant risk transfer” rules (or “SRT” rules – so that securitisations that meet these rules are called SRT securitisations).

Very rare until a few years ago, recently released EBA data shows a very notable growth in SRT securitisations<sup>6</sup>. This is unsurprising in light of forthcoming changes to the Basel requirements.



SRT Transactions by number (top) and by EUR volume (bottom)

Source: EBA<sup>7</sup>

### Growing role of synthetic securitisations

One way to achieve SRT securitisations is to issue “synthetic securitisations”. Behind the intimidating name is a fairly simple instrument. Instead of relying on a sale by the financial institution of its assets to a vehicle that issues securitisation bonds, in a synthetic securitisation, the financial institution insures those assets against credit losses. Once properly insured, these assets do not require

capital to be held by the financial institution since, in cases of loss, the loss is covered by the insuring investor.

A key aspect of synthetic securitisations though is that they are, legally, “securitisations” and are therefore subject to the European regulations on securitisations, including the rules on Basel capital requirements. As a result, they are also strongly negatively impacted by the newly introduced capital requirements. This has resulted, in some cases, in transactions which can no longer be made to work as capital freeing tools or, in most other cases, in transactions with much reduced benefits in terms of the amount of capital becoming available for additional lending.

Acknowledging the importance of synthetic securitisations, the co-legislators allowed de facto STS status to certain SME synthetic<sup>8</sup> securitisation and requested the Commission to investigate the extension of the STS category to synthetic securitisations generally<sup>9</sup>.

### Conclusion

**Despite the passing of the STS Regulation, European securitisation is stagnating at historically low levels. This is despite the increased use of securitisation for SRT purposes both via traditional securitisation and synthetic securitisation.**

### We should now examine why this is and why this matters

There are three main reasons why reviving the European securitisation market is urgent and vital for the well-being of the European economy and the fulfilment of Europe's global ambitions.

#### Basel implementation

According to the EBA, the coming implementation of the Basel capital requirements will require European banks to raise their capital by 25% on average and 28.5% for systemically important institutions.<sup>10</sup>

Should European banks merely want to maintain the same level of financing to the economy, these rules will require European banks to “find” €100bn of additional capital.<sup>11</sup> Any additional lending – to fund additional growth or ambitious projects such as those envisaged in the Green Deal – will require even more capital to be raised.

Bank capital can be found in one of two ways. A bank can raise additional cash in the form of shares or other instruments meeting the regulatory definition of capital. A bank can also remove risk from its balance sheet so that capital allocated to that risk is now free to be used for new lending. This is what SRT securitisation can do.

Raising new cash for capital in a minimum amount of €100bn – just to stand still – when banks' profitability is stagnating or falling is a challenge containing many uncertainties and risks for the European economy. There are good reasons to doubt that it is even feasible.

Therefore, European banks will either have to sell assets or securitise them. And the sale of assets itself will require the assistance of a healthy securitisation market to succeed as many of the funds that buy assets outright themselves fund these purchases in the securitisation market.

To give a sense of the size of the challenge, if we assume that half of the capital EU-27 bank increase is due to residential mortgages and half of that increase is addressed via securitisation, then we

<sup>6</sup> See page 22 of the EBA's Discussion Paper.

<sup>7</sup> <https://eba.europa.eu/sites/default/documents/files/documents/10180/2963923/67358bc9-921d-49ec-86b6-144e90fa97b3/EBA%20Discussion%20Paper%20on%20STS%20synthetic%20securitisation.pdf?retry=1>

<sup>8</sup> Article 270 of the Capital Requirements Regulation (Regulation (EU) 2017/2401)

<sup>9</sup> Article 45.2 STS Regulation (Regulation (EU) 2017/2402)

<sup>10</sup> These numbers do not take into account the short term measures taken by bank regulators in the face of the COVID19 emergency which have artificially reduced the immediate current “point in time” capital shortfall. However, they remain relevant for any long term planning around banking resilience in the European Union.

<sup>11</sup> Figure provided by BAML Global Research.



estimate a need for €800bn of new RMBS issuance over 5-10 years. As mentioned, RMBS issuance for the whole of 2019 was €7bn.

It is also worth noting that this is not only a challenge for the large international universal banks that operate in Europe but for the whole banking system, including the smaller regional lending institutions that dot the European landscape.

It is sometimes argued that Basel is an international agreement applicable to all nations and therefore designed to create a “level playing field”. So, in this context, we should point out that these challenges are nowhere as relevant to the United States. By excluding all their small regional banks from the Basel accords, the US have shielded the small lenders that play such an important role in Europe. By effectively nationalising the mortgage market via institutions such as Fanny Mae and Freddy Mac, the US has provided a state-sponsored and state-backed means for all banks to manage their capital with enormous flexibility. This has allowed the United States the luxury to take very strong positions on Basel in the knowledge that these did not affect their own banking system's lending envelope. Adding to this the much more developed capital market in the US, it becomes clear that Europe's challenges are very different, and Europe's solutions will need to be its own.

### Capital Markets Union

Set up under the previous Commission in response to the crisis of 2008/2009, the Capital Markets Union project retains all of its importance and validity today, and even more so in the context of Brexit.

Whereas around 70% of the financing of the economy in the United States is derived from capital markets and 30% from banks, the proportions in the EU are basically reversed.

This creates a number of problems for Europe:

- An over-reliance on banks which makes any crisis in the banking sector almost immediately systemic;
- An over-reliance on banks which creates an artificial ceiling to the amount of financing the European economy may source – namely the amount of capital banks can raise. In other words, if banks find it difficult or expensive to raise capital, necessary lending to the economy may not materialise;
- A hurdle in moving away from Europe's over-reliance on banks as new entrants to the lending business (including fintech houses) rely on capital markets to grow.
- An absence of channels for European savers that provide safe yet decent returns on investments – a problem likely to become ever more acute as the population ages and pensions become a key issue.

There are many causes to the much greater role of capital markets in financing growth in the United States, but one of them is the difference between an EU27 securitisation market that currently stands at US\$450bn and a comparable US market that stands at US\$2,558bn in 2019. And this comparison excludes all the US state-guaranteed mortgage securitisations which accounts for a staggering US\$7,000 bn of additional funding to the US economy. Even if only half of the mortgages currently funded in the US through state sponsored securitisations were to be funded by the private securitisation market, Europe's 450bn market would be set against a US\$6,000bn US market.

2018	GDP	Private Securitisation		Agency Securitisation	
	bn	bn	%GDP	bn	%GDP
USA (US\$)	20,494	2,558	12.5	7,208	35.2
EU27 (EUR)	12,398	450	3.6	0	0
UK (GBP)	2,110	250	11.8	0	0

Source BAML – Global Research

Finally, to those who argue in respect of the CRR and LCR changes that are advocated later in this paper that the aim of revitalising the European securitisation market is to increase non-bank participation and so we should be indifferent to improving the terms of bank participation, we would argue that this is to ignore the reality of markets. Banks are the most obvious “first mover investors” in the European securitisation market. They have continued to be investors during the crisis. Therefore, they can and probably have to be the locomotive that generates the first wave of volume and liquidity. Only once the volume and liquidity builds up will players who have not been participants in this market for over a decade start to come back.

One should stress also that in addition to capital relief opportunities, securitisation provides banks with a day-to-day tool for diversifying their risk portfolio and optimising their risk profile. Indeed, securitisation enables them to address any excessive concentration within their loan portfolio in certain economic areas (real estate, consumer finance, residential mortgages...) or geographies. This should greatly contribute to improving bank resilience in the EU and dampening the consequences of any future asymmetric shock, notably by facilitating cross border private risk sharing.

### Green Finance

In addition to funding “business-as-usual”, Europe has also set for itself a very ambitious green project. This project will require funding above and beyond what would be expected from traditional growth.

To find this funding, it is essential that no legitimate and safe financing channels be blocked.

One of the conundrums of green finance is that a substantial part of it will be required to fund innovative solutions often from new companies. Much of it will be in the form of green projects which require upfront finance and produce income streams later. These types of financings are often somewhat or completely speculative. As such, it is not always clear that they would be safe investments into which policy makers would want to direct retail savings. The risk profiles of these investments, in particular, do not make them obvious candidates for the savings backing the pensions of European citizens.

However, the definition of a “securitisation” is a financial investment which is “tranching”. This means that securitisation is a financing that is uniquely capable of unbundling risk and segregating it in discrete blocks of higher and lower quality. This would allow risk-averse savers to invest solely in the least risky part of a green financing, letting more speculative funds invest in the riskier parts. This could attract savings that would not otherwise be capable of investing in such green finance.

For example, a company does solar or geo-thermal projects across Europe. At any point in time, that company owns 5 completed income generating projects and 7 projects in development. The projects in development have a high-risk profile, and so the company's own credit score is middling at best and not suitable for conservative investors.

But if, through a securitisation, the company can segregate away from the speculative projects in development the profitable existing income-generating projects and securitise these, it can provide a much safer investment that might now attract pension or insurance money.

In addition, those securitisations of completed projects can, through tranching, unbundle the risk of those projects and potentially create a large senior tranche of AAA or AA risk. This might be 70-75% of the existing project's financing and be of great interest to risk averse European (and extra-European) funds. The less safe tranches can be funded by the same investors who would have funded the company itself.

Through those securitisations, the company can now raise funding to invest in new ESG projects.



This is why securitisation can provide additional and not substitutional funding to the Green Plan.

We have already seen, globally, securitisations of green mortgages, water processing plants, solar panels, clean energy projects and other ESG asset classes.

Also, as we saw above, by allowing banks to extend more finance to the economy – including green projects – even when raising capital is difficult, securitisation also, in a more general but yet important sense, allows banks to mobilise more resources for green initiatives.

## Conclusion

**Without a deep and safe securitisation market, Europe could face meaningful constraints on the borrowing capacity of its economic actors, a continued over-reliance on banks, a struggle to create a modern fintech sector and an artificial and unnecessary restriction on its capacity to fund its green ambitions.**

Taking as a basis the €800bn over say 7 years for Basel capital (see above) being €115bn a year and a rough but conservative amount of €125bn a year for green projects (€50 for green securitisations and €75bn of bank securitisations reducing capital requirements and allowing an additional equivalent of green lending), we conclude that anything below €240bn of new securitisations in the EU27 would fail to unlock the value of the STS reforms. We stress that this is the floor of our hopes should the proper measures be put in place. In 2006, the last year before the crisis, Europe saw €450bn of securitisation issuance in its traditional asset classes.

## What can be done?

To understand what can be done, we need to understand why the STS Regulation has not spurred the market.

For a strong but safe market to arise, one needs to have a larger group of issuers and investors able to agree on a mutually attractive price for safe securitisations taking into account any regulatory capital costs and benefits. Currently, that balance cannot be achieved because the capital costs and benefits are not commensurate with the risks of safe STS securitisations and distort the market to a point where it is not attractive for many players. This is particularly obvious when compared to other asset classes such as covered bonds whose admittedly excellent credit performance during the crisis is not better than that of senior STS securitisations.

### CRR calibration for banks

The new CRR calibrations have substantially increased the cost for banks to hold securitisations. Even at the floor for STS of 10%, this is more than a 40% increase over earlier requirements. (For non-STS, the floor has more than doubled.) From this point of view, it is clear that – although STS has been rightly presented as a “gold standard” for securitisations – the introduction of this higher standard has, in fact, resulted in a much more severe treatment regulatory-capital wise.

Although many highly mathematical and data abundant arguments are bandied around in this area, the basic flaw of the current calibrations is simple. After the crisis, regulators agreed that risk weights for securitisations should be (much) greater than the risks of the underlying securitised assets because of “agency risk”. This expression covers the idea that the very act of securitising creates additional risks<sup>12</sup>. To counter agency risk, the Basel committee introduced to the formulae setting the capital required to hold a securitisation an added number: the p factor.

It is this p factor (together with the arbitrary floors on senior tranches) that accounts for the non-neutrality of the capital

requirements – i.e. that the capital requirements of the same pool of assets in securitised form is a multiple of the capital requirement of those assets before they were securitised. By way of example, for the exact same standard mortgage portfolio, the capital is over two and a half times greater when securitised as when on the bank's balance sheet.

At the same time, learning from the crisis, policy makers – together with the regulators – designed the new extremely detailed and comprehensive STS standard. One of the aims of the STS standard was to identify all agency risks and remove them. We would argue that this has been successfully done.

But largely because of an accident of how these changes were sequenced through time, the achievement of the STS criteria – i.e. the removal of all the causes of non-neutrality – was never incorporated in the final CRR formulae.

We need to remedy this error and see through to its logical conclusion the work of the Commission and the Co-Legislators when they created the STS standard.

The calibration bias in securitisation capital for banks can be corrected through reviewing the CRR calibration of the p factor for the SEC-IRBA (art. 259 of the CRR) and of the p factor for SEC-SA (art. 261 of the CRR). We recommend a p factor of no more than 0.25 for STS deals reflecting the elimination of agency risks brought about by the STS standard.

The risk-weight floor should also be recalibrated: at present, senior tranches attract between c. 25% and c. 50% of the total risk-weight although they cover only a minimal share of the risk. For instance, for a typical transaction on residential mortgages with loan-to-value ratios of 80%, the senior tranche would be attracting c. 50% of total risk weights. We should aim at applying the initial 7% RW floor to STS senior tranches and 15% for non-STS, in order to really provide an incentive for the market to focus on the STS regime and reflect both the actual performance through the crisis of those senior tranches of securitisations which would have met the STS standards had it then been in existence.

### LCR Eligibility

With the introduction of the STS standard, on 13 July 2018, the Commission published the final text of revisions to the LCR Delegated Act. This amendment did not provide any recognition of the new standard's strength and thoroughness and simply inserted the new standard (STS) in place of the old.

Yet, the new STS standard is more comprehensive than the old LCR eligibility standard – containing over 100 separate criteria. The new STS standard is backed by a new severe sanctions regime. The new standard is framed by new regulated market participants – third party verification agents and data repositories – to reinforce its integrity and transparency. The new standard is an official designation enhancing its market liquidity. And yet, the new standard was granted no benefits whatsoever in the revised LCR rules.

Considering how strict those rules were at the outset, it is difficult to conclude that either (i) they were in fact too lax – even passed at a time of great diffidence toward securitisation or (ii) the STS standard devised after considerable work by the Commission and Co-Legislators really added nothing to the existing rules.

Again, it is essential to complete the reforms of the securitisation framework begun with the creation of an STS criteria and re-classify STS senior tranches to Level 1 or, at worse, 2A and restore the eligibility at a single-A rating level to recognise the resilience and transparency of the new standard.

<sup>12</sup>The most obvious agency risk was the originate-to-distribute model common in the US sub-prime sector where it was rightly perceived that a finance house originating mortgages which would all be swiftly sold would originate worse quality assets. Similarly, lack of transparency was an agency risk.

## Solvency II calibrations

A key target for increased investor involvement in securitisation, are insurance undertakings. Here, again Solvency II calibrations display an unjustifiable non-neutrality. This time, the non-neutrality does not arise from an artificial p factor but as an artificial artefact of the division within the legislation of risk assessment into different «modules» using completely different methodologies.

The result of this artificial distinction is that the capital required by an insurer to be set aside for the purchase of a whole pool of mortgages is less than the capital required to purchase via a securitisation only the senior 80% of the risk of the identical pool and considerably less than purchasing the exact same pool in securitised form. This is even though the securitised pool is considerably more liquid than the un-securitised whole loan pool.

In addition, the data on which the original calculations, were based adversely and idiosyncratically affected securitisations compared to other asset classes. Much of the worse effects of this in the original Solvency II calibrations was ameliorated following the STS Regulation, but – as with CRR – to fulfil the purpose of the new STS standard it is necessary to revisit what we believe to be a no-longer justified non-neutrality. This is particularly, but not only, true of the treatment of junior tranches of STS securitisations.

## STS for synthetics

On the introduction of the STS Regulation, the CRR was amended so as to allow benefits equivalent to those afforded by STS to certain synthetic securitisation involving SMEs<sup>13</sup>. Also, the European Parliament specifically requested the Commission to produce a report on how the STS regime could be extended to synthetic securitisations<sup>14</sup>.

Currently, this report is the subject of a preliminary EBA discussion paper.<sup>15</sup>

As set out above, synthetic securitisations are no more than a form of credit insurance designed, by passing on the risk to a third actor, to remove the requirement for the originating bank to hold capital to cover the transferred risk.<sup>16</sup>

Sometimes, banks choose synthetic securitisations for ease of transaction, but sometimes they have no choice for legal or commercial reasons but to use a synthetic form of securitisation.

The implementation of the new Basel rules will, however, make synthetic securitisations at best much more costly and, at worst, financially impossible.

Using the most favourable approach for banks, the SEC-IRBA approach, the new rules will – in the case of a synthetic securitisation of corporate loans – provides on average 20% less capital reduction and increases the cost of capital reduction by 26%.

Bearing in mind the issues raised earlier about constrained lending, we have asked a major European bank to provide a practical example. They provided us with the figures from an actual synthetic securitisation which they completed for SRT purposes.

Their figures show that, for the same synthetic securitisation of around €2.4bn, the new rules reduce available finance to the economy by €300m. This is €300m that could otherwise be channelled to SMEs or ESG projects.

How unrealistic the new requirements are under the SEC-SA rules, likely to be used by smaller financial institutions, can easily be demonstrated by another calculation. Capital, under the Basel system, is designed to meet “unexpected losses”. (“Expected losses” should be met from operating income, obviously.) Yet, under the new rules, a bank would need to insure via a synthetic securitisation THREE times the entire expected AND unexpected losses merely to reduce its capital requirement to the floor of 15%. In other words, if you remove three times over the entire risk for which Basel requires capital, you still are required to maintain capital against that risk. It is difficult to conclude that such a result is anything but absurd and offends against any logic behind the capital requirements regime.

There is no technical, structural or policy reason why the rules of STS cannot provide – with some adaptations – a robust standard for synthetic securitisations. The EBA itself concluded as much in its discussion paper<sup>17</sup>. This should be accelerated so that this tool may be used in sufficient time and with sufficient deliberation, by European bank before the new Basel implementation cliff-edge. Timing is as important here as is the result<sup>18</sup>. Once this is achieved, the same CRR capital requirement benefits should be provided for synthetic STS securitisations. Not to provide such benefits would negate the policy purpose of extending the STS standard but would also be unexplainable from a logical point of view.

## A proper and reasonable SRT infrastructure

As we have noted, achieving SRT and capital reduction is a key to the benefits of securitisation. That key, in turn, can unlock the issuance volume to drive the CMU. But this is dependent on a reasonable process and clear rules through which European banks can be confident that their transactions will, if the rules are followed, result in an improvement of their capital use.

There are currently two stumbling blocks to this.

## ECB process

For systemic banks, it is the ECB that determines whether SRT is achieved.

Thanks to intensified dialogue with the ECB, some improvements in the process have been recently observed, however, the process continues to lack transparency.

EU banks are currently required to inform the ECB of their intention to execute a significant risk transfer transaction at least 3 months in advance, the ECB has then 3 months to assess the risk transfer before reverting to banks and indicate if it has an objection or not to the recognition of capital relief from the transaction. The ECB can add new conditions to this recognition. However, some of the deal characteristics that the ECB will incorporate in its analysis, such as the thickness of tranches and the market prices of the tranches, typically evolve until closing. As and when the ECB considers that one of the material characteristics of the transaction has changed, it requires a new 3-month period to revise its SRT analysis. Such a requirement is therefore impossible to meet since, for securitisation as for any other type of market transaction, market conditions evolve until the last minute. If they evolve outside of the ECB decreed parameters, the transaction built over many months of negotiations with potential investors has to be cancelled or proceed with no SRT benefit to the bank.

<sup>13</sup> Art. 270 the Capital Requirements Regulation (Regulation (EU) 2017/2401)

<sup>14</sup> Art. 45.2 STS Regulation (Regulation (EU) 2017/2402)

<sup>15</sup> EBA discussion paper: <https://eba.europa.eu/sites/default/documents/files/documents/10180/2963923/67358bc9-921d-49ec-86b6-144e90fa97b3/EBA%20Discussion%20Paper%20on%20STS%20synthetic%20securitisation.pdf?retry=1>

<sup>16</sup> Although banks sometimes complete synthetic securitisations for internal risk management rather than regulatory capital reduction, the great majority are SRT securitisations.

<sup>17</sup> See footnote 15.

<sup>18</sup> We are, of course, aware of the current COVID19 driven discussions around the timing of the Basel revisions. But we were extremely late in moving towards a more appropriate securitisation regime and so, notwithstanding any delay in implementation of the Basel changes, it is important to proceed with all necessary speed with the required amendments.

Admittedly, banks have recently observed some improvements in the SRT process. Notably, efforts to provide banks with feedback within a timeframe consistent with their planning and market constraints have been noted. Also, monthly meetings between some banks and their respective Joint Supervisory Teams (JSTs), mainly focused on SRT notifications, have taken place. JSTs have also sometimes provided explicit feedback on modifications to structural features during the structuring phase of transactions. Finally, accelerated processes have been noted on some repeat cash deals by certain banks.

While these improvements are helpful overall, additional steps are necessary to achieve the right balance of predictability and dialogue so that the market can function effectively:

- Transparency of the ECB methodology applied to assess significant risk transfer transactions and the criteria used. Banks should be able to understand and anticipate an objection from the ECB based on public, objective and stable criteria.
- Changes could be made to the ECB public guidance for the simplification of data requirements (notably for simple transactions) and to achieve greater proportionality of information required to ensure information requests are relevant to SRT assessment objectives.

Finally, a “fast track” process should be put in place for “simple and repeat” transactions, i.e. transactions which do not contain any new or non-standard features, are a repeat of previously approved transactions or, for traditional securitisations only, where 95% of the tranches are placed. These transactions should benefit from a faster assessment process: full documentation would not have to be re-submitted pre-closing and permission to recognise SRT would be deemed granted in the absence of objection pre-closing. In addition, more limited / pro-forma information requirements should be envisaged. For transactions with new or non-standard features, of course, the process would be more extensive.

Articles 244(3) and 245(3) of the CRR provide a mandate to national competent authorities (or the ECB for large banks) to assess whether significant credit risk transfer is justified by a commensurate transfer of credit risk to third parties, for both traditional and synthetic securitisations<sup>18</sup>. However, the wording of these articles is too vague, leaving the ECB and the national competent authorities with an insufficiently defined latitude for interpretation with the ensuing risk of the growth of an additional layer of pre-conditions, beyond the intent of the Co-legislators. This problem is even greater in the absence of the still to be finalised EBA guidelines.

The SRT assessment must therefore be better structured, to prevent individual national competent authorities or the ECB from imposing diverse and inconsistent additional non-legislative rules. Such rules undermine one of the key initial aims of the SRT rules, namely to avoid regulatory arbitrage. They prevent the creation of a European level playing field and the emergence of a fairly standardised securitisation market – especially in the synthetic area. Yet, such standardised markets are key to volumes.

## Conclusion

**The SRT process should be considered to be a normal day-to-day process of insurance and capital allocation rather, as appears to be currently the case, an exceptional measure requiring individual bespoke analysis by the prudential regulator and involving unpredictable yet unchallengeable additional rules. It needs to move to a rules-based supervised regime consistent across European jurisdictions in the same way as the rest of the CRR framework.**

## EBA rules

The final shape of the SRT landscape will be created by the EBA rules which are still in drafting.

This paper is not the forum to go into a detailed analysis of the prospective rules, but serious concern has been raised by market stakeholders about the regulatory approach to some specific topic. These concerns have been raised in circumstances where the results of the discussed rules are not only highly deleterious to the hopes of a robust and effective market but also deeply puzzling and, at time, seemingly inexplicable to market observers.

Some of the highly technical areas of concern would be:

- The differing treatment of sequential and pro-rata pay
- The definition of tranche maturity
- The zero pre-payment assumptions
- The use of “excess spread”

It should also be noted that many of these proposed rules are currently being applied by the ECB.

## Conclusion

**It is essential for the whole future of the European securitisation market that the SRT rules to be published by the EBA, whilst conservative, should be realistic and capable of operation. There is a real concern from market participants and market observers that any positive changes of the types outlined elsewhere in this paper could be totally negated by highly technical but deeply damaging and unnecessarily conservative SRT rules.**

## Additional measures

In addition to these key five measures, a number of additional steps should be considered.

### Simplify / better target ESMA disclosure templates

Originators, sponsors and securitisation special purpose entities (SSPEs) must make available to holders of a securitisation position, competent authorities and, upon request, to potential investors, certain information on the transaction and underlying exposures.

The ESMA templates are extremely granular. Although they have been simplified in January 2019 notably for ABCPs, they continue to apply to both public and private transactions, penalising the private market. Securitisation market participants have faced major difficulties in achieving the new standard because of very substantial additional information required to be made available, beyond long-standing market practices and the requirements of investors and rating agencies. This is particularly pressing for less sophisticated issuers, and in particular for corporates who rely upon private securitisation to finance trade receivables – an important source of funding for the real economy. Achieving complete compliance across all market sectors and asset classes is not achievable as a practical matter, nor necessary as a prudential one.

Disclosure templates should be adapted to various asset classes and unrealistic expectations should be eliminated, based on an open dialogue with market practitioners. Reporting should also be simplified as relates to private transactions, which by construction should not require public disclosure. The currently proposed ESMA templates are often impossible to apply especially to synthetic securitisations.

### Re-examine CRR and Solvency II calibrations for non-STS

Twelve years on from the crisis we have acquired considerable additional data both on the performance and behaviour of non-STS securitisations and other asset classes. It would be useful to use this

<sup>18</sup> « By way of derogation from paragraph 2, competent authorities may allow originator institutions to recognise significant credit risk transfer in relation to a securitisation where the originator institution demonstrates in each case that the reduction in own funds requirements which the originator achieves by the securitisation is justified by a commensurate transfer of credit risk to third parties. »

data to see whether a re-calibration of non-STS securitisations or some sub-class of non-STS securitisations would be justified, so as to broaden the whole market in a safe way.

#### **Adopting the STS standard in the ECB rules**

Currently the ECB makes no space in its rules – whether with regards to outright purchases or repo collateral eligibility via the Eurosystem – for the STS standard.

This is strange considering that the standard, in addition to embodying the best aspects of securitisation as defined by regulators and policy makers, is a key tool in assisting the recovery of the European market. This recovery is in line with the ECB's own obligations to assist in creating a stable European banking system and could be achieved without taking additional risks on the ECB's balance sheet.

Such adoption need not be achieved by excluding non-STS securitisations but by providing differential treatment for STS and non-STS securitisations within the different ECB programs and collateral frameworks.

#### **CONCLUSION**

The STS Regulation and, in particular, the creation of the STS standard, the most detailed and comprehensive securitisation standard in the world, was a necessary and laudable reform introduced by European policy makers. Yet, it has failed in its aim to revive the European securitisation markets.

Those securitisation markets though are vital to avoid a shrinkage of European bank lending in the face of the new Basel capital requirements. It is vital to any successful development of the CMU. It is vital to help in funding the European Green Project.

Revitalising the European securitisation market requires no new initiatives. It requires that the European Union completes the unfinished business that is the STS reforms.

This can be done in practical ways by modifying the CRR and Solvency II capital calibrations to reflect the work on European institutions in creating the STS standard.

It can be done by seeing through the value of this standard in the LCR eligibility rules and the ECB collateral rules.

It can be done by extending logically the STS standard and its capital benefits to synthetic securitisations.

It can be done by creating a streamlined, safe but sensible SRT framework which allows European banks predictably and swiftly to incorporate risk adjustments in their normal business.

*This document was drafted by Ian Bell, PCS with the input of*

*Alexander Batchvarov, Bank of America Merrill Lynch*

*Alexandre Linden, BNP Paribas*

*Veronique Ormezzano, BNP Paribas*

*Steve Gandy, Grupo Santander*



# Are the powers of ESMA sufficient for CMU?

Well-integrated capital markets are essential for the financing of the EU's real economy, for a well-functioning Capital Markets Union and to act as important shock-absorbers in the Economic and Monetary Union. More integrated supervision at the EU level also means fewer costs and obstacles for financial firms that wish to expand within the EU and more choice for consumers. In addition, integrated supervision reduces the risk of regulatory arbitrage, ensuring the same standard of supervision for non-EU players who can also benefit from a single point of entry into the EU.

The three European supervisory authorities (ESMA, EBA, EIOPA) have strengthened substantially the stability and efficiency of the European financial system in response to the 2008 financial crisis which exposed significant failures in financial supervision. Their responsibilities include defining common practices and standards for the regulation and supervision of banking, securities markets and insurance activities, and ensuring the consistent application of these measures within the Single Market. They launched their activities on January 1, 2011.

The positive role that the ESAs have played in fostering the creation and implementation of common rules for financial services in the EU is widely recognized. This objective has however not been fully achieved yet, since the implementation of EU laws is not always consistent across the Union. There remains significant potential to further enhance regulatory and supervisory convergence in the Single Market. Brexit is a further reason for strengthening EU supervisory arrangements, particularly those regarding ESMA, since the decision of the UK to leave the EU reinforces the importance of developing financial markets within the EU in order to continue to support the EU economy and of appropriately managing interactions with third countries.

In 2019 the EU institutions adopted a review of the supervisory framework for financial institutions. This note presents the progress and limitations of the EU agreement reached last year on the ESAs review and focuses solely on ESMA. Any future review should start with a vision of what the EU wants to achieve in the financial sector and adapt the desirable European supervisory structure to that.

## 1. Commission legislative proposals from September 2017 and conclusion of the legislative process in March 2019

On 20 September 2017, The EU Commission presented a proposal to review the operations of the ESAs. Its objective was to further enhance regulatory and supervisory convergence in the internal market in order to support the implementation of the Capital Markets Union (CMU) and the Banking Union in particular.

The ESA review proposal included a broad range of measures concerning the governance of the ESAs, their direct supervisory responsibilities and their interactions with National Competent Authorities (NCAs) in order to ensure a more consistent application of EU law, the enhancement of the powers of the ESAs regarding third countries to support appropriately equivalence decisions, as well as measures to ensure that ESAs benefit from sufficient funding: These legislative proposals were finally concluded on the political level in March 2019.

## 2. The political outcome is indeed less ambitious than the initial Commission proposals

### 2.1 Very limited changes in the ESAs structure

The main significant change on the governance side is the strengthening of the powers of the Chair, who will be able to propose decisions to the Board of Supervisors on issues relating to breach of Union law, binding mediation and inquiries into financial products or institutions. The Chair can now also vote in the Board of Supervisors, with a few exceptions.

Regrettably even the proposal to increase the independence of the existing Management Board, with the addition for instance of two independent members coming from academic and corporate circles was not adopted.

### 2.2 The current funding system was not improved

The funding of ESMA should guarantee its independence and avoid creating potential conflicts of interest. The current model, where NCAs provide an important part of the ESAs' funding, creates pressure on NCAs budgets and does not appropriately reflect the size of the financial markets of Member States. Bigger and more interconnected financial markets need more supervisory resources to ensure their stability and investor protection, at both EU and national level.

However, the final agreement unfortunately did not successfully address these drawbacks of the current model, which is a missed opportunity. Indeed, the Commission proposal to make financial institutions pay to the budget of the ESAs for non-supervisory activities of the ESAs was not maintained. In the end, the current system of 40% direct contributions from the EU budget, and 60% from the NCAs was kept, which means some member states pay proportionally too much in relation to the local financial activity.

## 3. However, the text agreed will mean a step forward for ESMA and ESMA's contribution to the objectives of the Capital Markets Union

The EU agreements on the ESAs review and EMIR 2.2 enhance the role and responsibilities of ESMA and strengthening the supervision of EU and non-EU CCPs.

### 3.1 Enhancing the role and responsibilities of ESMA

The most important changes come via new and improved instruments to foster convergence in the way the European financial sector is supervised. Also, by 2022, ESMA will directly supervise additional significant parts of the EU's financial market infrastructure.

#### 3.1.1 Three new powers to foster consistent supervision

ESMA's mission is to enhance investor protection, ensure financial stability and promote stable and orderly financial markets. It is already supervising credit rating agencies (CRAs) and trade repositories (TRs), including for securities financing transactions.

The agreement extends ESMA's direct supervision to some specific areas of capital markets. In particular, ESMA will directly supervise specific sectors which are highly integrated, have important cross-border activities and which are, in most cases, regulated by directly



applicable EU law. Indeed, ESMA will authorise and supervise administrators of benchmarks that are deemed to be critical for the EU (such as EURIBOR and EONIA) and will also recognise non-EU administrators of benchmarks used in the EU.

ESMA will also centralise the authorisation and supervision of data reporting service providers which enables the reporting of transactions in financial instruments to regulators and to the public under MiFID II.

In addition, ESMA will also centralise its direct supervision of third-country CCPs that have systemically important activities within the EU. ESMA will play a central role in deciding if a non-EU CCP is systemically important, based on a number of criteria, and will subsequently be responsible for supervising those systemically important non-EU CCPs. The supervision of third-country CCPs is the third and important area of expansion in ESMA's powers. While it is not part of the ESA Review, it is a clear consequence of Brexit, and the 'EMIR 2.2' (see below, 3.2)

The new rules allow ESMA to set supervisory fees, to conduct on-site inspections, and to impose fines and periodic penalty payments upon the entities concerned, as is already the case for rating agencies and trade repositories

### 3.1.2 The peer review has been improved

The assessment of the work of national supervisors, the so-called peer reviews, will be headed by senior ESMA staff and be carried out by ESMA staff together with representatives of competent authorities, bringing more efficient and objective steering to the process.

The Management Board can also set up specific coordination groups to examine any emerging supervisory issues in a collective way.

### 3.1.3 The outcome of the ESAs Review introduces a range of changes across the spectrum of ESMA's duties and objectives.

Firstly, ESMA will now be able to use a tool similar in nature to so called non-action letters used by other financial markets regulators, in cases where certain regulations can be conflicting and/or not compatible with dynamically changing market realities. The change of the underlying legislation will remain however with the Brussels-based EU Institutions.

Secondly, ESMA will play a more pronounced role in the advising, monitoring and following up on equivalence decisions with third countries. These are both changes that will bring more supervisory certainty and stability to the EU.

The amended ESMA Regulation, with new powers and tasks, entered into force on 1 January 2020, except for the direct supervisory mandates which will start two years later (1 January 2022).

To accommodate these new responsibilities, ESMA will grow to 384 by 2022.

## 3.2 Strengthening the supervision of EU and non-EU CCPs (as of 1 January 2022)

For EU CCPs under EMIR 2.2, supervision will continue to be carried out at national level. The licensing of CCPs notably remains with national authorities, but there is an enhanced role for ESMA under the supervisory framework. EMIR 2.2 maintains the central role of the colleges for the effective supervision of Union CCPs, but it complements the EU-level supervision with a new CCPs Supervisory Committee under the responsibility of ESMA to carry out the tasks assigned to ESMA in relation to both EU- and third country CCPs. This Committee will with the help of ESMA staff

monitor EU-based CCPs and supervise third-country CCPs, which will be paid for by supervisory fees.

The more significant changes come for non-EU CCPs operating in the EU, based on an equivalence decision. CCPs based outside the EU who want to offer clearing services within the EU, need to be recognised by ESMA under the revised EMIR <sup>1</sup>.

In particular, ESMA will determine, in consultation with the ESRB and the relevant central bank of issue, whether a third country CCP is systemically important or likely to become systematically important for the financial stability of the Union or one or more of its Member States. The CCPs which are determined not to be systemically important (Tier 1 CCPs) will continue to be subject to a very similar regime as the one established today for the recognition of third-country CCPs. Instead, third-country CCPs which are deemed to be systemically important or likely to become systemically important (Tier 2 CCPs) will be subject to additional requirements and direct ESMA's supervision.

EMIR 2.2 also tasks ESMA to monitor regulatory and supervisory developments in third country CCP regimes that have been deemed equivalent by the Commission.

The CCP Supervisory Committee will be composed of a Chair and two Independent Members, the competent authorities of EU Member States where a CCP is established and, where applicable, the respective EU central banks, in most cases the ECB, which it has to consult. The committee is responsible for preparing draft opinions or decisions in relation to EU and third country CCPs for adoption by the ESMA Board of Supervisors. The Committee will participate in the supervisory colleges, but on a non-voting basis.

EMIR 2.2 came into force – similarly like the ESAs review – on 1 January 2020.

## 3.3 The EU equivalence model is expected to grow

In the near future, more supervised entities will fall under the remit of ESMA, and this concerns both EU market participants as well as third country market participants active in the European market through equivalence and recognition.

The EU financial markets are and will continue to be very open for business coming from outside the EU. With over 120 equivalence decisions in the area of securities markets across various legal frameworks and jurisdictions, the EU has been the world leader in applying the deference principle. A large number of third country market participants, like trading venues, CCPs, and CRAs, can do business in the EU while the EU relies on their home country regulation and supervision.

With the UK leaving the EU soon, the use of the EU equivalence model is expected to grow once an orderly exit is agreed, not only in terms of additional equivalence decisions but also through the proportion of non-EU market participants active in the EU Single Market. From this perspective it is important that the EU creates certain supervisory mechanisms concerning the most significantly important market infrastructures – like CCPs – in order to be able to ensure financial stability, orderly markets and consumer protection within the EU.

<sup>1</sup> The requirements for these third-country CCPs to do business in the EU are quite strict, but less strict than corresponding requirements in the US or Japan: 1) compliance with the relevant and necessary prudential requirements for EU CCPs, 2) compliance with EU central banks' requirements on liquidity, payment or settlement arrangements and 3) written consent allowing ESMA to visit its premises (Art. 25h). Reciprocal 'comparable compliance' may be established between ESMA and any third-country's competent authority (Art. 25a). ESMA can also impose fines or penalty payments on third country CCPs

# Capital market development in CEE

## On-going changes in the growth model of the CEE region

Before the Covid-19 outbreak, CEE economies were enjoying relative economic stability, after having recovered from the 2008 crisis, but potential growth forecasts in the region were deteriorating and the timeline for the completion of the economic convergence process was spreading out. In addition, there was a persistent investment gap in the region in terms of quantity (approximately 4% of GDP) and composition. This gap is more pronounced for NFCs (Non-Financial Companies) because EU funds tend to target mainly the public sector and infrastructure investments at present.

These trends mean that the growth and financing model of the region will need to evolve in the coming years. The economic impacts of the current sanitary crisis will however also need to be evaluated. The pre-2008 crisis model involved a great deal of foreign investment going into labour-intensive industries and infrastructures, as well as portfolio capital coming into foreign-owned banks, both of which are expected to diminish in the future. Financing infrastructure and manufacturing plants will remain a priority, but there will be a need to place a greater emphasis on domestically driven productivity growth (requiring further investment of NFCs, particularly in the service sector, into new equipment and ICT i.e. information and communications technology) and the financing of more innovative, technology-intensive and high-growth industries. This will require developing workforce skills and a higher capacity to invest in intangible assets.

## A rebalancing in the CEE region in favour of more capital market financing is necessary, but challenging

Several supply and demand-related issues need to be addressed. Currently, banks finance 90% of the economy in CEE, which is higher than the EU average of 75%, and they focus mainly on traditional business such as loans and savings products. A result of this is the relatively limited range of financial products available to investors and savers. That said, a growing number of CEE banks are increasingly accessing domestic and international capital market financing and are issuing more innovative products such as covered bonds, which has helped local capital market development and expanded the product range available. Despite these positives, local capital markets currently lack the scale and capabilities that are needed to attract foreign investors and support larger issuers.

In this context, banks will continue to be the main source of financing in CEE in the short term. Potential underlying factors such as bank deleveraging, NPL issues, compliance with prudential requirements and local tax measures, etc. could restrict lending to the real sector and need to be closely monitored in these countries. Additional measures to facilitate bank lending for innovative companies and infrastructure investment may also need to be encouraged.

However, there is a growing realization amongst policy makers that the financing model needs to be progressively diversified in the CEE region as a consequence of the economic evolutions mentioned above, with a greater role for capital markets, supported by a stronger local investor base with a longer term investment horizon (pension funds, life insurance). Capital market instruments and particularly private and public equity are

indeed more suitable than bank credit for financing innovative projects and intangible assets, because they have a longer term perspective and do not require the same guarantees, collateral, credit history or regularity of cash flows. In addition, compliance with applicable prudential requirements might restrict the availability of bank financing over time to the broader economy and particularly the SME sector.

Companies in the region are mostly small and prefer debt financing. Their managers have limited experience of capital markets and perceive them as complex and costly to use. They are also reluctant to make the changes required in terms of governance and transparency. Retail investors based in the CEE region also generally do not participate in financial markets and mostly use cash holdings and bank deposits for their savings, leading to an erosion of wealth over time. The expansion of local institutional investors such as capital-funded Pillar 2 retirement systems may also be hindered by decisions made by several CEE countries to revert to the traditional system of paying pensions from the central budget.

## The actions that are underway at the EU and regional levels to develop capital markets and local financing resources need pursuing and expanding

The actions initiated at the EU level to foster the development of capital markets need to be beneficial for the CEE region. The efforts made to implement the EU capital market rulebook throughout the EU should provide the CEE countries with a consistent set of rules. This should facilitate the development of appropriate investment offerings across the multiple and relatively small CEE markets and also facilitate investment into the CEE region from other parts of the EU and third-countries. Actions proposed in the context of the Capital Markets Union (CMU) should further support the development of capital markets in the region. Whilst the progress made so far with this initiative is promising, it is still limited. Actions are being conducted under the aegis of the EU Commission in the context of the Structural Reform Support Programme (SRSP) to support the development and integration of local capital markets. Projects in CEE countries range from capital markets diagnostics and strategies, through SME equity listing support instruments and pre-listing support programs, to reforming the legal and regulatory framework for covered bonds and securitization, and improving the investment environment for institutional investors.

Multiple initiatives are also underway at the regional level, with the support of IFIs (international financial institutions such as the EIB and the EBRD), to develop and interconnect local capital markets. Work is under way to establish a Pan-Baltic framework for covered bonds, with an additional project aiming to obtain a single Frontier market classification jointly for the three Baltic countries to enhance the attractiveness of these combined equity markets to institutional investors. The SEE link project, also supported by the EBRD, aims to create a regional capital markets infrastructure by connecting the stock exchanges of 7 countries including Bulgaria, Croatia, Slovenia and N. Macedonia. A follow-up project is being implemented to connect securities clearing, settlement and depository infrastructures at the regional level for the SEE Link markets. Local initiatives have been put in place in Romania or Bulgaria to activate dormant retail share accounts,

a legacy of the 1990s Privatization processes. Actions are also being conducted by the EIB through the EIF Investment Facility and the EBRD to support the development of venture capital and private equity in CEE, investing in funds that operate in the region and also providing investment expertise. The EBRD has also provided capacity building to venture capital and private equity funds and public implementation agencies, and supported the development of a new fund law in Estonia.

Moreover, the IFIs provide local banks with support, aiming to increase their lending capacity in the region. The EIB is supporting new securitisations and providing local banks with new risk-sharing mechanisms (through the SME initiative) that enable them to lend to innovative SMEs in an uncollateralized way. This includes providing banks with a first-loss guarantee on portfolios of loans to growing SMEs and innovative firms, which should help them to take more risks notably regarding intangible investments. The EBRD has helped implement covered bond reforms in several CEE jurisdictions, including Romania, Poland and Slovakia, with work ongoing in the Baltics and Croatia, bringing national regulatory frameworks in line with EU and international standards and providing these markets with renewed momentum in CEE.

*This note was drafted with input from Jim Turnbull  
and Kate Galvin, EBRD*

# SUSTAINABLE FINANCE

---

The financial and non-financial challenges of the Green Deal	33
Sustainability transition challenges for Small and Mid-Caps	36



# The financial and non-financial challenges of the Green Deal

## The Green Deal and the coronavirus crisis

This article has been prepared before the health crisis and the dramatic impact it has on the European and the world economies.

But the Green Deal has not be made obsolete by this new crisis, it is only a new challenge for it. In the coming months, the priority will be to combat this crisis and support the economy. But, as we argue in part III of the article, the ambitious medium-term Green Deal project should not be forgotten. This crisis shows also the need to pursue a structural rebalancing of our economies in favour of ESG criteria. The Green deal should be inserted in the measures to support the recovery of the economy in order to put it on the necessary trend more respectful of a good life on our planet.

Finally, we are of the opinion the Green Deal should not be considered as a priority that should follow the relaunching of the economy, but rather as the indispensable set of ESG targets required to reduce risks in the EU, be they climate or biodiversity related.

## The Green Deal in a nutshell

The President of the new European Commission, Ursula von der Leyen, has launched an ambitious programme of transition to a low carbon and circular economy, called the European Green Deal. It is the first priority of the Commission's five year-mandate and its first goal is for the European Union to be carbon neutral by 2050. This programme and this goal have generally been well received by the European Council, the European Parliament, the experts and public opinion, although some green militants have criticized it for not being ambitious enough.

## The financial and non-financial challenges of the Green Deal

To reach this goal, the Communication of the European Commission on the Green Deal draws a very impressive list of actions, including EU legislation and EU budget proposals, but also actions by member states and the private sector.

To finance this ambitious programme, the Commission proposes to mobilise the quasi magical figure of €1,000 billion in the next 10 years. The volume of finance necessary for reaching the new ambitious targets is of course an important challenge and, even if there is not a reliable estimation at this stage, much more than €1,000 billion is needed from the private sector alone.

This high volume of private funding could probably be available if there was a framework of regulations, incentives and support which would both induce businesses and households to launch the necessary number of big and small "green" projects. These non financial challenges are more important than the financial ones and, if they are met, the financial sector could probably bring the high volume of funding which is necessary.

### 1. The financial challenge: the €1,000 billion of the Green Deal and the need for a higher volume of private finance

**1.1 The €1,000 billion of the Green Deal for the period 2021-2030**, as proposed by the European Commission, are a rather complex addition of EU budget funds, national budget funds, public development banks and private finance "triggered" by public guarantees, which in a nutshell is the following :

- EU budget funds of around €500 billion, including €100 billion or more for the Just Transition Fund, which will help the most impacted regions, like the coal regions in Poland; it is worth remembering that the EU 27 budget (without the UK), currently under discussion for 2021- 2027, is roughly 1% of GDP (around €135 billion per year);

- Member states' budgets for €100 billion;
- €300 billion from private funds "triggered" by public guarantees, like in the Juncker Plan and its successor "InvestEU";
- €100 billion from international financial institutions, EIB and national public development banks.

### 1.2 Much more is needed from the private sector

The €1,000 billion over 10 years, i.e. €100 billion per year, will be far from enough to finance the needs linked to such an ambitious programme of energy transition and environmental protection.

The estimation by the Commission is that a supplementary gap of €160 billion per year has to be financed by the private sector alone, but this gap is probably undervalued.

The estimation of a total gap of €260 billion was already linked to the Sustainable Development Action Plan introduced in 2018, for which the amount of financing needed in transport, energy and circular economy reached €530 billion, of which €270 billion was, on average, already financed in the preceding years.

The level of ambition of the Green Deal is significantly higher compared to the previous action plan. For instance, the target for the level of emission of greenhouse gas by 2030 has been increased from -40% to between -50% and -55%, an increase in effort of at least 25%. The total amount and the additional need will have to be significantly increased. A conservative estimate is to increase the total needs by 20% at €110 billion. The gap will also increase by €110 billion to be financed by the private sector.

In conclusion, while there is no reliable estimate of the financial funds needed from the private sector alone at this stage, it is probably at least €2,700 billion over the next 10 years in addition to €1,000 billion proposed by the Commission.

### 1.3 The recent known figures of investment in energy transition are disappointing

The last Investment Report of the EIB, published in November 2019, gives figures which are disappointing: in 2018, the EU invested only 1.2% of its GDP (€158 billion) in the fight against climate change, less than in 2017 and a little less than the USA (1.3%).

This figure is also to be compared to the goal of €390 billion per year for energy and transport in the Commission's document linked to the action plan of 2018.

### 1.4 Why the financial challenge can still be overcome

Private financial funds directed to "green" financing are rising each year.

The green bonds market, for instance, reached a record volume in 2019, with \$278 billion of bond issues, 40% of which in the EU (\$110 billion). Most of the pension funds, insurers and asset managers have set ambitious targets for investing in green assets or green projects. What we hear from many European financiers is that they are more and more willing to invest to combat climate change and environmental deterioration.

Today, many financiers complain that they have money ready to be invested in green projects but that there are not enough projects to be financed.

The availability of funds is often not the most important challenge, as we can see if we take the example of the financing of housing. The volume of loans to households to buy their homes in the EU is very high, at more than € 500 billion per year. A probably very small

part of these loans finance energy efficiency investment for homes (insulation, change of heating system...), although we do not have precise figures up to now. More importantly, we know that the lack of energy efficiency in residential housing is one of the important weaknesses in the EU in the fight against climate change.

Let's imagine that as soon as a household wants to buy a home which is not energy efficient enough (probably 80% of the market), a part of this loan will also finance measures leading to energy efficiency (insulation, modernisation of the heating system, solar roof, etc). Thus, an important volume of "green financing" would take place. The constraints here are linked more to the information to be given to the households, good and neutral advice being offered to them, and also incentives, including regulatory constraints and fiscal inducements.

There are still improvements to be made in banking and financing regulation to stimulate green finance and remove some major obstacles in the way of a large increase in private green finance (cf. II) 5 § below). The EU action plan on sustainable finance has to be implemented to deliver notably a helpful taxonomy and necessary "green transparency" and sharing of data, but the existing banking and financial regulation must also be modified because it discriminates too much against long term finance, as has often been shown at Eurofi meetings.

## **2. The four main non-financial challenges of the Green Deal**

It seems that there are four challenges for a successful Green Deal and the necessary mobilisation of private finance. We must:

- Get the political and popular support for the most difficult decisions;
- Set the necessary targets and incentives (including constraining regulation) for businesses;
- Develop a specific programme for the energy efficiency of residential housing;
- Engage with third countries to induce them to implement the Paris Treaty and to avoid carbon leakages.

### **2.1 Get the necessary political and popular support for the necessary legislation and good choices in public finance**

What is needed first is to pass the necessary legislation in all sectors concerned, with ambitious but achievable targets (for instance in transport), and regulation to reach these targets. The programme of the Commission, which will be implemented in detail in the coming months and years, seems a priori in line with this objective.

Then good choices must be made in public finance at the EU level, but also at the national or regional level. There is a need to support the people and regions suffering from the transition, to support research and the most risky projects, and to create the necessary incentives, particularly for households. EU member states should also cut the subsidies to fossil energy and increase carbon pricing (which will also increase public resources).

Finally, the implementation of the Green Deal must be ensured by active monitoring, support of the member states that need it, but also by putting the necessary pressures on lagging member states.

Since the announcement of the Green Deal, the Commission has had good general support from the Council, which agreed (with the exception of Poland) on the goal of carbon neutrality by 2050. The European Parliament will also support this goal, but tough choices remain ahead, including on the next multiannual budget for 2021-2027.

### **2.2 Provide businesses with good incentives in order to get a much bigger number of projects to be launched through:**

- Regulation bringing new targets and higher standards, especially for industry, transport and housing;
- Public funds and private-public partnership where necessary (the EU battery project, for instance);

- Improving data and experience sharing within the different economic sectors and the financial sector.

### **2.3 Develop a specific and massive programme for the energy efficiency of housing through a specific partnership between public actors and the financial sector, providing incentives, but also adequate advice to households.**

For households, measures to improve the energy efficiency of the home generally have only a long term financial interest and are difficult to sort out. For instance, is it better to insulate the windows, walls, doors or roof, or to change the heating system? Is it safe to have a solar installation on a roof? Which of these measures will allow a good certificate of energy efficiency, etc? The projects are also often complicated by the legal framework.

Public actors, at national and/or local level, should commit themselves to implement clear energy standards, simplify legislation as much as possible to facilitate these investments, provide incentives (fiscal incentives), and provide good and neutral advice to households through public agencies or monitored by them.

The banking sector should green large parts of the regular housing loans. Each household applying for a loan to acquire a home which is not energy efficient should receive a proposal from the bank to also finance energy efficiency measures targeting levels of energy efficiency rewarded by the adequate certificate. They should also ensure that the household can benefit from adequate and neutral advice.

This banking sector effort should be supported by a "green factor" (which is also justified on the prudential side, as shown by many studies). There is also the need to improve and simplify the regulatory framework regarding securitisation by creating a "green securitisation" regime, which could attract long term investors eager to invest in green products with regular cash flows. Such a framework should benefit the loans to transition projects, like households' home adaptations and households and SMEs to buy electric vehicles.

### **2.4 Engage with third countries, because fighting against climate change is a global fight and there cannot be free-riding countries:**

The EU has made more progress in fighting climate change and protecting the environment than most other countries. Accelerating this progress through the Green Deal is necessary, but will be useless if it is not followed by all the world regions.

The EU should induce international partners to implement the Paris Treaty, including leading by example, exporting standards and providing financial support for the poorest countries.

It is also necessary to avoid carbon leakages of countries which will not comply with the Paris Treaty by building, as proposed in the Green Deal, a "carbon adjustment" mechanism at the EU border, at least for the goods of the most energy intensive industries.

### **2.5 The private financial sector will have also to increase its efforts and play, for instance, a bigger role to redirect financial flows from fossil and polluting activities to "green" activities and further innovate regarding financing tools.**

The financial sector has started to engage with greenhouse gas intensive industries. Some banks and long term investors have, for instance, decided to stop financing coal, but these efforts and the pressure on the users of fossil fuels should be further increased. At the same time, the financing of the transition of the polluting industries to the circular economy should be increased.

These efforts should be supported by the implementation of the action plan on sustainable finance. The development of a clear taxonomy is welcomed, provided it allows the necessary transition. "Green transparency" is necessary to put pressure on the laggards in the financial sector, but also to trigger the sharing of data, the development of models and scenarios, and thus progress in the knowledge gained and choices to be made.

As already said, part of the financial regulation will also have to be improved, especially to alleviate the constraints weighing on securitisation and on long term investments, and to introduce a “green implementing factor” at least for “green loans”.

### 3. The challenge of the economic outlook post Covid 19

The sanitary crisis created by Covid 19 has become the number one concern in the world and has led to a strong and global decrease of production and consumption.

This economic crisis is of a new type and its effects are correlated with the duration of the sanitary crisis.

The governments of countries impacted by the crisis have taken measures to support firms and their employees. Central banks are also injecting liquidity to refinance the debt of households, firms and the public sector. These measures are providing temporary support pending the end of the sanitary crisis.

This pandemic, like all pandemics in history, will hopefully stop in some months, opening the way for recovery.

Given the very strong impact of the crisis, this recovery will need to be supported by public finance and continuous central bank intervention as in 2008-2009.

The Green Deal should be an important part of the recovery programme, based on a partnership between public authorities and the private sector.

Of course, there will be some pressing short term financing needs to avoid bankruptcies and massive unemployment. But, in parallel, a priority will be to encourage investment, as it is the only way to achieve a robust recovery in the medium term. In this respect, energy and environmental transition investments must be a central part of this new Marshall plan that Europe needs. The increase in the intervention of the central banks, for instance, should support “sustainable” finance.

We should also not forget the three “sustainable” lessons that we have to draw from the Covid 19 crisis:

- First, this crisis illustrates the strong links between our present development model and the increasing frequency of global sanitary crises. Often originating from animal sources, the spread of global pandemics cannot be detached from human actions such as deforestation, rapid urbanisation and the illegal trade of endangered species;
- Secondly, the excessive dissemination of production and the too strong dependency of Europe on mainly China, but also India, has to be reduced; this will increase employment in Europe and decrease the need for transport of goods and people;
- Thirdly, there are some positive consequences of the crisis. Some are temporary, like the strong decrease of pollution and CO<sub>2</sub> emissions. Others will stay, like a bigger usage of teleworking and teleconferences, which will reduce the need for transport. The decrease of the price of oil also offers the possibility for public authorities to increase the price of carbon, which will help their finance and bring useful support to the energy transition.

In this context we can assert that it is not the Green Deal that should be considered as a priority that should follow the relaunching of the economy, but rather as the indispensable set of ESG targets to be defined in order to reduce risks in the EU, be they climate or biodiversity related, and support the transition toward a sustainable economy, the importance of which is stressed by the current sanitary crisis.

Provided that the financing of the investments prioritised by the Green Deal will be made more difficult, at least in 2020, this year and 2021 should be leveraged to put in place the necessary framework targets and subsequent regulations to support and incentivise a strong development of projects in 2021 and the years after.

Private finance will have to take the bigger share of the financing needs, as long as the right framework is in place (cf. part II above) and if there is a good public-private partnership, sometimes on very

concrete details like advising households for the energy efficiency of their homes, with the common goal of putting the building of an economy more respectful of good life on our planet at the heart of the recovery .

Public authorities and some private firms have already signalled their support to pursue an ambitious policy of energy and ecological transition. In the communiqué of the European Council of 26 March, devoted to measures to fight the pandemic but also to support the EU economy, there is the following paragraph:

“The urgency is presently on fighting the Coronavirus pandemic and its immediate consequences. We should however start to prepare the measures necessary to get back to a normal functioning of our societies and economies and to sustainable growth, integrating inter alia the green transition and the digital transformation, and drawing all lessons from the crisis. This will require a coordinated exit strategy, a comprehensive recovery plan and unprecedented investment. We invite the President of the Commission and the President of the European Council, in consultation with other institutions, especially the ECB, to start work on a Roadmap accompanied by an Action Plan to this end.”

In the last weeks, there have been many public statements about the priority to be given to a sustainable agenda in the post-Covid recovery programme. Most of them, coming from EU and national politicians, NGOs, but also private firms have been in favour of this priority.

\*\*\*\*\*

In 1815, after the end of the Napoleon era, France was ruined. The Minister of Finance, Baron Louis, said to his King and his Prime Minister “*Faites de la bonne politique et je vous ferai de la bonne finance*”. This recipe is probably the same today, where the “good policy” to overcome the crisis, has to include an implementation of a robust strategy to deliver the energy and environmental transition that we need.

*This article has been written by Jean-François Pons*



# Sustainability transition challenges for Small and Mid-Caps

See the Eurofi Policy note “ESG Report on Small & Mid Caps - April 2020”:

[https://www.eurofi.net/wp-content/uploads/2020/04/esg-report-on-small-mid-caps\\_zagreb\\_april2020.pdf](https://www.eurofi.net/wp-content/uploads/2020/04/esg-report-on-small-mid-caps_zagreb_april2020.pdf)

## Key role of Small & Mid-Caps in the ecological transition economy

Small & Mid-Caps play a key role in the European economy and account for 80% of the listed companies in this region. However, they have been largely absent from the development of an ESG rating system (based on environmental, social and governance criteria) to assist the ecological transition. The measurement models for ESG ratings and Climate change issues that emerged in the 2000s primarily targeted Large Caps, as these feature heavily in the portfolios of institutional investors, who were the first to adopt a responsible investment approach under pressure from their customers, regulations and the weight of public opinion.

The adoption of the Paris Agreement aimed at limiting global warming to two degrees Celsius by the end of the century in 2015 has changed the face of the ESG rating system. It has become an essential tool for analysing the different risks and opportunities that each sector faces according to **the nature of its activities and products. The most documented risk analysis models** are those concerning energy models' urgent transition from fossil fuels to renewables.

## A lack of relevant ESG data for many Small & Mid-Caps

ESG data emerged in the 2000s with the first regulations requiring companies – only the largest, initially – to publish information on their greenhouse gas emissions or the gender breakdown of their boards of directors. These requirements led to the creation of a new business: corporate ESG ratings. Initially, data providers and specialised rating agencies assessed companies based on a large number of criteria from the data they provided. This remained largely confined to very large companies, which then deployed resources targeting this type of reporting, for which they identified strategic marketing opportunities. Small & Mid-Caps remained largely outside this ESG data structuring effort. While they have nevertheless provided data at the instigation of their shareholders and clients, the heterogeneity and lack of relevant information linked to the ecological transition demanded by the Green Deal and the Covid 19 crisis are regrettable. This is all the more problematic given their significant economic weight in the European economy in terms of jobs and development.

## New obligations linked to Europe's prioritisation of sustainable finance will have a significant impact on Small & Mid-Caps

Since 2018, Europe has actively implemented an offensive strategy aimed at making Sustainable Finance the core of its financial activity. It has already adopted binding measures that affect Small & Mid-Caps, especially as 40% of these operate in the sectors with the highest greenhouse gas emissions and are exposed to increasingly stringent regulations.

By 2021, the taxonomy of green activities will lead companies of all sizes to publish the green portion of their turnover and/or capex. They will have to communicate the portion of their products and services corresponding to the activities listed in this taxonomy. Similarly, from next year, investors who want to launch products claiming to be Sustainable Finance will have new obligations to inform their customers about these products' features. They will have to assess the financial cost of the environmental and social risks to their portfolios, and set up environmental and social performance indicators accordingly.

## Mobilise Small & Mid-Caps' high capacity for innovation and adaptation to create more resilient models

In the current times of health and ecological crisis, there are increasing calls for the emergence of a more sustainable European economic model. Small & Mid-Caps are hence faced with new expectations from their shareholders, who will demand to understand how their transition to more sustainable, more local, circular models that consume less natural resources is organised, and how this provides data for the risk and opportunity analysis models used in ESG.

All companies will have to mobilise their full range of adaptation capacities, which in the case of Small & Mid-Caps are significant. Small & Mid-Caps represent an excellent solution to these challenges, as they have real strengths in terms of adaptation, innovation and responsiveness that can be brought to this critical process. Their ability to rapidly develop their products and services due to shorter processes can make them very attractive to responsible investors. This is provided, however, that they can produce data explaining these strategic directions based on appropriate and comparable indicators.

## Small & Mid-Caps require strong support for their ESG initiatives

This report thus puts forward a series of recommendations likely to help the intensive deployment of a dedicated and relevant ESG approach among European Small & Mid-Caps. Solutions tailored to the current needs of this group of companies include the development of specific support systems, improved access to ESG data within a harmonised framework, and the promotion of access to financing for Small & Mid-Caps involved in ESG initiatives. This requires differentiated support that combines measures at both European and domestic level in a coordinated manner, and which makes full use of the principle of subsidiarity. It must be based on specific expertise, financial support from European bodies, and greater investor involvement, in particular regarding the demand for high-quality ESG data. This is a crucial challenge for European sovereignty in an increasingly less regulated world.

This ESG SMID initiative aims to propose an industry-wide approach to promote the adoption of ESG approaches in the Small and Mid-Cap sector.

Today we are presenting the report related to the initial phase of the initiative, that focused on:

- The analysis of the entities concerned, the investment potential for each business sector and the ESG issues associated with these sectors;
- The identification of the drivers and obstacles for the development of ESG for Small and Mid-Caps;
- The identification of possible proposal for industry-wide initiatives to promote the adoption of possible ESG approaches for Small and Mid-Caps.

In the Eurofi context, the initial phase of the initiative focused on the French financial market ecosystem. This phase has been driven by a working group with representatives from CDC Croissance, Ethifinance, Eurofi, Euronext, Novethic, and PwC, as well as Tradition.

The initiative will now be extended at the European level.



## Summary of the recommendations to promote the application of the ESG approach for Small & Mid-Caps

### Improve the accessibility and quality of ESG data at national and European levels

1. Coordinate long-term national investors to **standardise the ESG analysis grids** based on their ESG expertise.
2. Coordinate the National Promotional Banks and Institutions (NPBIs) and the European Investment Bank (EIB) Group at the European level to develop a **minimum European base of standardised ESG indicators** for the public sector.
3. Bring together national public opinion leaders (auditors, national central banks, accounting and financial association, etc.) and European public opinion leaders (EBA, EFRAG, ESMA, Eurostat, European Central Bank, etc.) as part of a **common normative approach for the production of ESG indicators**.
4. **Consider the specific features of SMIDs and SMEs** in view of the forthcoming revision of the Extra Financial Reporting Directive and promote the emergence of **extra-financial reporting of a similar comparability and quality to that of financial reporting**.
5. Promote **the automation of ESG data collection and the provision of data input, display and transmission tools for ESG indicators**.
6. Assess the **advantages and disadvantages of organising the collection and provision of ESG data as part of a public process** to facilitate data entry and data access.

### Develop a support system for listed SMEs in implementing their ESG approach

7. Develop **awareness-raising and methodological materials** to facilitate the implementation of ESG approaches by SMIDs.
8. Identify, mobilise and strengthen **structures offering support for SMIDs**.
9. Set up a **transition support fund** to provide financial resources at the various stages of SMIDs' **implementation of an ESG approach**.

### Preserve and develop intermediaries able to monitor the extra-financial performance of European SMIDs

10. Ensure the **sustainability and development of agencies specialised in the ESG assessment** of European SMIDs.
11. **Restore research capacities** for SMIDs and **promote the integration of ESG assessment in this research**.

### Promote access to financing for Small & Mid-Caps undertaking an ESG approach

12. Create **an index, fund of funds or an ESG market fund** to support the development of Small & Mid-Caps by prioritising a **Best Effort approach** in addition to the Best In Class approach. Encourage a pan-European approach in conjunction with the EIB group (including the EIF) and the European Commission.
13. Promote the creation of a **dedicated ESG European stock market section** to provide benchmarking and visibility for investors.
14. **Promote "impact" financing that combines financing with support** (performance improvement, support services), for instance via tax or regulatory incentives.

# ON-GOING POLICY DEVELOPMENTS

---

Optimizing third-country approaches: the challenges of Brexit	39
The protection of deposits in the EU	41
Stable-coins, digital assets and electronic payment prospects and challenges	47
Ensuring operational resilience in the Covid-19 crisis context	50

# Optimizing third-country approaches: the challenges of Brexit

## Progress of EU-UK trade negotiations

The Brexit timetable is now more clearly set out following the conclusion of the withdrawal agreement between the EU and the UK, which entered into force in February 2020, opening the way to a transition period until the end of 2020 during which the current situation will be maintained. Although the terms of the withdrawal agreement mention that the UK may decide in June whether to request an extension to the transition period until the end of 2021, a UK law has already been passed ruling out any extension<sup>1</sup>.

The terms of a potential trade deal that would govern future EU-UK trade relations after the transition period are however still to be defined. The UK government has expressed its preference for a Canada-style agreement<sup>2</sup> (i.e. a tariff-free, quota-free trade deal for goods, going possibly somewhat further than the current CETA agreement in some areas such as the range of products covered, but involving new frictions at the borders) and has also threatened to discontinue talks and leave the EU on WTO (World Trade Organisation) terms (i.e. Australia-style exit)<sup>3</sup> if no agreement has been reached in June. Moreover Britain has also reiterated its refusal to be bound by a strict alignment of rules with the EU or to be subject to the European Court of Justice as the ultimate interpreter of EU law.

The EU has however indicated that such a tariff and quota-free trade deal would require that the UK should sign up to level-playing field commitments - i.e. the upholding of common high standards using EU standards as a "reference point" (in areas such as State-aid, competition, social, employment and environmental standards, certain relevant tax and regulatory matters<sup>4</sup>, etc...). In addition the EU has proposed an overarching agreement with one single dispute-settlement system, rather than separate deals covering different areas.

The UK government has claimed that it is not ready to accept such conditions that may go against its objective to keep control on the future direction of UK regulations, arguing also that other nations that have concluded trade agreements with the EU have full regulatory autonomy and that the criteria put forward by

the EU to justify different requirements for the UK are irrelevant (closer geographical proximity and higher intensity of trade<sup>5</sup>). The UK has nevertheless stated that it will maintain high standards and agreed to commit not to undercut existing EU regulations in areas such as environmental policy and labour laws, but does not want these commitments to be covered by the trade agreement's dispute-settlement system. In any case a possible EU-UK trade agreement would most probably be mainly focused on goods and would have limited impact on financial services.

## Equivalence as the way forward in the financial sector

Regarding the financial services sector, equivalence arrangements were agreed to be the basis for future EU-UK relations in the political declaration related to the withdrawal agreement (dated October 2019). This would concern the 40 areas or so of financial services covered by such arrangements<sup>6</sup>. It was also agreed that the EU<sup>7</sup> and UK "should start assessing equivalence with respect to each other as soon as possible after the UK's withdrawal from the EU, endeavouring to conclude these assessments before the end of June 2020". This reliance on equivalence arrangements has since been reaffirmed in the respective negotiation mandates of the EU and UK, with an emphasis also on regulatory and supervisory cooperation.

The UK (in the perspective of Brexit) and some other third-countries such as Switzerland have been criticizing EU equivalence arrangements for their lack of predictability (agreements can be unilaterally discontinued with a 30 days' notice period), the alleged politicization of equivalence determinations (with assessments that may take into account criteria that go beyond purely technical regulatory aspects) and the cumbersomeness, level of detail and lack of transparency of the EU equivalence process.

For its part, the Commission reaffirmed in two recent communications (Working Document - February 2017 and Communication - July 2019) the main principles guiding EU equivalence arrangements in the area of financial services and has repeatedly claimed that its equivalence policy is fit for purpose for handling future EU-UK relations in the financial sector. The Commission's

<sup>1</sup> It has been suggested that the temporary suspension of Brexit negotiations due to the coronavirus crisis may lead to an extension of this standstill period, one reason being the time needed for companies to adapt to the new market situation, once a deal (or no deal) has finally been agreed. That would however mean changing the UK law which commits to put an end the transition period in December 2020.

<sup>2</sup> The CETA (Comprehensive Economic and Trade Agreement) between the EU and Canada is not a zero-tariff, zero-quota deal, but it does eliminate most tariffs (taxes on imports) on goods traded between the EU and Canada. Tariffs remain notably on poultry, meat and eggs. It also increases quotas (the amount of a product that can be exported without extra charges) but does not eliminate them altogether (e.g. quotas remain on EU cheese exports to Canada). CETA however does little for the trade in services - except imposing rules such as the most-favoured nation clause (i.e. the non-discriminatory treatment of third-countries) or the elimination of quotas for foreign providers - and nothing specifically for the trade in financial services.

<sup>3</sup> Under WTO rules, each member must grant the same 'most favoured nation' (MFN) market access to all other WTO members (and related customs checks, tariffs, quotas and regulatory conditions), except to countries who have chosen to enter into free trade agreements and preferential market access possibly granted to developing countries. To provide services in other countries UK providers will need to follow the terms set out in the legislation of the host country and vice versa.

<sup>4</sup> such as abiding by OECD protocols.

<sup>5</sup> The Commission explains that every trade deal has a level playing field element to it and that each agreement with a third-country depends on a number of different factors including distance and the level and intensity of trade. The greater geographical proximity of the UK and the intensity of its current trade with the EU justify specific level playing measures compared to e.g. Canada, according to the Commission.

<sup>6</sup> Equivalence regimes exist for financial services related to securities and derivatives transactions (MiFID, EMIR, CSDR, SFTR) and for services and products targeting professional customers and eligible counterparties (investment services under MiFIR, AIFMD) and reinsurance activities. There is also an EU equivalence regime for credit rating agencies and financial benchmarks. However, most core banking and financial activities are not subject to an equivalence regime providing access to the single market. This includes deposit-taking and lending in accordance with the Capital Requirements Directive; payment services in accordance with the Payment Services Directive; and investment services for retail clients. In addition there is no third-country regime for investment funds targeting retail clients (UCITS and AIFs) and most insurance activities except reinsurance.

<sup>7</sup> At this stage the negotiation mandate of the EU mentions the respective unilateral equivalence frameworks of the EU and UK as the key instruments the parties will use to regulate interactions between their financial systems, with a commitment to cooperate in order to preserve financial stability, market integrity, consumer protection and fair competition.

view is that equivalence needs to be conducted in a proportionate way, depending on the risks implied by the third-country considered in terms of financial stability, market integrity and customer protection. This means that the higher the potential impacts of a third-country market are on the EU, the more thorough an equivalence assessment should be. The Commission has moreover stressed that in terms of process, these assessments look at the outcomes of third-country regulation and supervision rather than an identity of rules. In addition, decisions to withdraw equivalence are not abrupt and take effect, depending on the circumstances, after a possible transition period and can be restored or limited in time<sup>8</sup>.

In its July 2019 communication, the Commission moreover mentioned some improvements underway regarding equivalence processes. Efforts have been made notably for increasing their transparency and accountability, with e.g. measures to improve the information provided regarding the way EU equivalence processes work and how equivalence assessments are progressing<sup>9</sup>.

In January 2020 changes were also made to the supervisory toolbox related to EU equivalence arrangements that should facilitate their monitoring by the European Supervisory Authorities (ESAs). Each ESA is to perform the monitoring of equivalent third country regulations and to submit a report on these monitoring activities to the European institutions on an annual basis. The ESAs have also been provided with more resources following the ESFS<sup>10</sup> review that should allow performing more regular and - detailed assessments of the third-countries concerned. In the capital markets area EMIR 2.2 and the reviewed Investment firm regulation have introduced changes regarding non-EU players, notably with a stricter recognition regime for systemically important third-country CCPs that will have to comply with EMIR requirements and be subject to certain supervisory powers of ESMA. Extending the supervisory role of ESMA in relation to non-EU trading venues and CSDs is also envisaged.

#### On-going EU-UK discussions regarding equivalence

At the beginning of 2020, UK representatives reiterated their concerns with the existing EU equivalence approach, notably its lack of predictability, and also their refusal to become a rule-taker in a sector of such vital importance for the UK as financial services. Proposals have been made by the UK, notably in their approach to EU-UK trade negotiations (February 2020), to move towards a more balanced, structured and principles-based system concerning the withdrawal of equivalence arrangements. The EU has so far rejected these proposals on the grounds that this approach would undermine the EU's regulatory decision-making autonomy and also that the same system should be used for all third-countries.

The timing of equivalence negotiations is another issue. Given the current identity of UK and EU rules, the UK has urged the EU to conclude equivalence assessments by June 2020, in line with the objective mentioned in the political declaration of the withdrawal agreement, in order to avoid any market disruptions. But the Commission has warned that this deadline only refers to the mapping of equivalence assessments and not to the decisions themselves, which would be guided by how far Britain wants to deviate from EU rules, particularly with regard to rules that may impact financial stability or consumer protection, considering the systemic importance of the UK-based financial sector for the EU.

Moving more quickly on equivalence has not been included in the negotiating mandate of the EU, which sees this as a strictly unilateral matter. Moreover, the Commission considers that the risk of a cliff edge at the end of 2020 is exaggerated, given the additional time that the industry has to adapt its operations during the transition period. Some observers however suggest that this is also a way for the EU to keep access rights for financial services as a bargaining chip in the broader discussions on trade with the UK.

#### Implications of equivalence negotiations for the EU and UK

The way equivalence is implemented between the EU and UK may change to a certain extent the current dynamics in the EU and UK financial markets, which are essential for both economies, potentially raising costs for clients or splitting up existing processes and flows with new barriers.

Achieving appropriate equivalence arrangements with the UK is important for the EU, given its current dependence on UK-based financial activities, particularly in the wholesale capital market area. For example, almost half of all debt and equity issuance for non-financial institutions in the Eurozone is carried out by global banks based in London, up to 90% of certain euro-denominated swap transactions are cleared in London... This dependence is likely to continue if the transfer of activities to the EU remains limited and also until the EU develops sufficiently deep, liquid and integrated capital markets, possibly thanks to the Capital Markets Union (CMU) initiative. The UK will also be putting in place its own equivalence arrangements which may impact to a certain extent EU players operating in the UK. At the same time providing longer-term (or possibly permanent) stability to an equivalence regime would offer the UK a status fairly close to being in the single market for the activities concerned, which is not acceptable for the EU.

For the UK, beyond possible internal political considerations, the question is whether the opportunities offered by divergence from EU financial directives such as MiFID II or Solvency II and avoiding the possible downsides of being a "rule-taker" or "outsourcing financial regulation to the EU" (in terms of risk mitigation or adequacy of rules to UK needs) are worth the cost of losing access to EU markets, which at present make up about 20% of activity in the City. In addition the opportunities and downsides of divergence may vary across financial activities when taking into account specific market dynamics and the (incomplete) coverage of EU equivalence arrangements. Whether the business continuity of current equivalence arrangements is acceptable for UK-based market players and the feasibility of possible alternatives (e.g. increasing presence in the EU) are also an important factor.

<sup>8</sup> EU representatives have also explained on other occasions that although steps and timelines are not strictly defined, a withdrawal of equivalence only happens after an in-depth assessment normally performed by one of the ESAs. Moreover, equivalence assessments have to take into account several micro and macro dimensions (beyond regulatory requirements related to the policy under consideration) including investor protection, potential systemic risks, as well as AML, market disruption or level playing field aspects, in order to ensure that EU markets and customers are not exposed to unwanted risks as a result of equivalence agreements (see Summary of Discussions – Eurofi Bucharest Seminar April 2019).

<sup>9</sup> For example the Commission now generally submits for public consultation draft equivalence decisions that are envisaged for adoption with a 30 day feedback period.

<sup>10</sup> The review of the European System of Financial Supervision (ESFS) also called the ESAs review.



# The protection of deposits in the EU

Could a Common Deposit Insurance Scheme effectively reduce the vulnerability of national Deposit Guarantee Schemes (DGS) to large shocks, instilling confidence of investors and citizens in our common financial system. Seven years after the EU embarked on building a Banking Union in response to the financial and sovereign debt crisis, Germany proposed to break the stalemate by setting up a European deposit reinsurance scheme.

This note presents the expected benefits of a European Deposit Insurance Scheme (EDIS), the arguments against it and possible ways forward.

## The current protection of deposits

For the time being depositors are protected by Directive 2014/49/EU of 16 April 2014 (Deposit Guarantee Scheme Directive / DGSD). This Directive includes all credit institutions and all schemes, without distinction. By July 2024, the available financial means of a Deposit Guarantee Scheme (DGS) should at least reach a target level of 0,8 % of the amount of the covered deposits of its members.

These requirements will ensure that regardless of where the deposits are located in the Union, depositors will always have a claim against a scheme and that all schemes must be soundly financed. Depositors thus benefit from significantly improved access to DGSs, thanks to a broadened and clarified scope of coverage, faster repayment periods, improved information and robust funding requirements. At the same time, the common requirements laid down in this Directive ensure the same level of stability of DGSs and eliminate market distortions. The Directive therefore contributes to the completion of the internal market.

## **1. Weaknesses of the current system**

Despite the many improvements made by DGSD, some weaknesses remain.

The most important ones concern the case of large local shocks. No national deposit guarantee scheme has sufficient resources to deal with such shocks, which could overburden a national DGS, taking into account that the DGSD provides only a vague voluntary borrowing facility between national DGSs. Under the regime of DGSD a national deposit fund, which is depleted in the case of a large pay-out, would typically get a loan from the relevant national government that would intervene as a national backstop.

This system will have negative impacts. It undermines the credibility of national DGSs in less wealthy Member States that have no financial means available to intervene as backstops. In addition, the financial disparity across backstops of national DGSs may create adverse incentives, contributing to market fragmentation and competitive distortion. Finally, it intensifies the loop between sovereign risk and banks.

Against this background, the EU Commission was aiming for the mutualisation of the national DGSs by establishing a European Deposit Insurance Scheme. In line with the Five Presidents' Report of 2015, the Commission tabled a legislative proposal on EDIS at the end of 2015 that would progressively evolve from a reinsurance scheme into a fully mutualized scheme over a number of years, replacing the existing national DGSs which are then entirely depleted. A joint Deposit Insurance Fund (DIF) would be created,

managed under the auspices of the existing Single Resolution Board. EDIS would be mandatory for euro area Member States and open to non-euro area Member States willing to join the Banking Union.

Discussions at the EU Parliament and the EU Council, particularly related to legacy risks (Non-Performing Loans / NPLs) and the fully-fledged mutualisation approach set in immediately and were very intensive. The EU Commission tried to address some of the concerns voiced in its Communication dated 11 October 2017, in an attempt to reconcile the diverging views that emerged during the negotiations and to influence the discussions in the European Parliament and the Council while not giving up the initial idea of a fully mutualised scheme with one central fund. In particular, EDIS could be introduced by the co-legislators more gradually: In the reinsurance phase, EDIS would provide national DGSs with liquidity in the case of a bank failure, which would have to be paid back by the national DGS. Liquidity support is the most essential element to ensure that depositors are paid out. In the coinsurance phase, EDIS would also cover losses, without recouping them from the national DGS. This would further reduce the link between banks and their Member States. However, moving to this second phase would be conditional on the progress achieved in reducing the level of NPLs and other legacy assets recognised in the course of an Asset Quality Review (AQR).

Further to the Franco-German declaration of Meseberg and a decision of the heads of government in 2018, a High Level Working Group (HLWG) was established at the Council in order to work on ways forward on the political level since all the technical details and options of a European deposit scheme have been laid out in the Council discussions. The HLWG has been given a broad mandate, acknowledging the fact that any European deposit guarantee scheme has to be embedded in a wider context, dealing with legacy issues, existence of any backstops and the general set-up of the Economic and Monetary Union

In June 2019, this HLWG produced a report, which identified the areas where further work was needed. These include EDIS, crisis management, cross-border integration and the regulatory treatment of sovereign exposures as well as financial stability aspects. The Eurogroup in inclusive format in June 2019 mandated the HLWG to continue technical work to define a transitional path to the steady state Banking Union for relevant elements and their sequencing, adhering to all the elements of the 2016 roadmap, and to set out a roadmap to begin political negotiations on a European deposit insurance scheme.

The chair of the HLWG in its report from December 2019 proposed such a roadmap on EDIS for political negotiations.

Work could start immediately on the following actions:

- On EDIS: Negotiations on the set-up and features of an EDIS could be taken forward by the Eurogroup in inclusive format, supported by the HLWG, in particular to agree among Member States on the main features and set-up of EDIS.
- On incentivising banks to diversify their portfolios, including sovereign exposures: The Commission and ECB could be invited to conduct further analysis and impact assessments on the options identified for the regulatory treatment of sovereign exposures (RTSE) as well as on what a European safe portfolio

could look like. The aim should be to incentivise banks to further diversify their portfolios with regard to sovereign debt and other assets, while safeguarding financial stability.

- On crisis management: The Commission, where needed with the ECB and the SRB, could be invited to carry out the required assessments with respect to the existing crisis management framework, and report back to the HLWG, in order for negotiations to take place. This includes an assessment of the adequacy, effectiveness and overall consistency of the crisis management framework including reviewing the public interest assessment, dealing with non-systemic institutions within the framework, availability of resolution tools and the use of alternative measures, identifying the parts of bank insolvency laws that need to be harmonised and reviewing the conditionality of precautionary recapitalisation.
- On cross-border financial integration: The Commission, and where needed the ECB and EBA, could be invited to come with an assessment of the current state of play on obstacles to further integration, an impact assessment of the effect of gradually removing the identified obstacles and on potential safeguards. In parallel, an assessment of potential measures to enhance cross-border integration could be undertaken, including possibly further incentivising geographical diversification in prudential regulation and whether adjustments to prudential requirements (risk weighted assets (RWA) and leverage ratio) within a financial group are unduly inflated due to internal MREL and if adjustments to prudential requirements are justified to strengthen cross-border integration.

In December the Eurogroup took note of this report. There was broad recognition that “this report by the high-level working group contains important elements for a strengthened Banking Union. Besides the gradual introduction of a European Deposit Insurance Scheme, the report touches upon several elements which are really far-reaching. They are not yet ripe for endorsement or an in-depth discussion at ministers’ level. At the same time, they will help to frame political negotiations going forward. To that avail, we have asked the High-Level Working Group to continue work on all elements with a view to take it forward within this new European Union institutional cycle”.

## 2. The expected benefits of the European Deposit Insurance Scheme (EDIS)

### 2.1. Achieving a true single currency

Full monetary union and a single banking system cannot exist without “single money”, which has to be fungible whatever form it takes, independent of its location within the euro area. Therefore the concept of “single money” requires deposits to inspire the same degree of confidence regardless of where the Member States of the Banking Union are located.

And EDIS would be one effective tool to promote a uniform level of depositor confidence and help ensure the true singleness of the euro. Moreover, to ensure that deposits are truly safe everywhere across the euro area, the likelihood that a bank might fail means it has to be independent of the jurisdiction in which it is established. And, when push comes to shove, depositors must be awarded similar protection wherever they are resident.

Through a single fund, EDIS would ensure equal, high quality protection for all depositors across the Banking Union in the case of bank failure. Europe would have more resources than national deposit guarantee funds to cope with large local shocks, which could otherwise overburden national DGSs.

EDIS would be used notably when smaller banks are put into liquidation, although it is also open to bigger banks should the need

to use it arise within the frame of a resolution. EDIS is a European DGS and a way to break the loop between sovereign risk and the banks when the state has to intervene and fund the DGS.

If we look across the Atlantic, we can see that the US has a Deposit Insurance Fund which is pre-funded and managed by the FDIC, which has adopted a 2% Designated Reserve Ratio each year since 2010. In addition, the FDIC benefits from a guarantee facility of the US treasury. By comparison, in the EU we have two prefunded facilities to address bank failures: Deposit Guarantee Funds at the national level and the Single Resolution Fund. These facilities shall be complemented by the backstop to the SRF, which will have the same size as the SRF. Implementation of EDIS could ultimately centralise the deposit guarantee funds and would therefore align the EU and US more in this regard (even though the EU would still retain two separate pre-funded facilities).

### 2.2. Increasing financial stability

The Banking Union must be completed without delay if we do not want the EU banking system to be still vulnerable in case of crises and for two reasons:

- The first is size, which is the same as the law of insurance: it works better when it pools more resources. By pooling resources at a central level we will significantly increase the resilience of the financial sector. No national DGS would have sufficient resources to do this.
- The second is that, even if you believe that national DGSs can deal with a systemic crisis by themselves, bank failures do not happen in isolation. Banks are so strongly interconnected that an instrument like EDIS is much better placed to deal with spill-over effects.

EDIS could trigger the creation of smoother, more credible and transparent insolvency procedures. There is a concern that national DGSs could trigger massive deposit outflows that could provoke the resolution or insolvency of a bank. The financial disparity across backstops of national DGSs may indeed create adverse incentives, contributing to market fragmentation and competitive distortion. In such a context EDIS should reinforce depositor confidence, reduce market fragmentation and the risks of bank runs and increase financial stability across the Banking Union.

People need to be convinced that there is one Europe and one euro, so that whichever country their bank is in, they can trust the entire system, not just one part of it. Such a system will support confidence in the market. To achieve this goal the Eurozone must put in place a process of gradual increase in risk-sharing, that must go hand in hand and in parallel with risk reduction in a reasonable timeframe.

### 2.3. Aligning liability and control

EDIS is a small part of a big mosaic serving two goals: the first is to ensure that accidents in the financial sector are less frequent, cost less and are less severe; the second is to provide the financial sector with a level playing field, as soon as possible.

EDIS is important for enhancing the sector’s credibility especially within the European Union, but it also has a political dimension. If the responsibility for supervision is elevated to the EU level, the question can be asked as to whether accidents should be paid for at the national level.

There is currently a mismatch between European control and national liability. As supervision and resolution are European, their effectiveness will influence the “if and when” a DGS has to pay out to insured depositors or contribute to resolution.

The supervisory powers of the Banking Union are under the lead responsibility of the ECB, so we cannot argue that national DGSs should pick up the bill in any event of failure. Thus there is a

mismatch between European control and national liability that can lead to extra costs and inefficiencies. An EDIS is therefore felt to be necessary to eliminate such asymmetry by elevating accountability for a trusted safety net for deposits to the European level.

#### **2.4. Completing the Banking Union is necessary to reduce risks of systemic crises**

Unfortunately, the European Union has a history of launching new projects and leaving them incomplete. Take the Schengen treaty. It opened up opportunities for people to travel, but Europe forgot to put police in its borders until later finding out that this had created risks. The monetary union has been left unfinished, because there is no de facto economic union. The Banking Union was launched, and there are doubts about whether it will be completed.

The three pillars of the Banking Union were tabled for all the negotiations taking place at the European institutions. Everybody agreed to them then, but some argue that now people are having second thoughts. Consistent in the project is that a Banking Union can unleash more risks.

It thus needs instruments capable of managing such risks. Without being part of a Banking Union, all national DGSs might prove effective in dealing with a domestic crisis, but this is a globalised financial system with a globalised banking system. Europe is part of that process.

The objective of having a fully integrated banking and financial system must also include the instruments for managing this supranational system. Instead, some argue for a reliance on national schemes and procedures, backtracking on what had been agreed at the beginning. The reason EDIS is now needed is not just for the sake of the completion of the Banking Union; it is because the industry is not immune to the possibility of a major liquidity shock that may affect European or global banking systems. Europe needs to be prepared for such an emergency but it cannot do so using the domestic imbalances of individual countries. The crisis of 2007-08 came from difficulties in controlling capital flows, and the risk management strategies adopted to deal with them. We may continue to live without EDIS, but we will be running greater risks and have insufficient instruments to deal with future crises.

Reaching an agreement on the deposit insurance mechanism would also show inter alia that political commitments taken in 2012 are fulfilled.

### **3. Arguments against implementing EDIS**

The on-going debate on EDIS since 2015 has shown many concerns expressed by various stakeholders (Member States, the European Parliament, industry, consumers) they range from legal ones (EDIS cannot be implemented without a treaty change; infringement of the principles of subsidiarity and proportionality), a missing comprehensive impact assessment, the lack of a necessary and suitable mutualized system up to fears of moral hazard effects and risk sharing as an entry into the transfer union through the back door (in case a European backstop has to intervene as a last resort), which would be in contradiction to the EU treaty. Not least, the abolishment of well functioning national deposit schemes, including the Institutional Protection Schemes, raises questions whether such a toll to be paid is not too high given the fact that EDIS will not be able to resolve more pressing issues such as the lack of profitability in the European banking sector or the need to invest in digitalisation.

Apart from the above mentioned legal problems and risk sharing issues the main concerns involving these stakeholders are:

#### **3.1. Moral hazard**

EDIS could have negative impacts on banking markets, the most important one being moral hazard. Experience shows, depositors will invest in highrisk assets in riskfriendly banks. By mitigating the risks of overburdening national DGS, a mutualised Deposit Guarantee Scheme would create incentives to direct flows to Member States whose banking sector as a whole has a relatively high risk affinity (including with regard to investments in government bonds) and spread precisely these risks across the entire euro area with negative impacts on financial stability. In this way relatively 'healthy' banking sectors in Member States with a low level of risk and a high level of debt sustainability would support their competitors in other Member States. EDIS thus leads to cross-subsidization on a massive scale.

It is agreed that in the context of EDIS banks with higher risk-taking will have to contribute proportionately more to the DIF, although detailed contribution schemes do not seem to exist so far. And the existing DGSD also provides for risk-based contributions. Recent examples in some Member States show, that higher contributions to the national DGS because of excessive risk-taking have absolutely not deterred banks from continuing to do so. And even enhanced supervision based on now available supervisory tools under SSM has not prevented that behaviour. General experience in insurance teaches that the larger the insurance funds the lower the risk of having to bear losses and the more careless the investor becomes. Therefore, concerns are serious that EDIS would loosen the close link between risk and responsibility.

#### **3.2. EDIS prevents the use of alternative measures and Institutional Protection Schemes (IPs)**

Alternative measures are an important issue concerning the use of funds. Alternative measures would apply to credit institutions that are in difficulty. In some Member States (e.g. Italy) DGSs have played an important role over the years in handling banking crises, mostly by applying alternative measures. Therefore, the DGSD explicitly encourages all kinds of DGSs to use their funds for alternative measures in certain cases.

In contrast to this, the EDIS legislation does not include the use of alternative measures. This restriction does not only affect DGSs as in Italy but in particular institutional protection schemes (IPs) as in Germany or Austria, which are protecting the credit institutions as such and are ensuring the liquidity and solvency of their members. Such systems guarantee a different level of protection for depositors in comparison to the protection provided by a standard DGS. If, due to the support of an IPS, a bank does not fail and its services continue to be provided, which is a big advantage from the perspective of the clients, it is not necessary to reimburse depositors.

According to the DGSD an IPS may be officially recognized as a DGS if it complies with DGSD criteria. Under a fully mutualised EDIS such an IPS will see all its funds transferred to the DIF. Its functioning as an IPS will no longer be possible due to the lack of funds. The argument of the Commission that risk based contributions to the DIF of banks belonging to an IPS will be much lower compared to normal banks does not apply to an IPS that is recognized as a DGS. Once its funds are transferred to the DIF, the IPS would have to abandon its activities. Without an active IPS, the banks belonging to it have no claim to reduced contributions to the DIF. This result would force the IPS member banks to completely refinance the IPS which would financially overburden them given that a potential reduction in the contributions will never cover additional costs in view of the fact that contributions to an IPS would always come on top of the contributions to the DGS. Consequently, this results in a contradiction to the key principle of EDIS: No increase of costs for the banking sector, as compared to current obligations under the DGSD.



### 3.3. No respect of diversity and subsidiarity by eradicating ONDs

It is widely accepted, that the diversity of banks fosters the resilience of the banking system in Europe just as in any credit or investment portfolio, nobody would put all the eggs in one basket. The specificities of the banking structures in the Member States are mirrored by the national options and discretions within the DGSD. This is especially true for the possibility of Member States to allow the use of alternative measures or a reduced target level in Member States with a highly concentrated banking market. Under the Commission proposal, EDIS would eradicate those national options and discretions.

Recent activities undertaken by EBA and the EU Commission show that the elimination of national options and discretions is even targeted under the upcoming revision of the DGSD. This clearly affects the diversity and resilience of the banking system on the one hand, making it more uniform but at the same time also making it more inflexible. On the other hand, these negative impacts are directly linked to legal concerns emphasizing that EDIS does not respect the principle of subsidiarity and proportionality.

### 4. Proposed alternative approaches

The debate on EDIS is stuck since 2015. Therefore, the political pressure on all sides to come to a decision is increasing. Taking the above mentioned weaknesses of the current system into account, the need for support among the national DGSs in the case of distress of one of them is widely accepted. It is agreed that depositor confidence in all the Member States should be fostered independently of the geographical location of a bank in the EU.

The overview of the concerns with regard to EDIS and the proposed alternatives shows that, in principle, there is a willingness from most stakeholders to establish a support system between the national DGSs in case a national DGS is in distress. On the other hand, the rejection of a fully mutualized European system remains important in some Member States and not the least with a view to the issue of how to deal with legacy problems. But also other stakeholders more and more acknowledge that the full mutualisation of deposit protection may be overambitious and not justified by the facts. Obviously, it is important to some stakeholders to retain national DGSs, so that they can maintain their important functions in the framework of the DGSD.

Therefore, most of the proposed models are based on the principle that the any DGS remains anchored at the national level while also including a "European" element. The models discussed range from a simple mandatory lending concept (favoured by some Member states) to hybrids that are based on national DGSs and complemented by European components (e.g. EP rapporteur, Council Presidency).

In addition, the in-depth discussions have clarified that it is too short-sighted to only look at deposit protection in order to enable more cross-border activities in the banking sector. In this vein, in November 2019, The German Finance Minister advocated for the implementation of a reinsurance scheme on the basis of a liquidity support scheme and stated the possibility of considering a limited loss coverage component for the European deposit insurance fund, rather than a fully mutualised system. His non-paper also took up all the other important elements in a banking union that have to bring their share in order to make the monetary union work.

Given these persisting differences, one of the following models, both based on a genuine reinsurance approach, should be a possible way forward provided that the home – host debate has been solved and the crisis management has been adjusted in order to become more predictable and provides a consistent treatment of banks and creditors across the EU.

### 4.1. European Deposit Re-Insurance Scheme (EDRIS)

Proposed by the French Banking Federation, EDRIS would be an instrument of last resort: only where the national DGS is depleted following an intervention, should the European re-insurance scheme kick in to help pay out depositors or fund resolution measures. More concretely, in cases where the national DGS has insufficient resources to finance its intervention, it would turn to the European Deposit Re-Insurance Fund (EDRIF) which would intervene as re-insurer for the DGS.

EDRIS would be funded ex-post by the national DGSs. It would call on the other national DGSs to provide funding, taken from the fees collected ex-ante at a national level. The national DGSs' respective contributions would be proportionate to the covered deposits of each participating country, weighted according to risk parameters/scoring which reflect the level of stability of the respective national banking systems.

National DGSs' ex post contributions to EDRIS would be capped so that after intervention for re-insurance purposes the available financial means of the DGS shall not decrease below a certain percentage of the target level.

#### Pros

- The existing model of national DGSs with all the options and discretions of DGSD would be maintained, including alternative measures and IPSs.
- Possible moral hazard effects would be reduced (pay back).
- Consistent methodology for contributions.

#### Cons

- Liquidity support only.
- EDRIS would impose significant organizational challenges due to ex-post contributions.
- Recovery depending on national insolvency law.

### 4.2. Another alternative approach : European Reinsurance Fund (EReIF) with fiscal backstop

CEPS proposed in 2013<sup>1</sup> a two-level framework in which deposit insurance would remain a national responsibility, only subject to the standards set by the EU directive, but the national DGSs would be required to take out reinsurance against systemic shocks. A new institution - the European Reinsurance Fund (EReIF) - would have to be created. This institution would collect premiums from all national DGSs and would pay out if losses at the national level exceed a certain threshold.

The responsibility for losses by individual institutions would thus remain at the national level. But the existence of the European Reinsurance scheme would stabilize the system even if a large, idiosyncratic shock destabilizes the local economy and puts the national guarantee in doubt.

Schematically there would be two tiers of deposit insurance: one by the national DGSs in relationship to 'their' banks and the other by the European re-insurer in relationship to the national DGSs.

The European re-insurer would intervene only in the event that so many banks fail in any given country that the national DGS would be overburdened. The ex-ante funding for the EReiF in turn would come from the national DGSs. National DGSs would thus continue to function as before, but each one would be forced to take out insurance coverage against large shocks to be financed from existing contributions.

Furthermore, CEPS recognizes that systemic shocks to a large country could not be handled by the two tiers of deposit insurance



alone. For this reason CEPS advocates that in such a case an effective common fiscal backstop at the European level should be in place as a last resort.

#### Pros

- The existing model of national DGSs with all the options and discretions of DGSD would be maintained, including alternative measures and IPS.
- Possible moral hazard effects would be reduced (pay back).
- A central body is created and facilitates the implementation.
- Common fiscal backstop is available in case of systemic shocks, which even overburden the two tier system.

#### Cons

- Liquidity support only.

### 5. It is time for a breakthrough

The necessity of deepening and completing the Banking Union is undisputed. And we need to move the current deadlock and more forward. Parliamentarians, Finance ministers, supervisors, academics, and market participants agree in principle because it is the interest of each member State and of the European Union. The German proposal is a constructive approach, which opens the way to a negotiation. Other capitals should engage with it.

#### 5.1. Germany is ready to consider EU-wide deposit reinsurance

Seven years after the EU embarked on building a Banking Union in response to the euro sovereign debt crisis, Germany proposed to break the stalemate by setting up a European deposit reinsurance scheme. It would be based on an Intergovernmental Agreement. It would complement national Deposit Guarantee Schemes fully set-up under the DGSD with a European Deposit Insurance Fund.

Proposals from Olaf Scholz, Germany's finance minister, mark a change of tone. Banking Union is not just essential for financial stability but for Europe's economic sovereignty, he says.

In his article of the Financial Times dated 5th November 2019, Minister Scholz stressed that an enhanced banking union framework should include some form of common European deposit insurance mechanism. A European deposit reinsurance scheme would significantly enhance the resilience of national deposit insurance.

However, such a scheme would be subject to certain conditions, one of which is that national responsibility must continue to be a central element. In the case of a bank failure, a three-tier mechanism would apply. First, the resources of the national deposit guarantee scheme would be used. Second, where national capacities have been exhausted, a European deposit insurance fund, administered by the SRB, would provide limited additional liquidity through repayable loans. Third, where additional financing may be necessary, the relevant member state would step in. A limited loss coverage component for the European deposit insurance fund could be considered, once all the elements of the banking union have been fully implemented".

In order to get there, the German Finance Minister has come up with four conditions.

First, we need common insolvency and resolution procedures for all banks (not only the systemically relevant ones falling under the Bank Recovery and Resolution Directive), building on the example of the US Federal Deposit Insurance Corporation. This would notably address the current discontinuity or asymmetry where supervision and resolution of significant banks are addressed at the EU level while liquidation still follows national rules.

Reducing the number of Non-Performing Loans (NPLs) and introducing capital requirements reflecting actual risks of sovereign bonds.

Changing the plans from a European Deposit Insurance Scheme to a reinsurance scheme with a final involvement of the relevant Member States, once the national DGS and the European Deposit Insurance Fund have been depleted. If the Member State has not sufficient capacity, then the European Stability Mechanism (ESM) could also support the Member State with normal programme resources on the basis of a case-specific situation and with suitable requirements (conditionality), as is standard practice in such cases.

Introducing "uniform taxation of banks in the EU" via common tax vase and a "minim effective tax".

#### 5.2. A pragmatic way forward

Before working on the final design of the third pillar of the Banking Union, several European reforms and decisions seem necessary:

- The home host debate' needs to be resolved; ring fencing practices have to be removed. In an efficient Banking Union there should no longer be any distinction between home and host supervisors for banks operating across borders and the possibility of "national bias" playing a part in regulation and supervision should be eliminated. A forward looking and equitable solution must take into account host country demand for fair burden sharing while allowing as much integration as possible. Prudential requirements (capital, liquidity, MREL. Pillar 2 ones) should be defined for cross-border banking groups at the consolidated level in normal times.

As long as the EU legislative framework does not recognize transnational groups at the consolidated level, the Banking Union cannot produce beneficial effects for significant banks and the EU economy. It would be a nonsense to ask them to contribute to an additional EU deposit fund (they already contribute to the Single Resolution Fund and will do so for its forthcoming backstop) if subsidiaries are still subject to individual – capital, liquidity, bail-in buffers, pillar 2 - requirements, which fragments banking markets and impede the restructuring of the banking sector and in a context where banks are facing profitability challenges.

In this respect, the solution proposed by Mr Scholz is an appropriate starting point for discussions. It combines maximum flexibility to efficiently allocate, capital, liquidity and bail-in buffers for transnational banking groups during normal times and a clear allocation of capital and liquidity between parent company and subsidiaries in time of crisis. According to Mr Scholz, this allocation would follow a mandatory "waterfall" payment scheme, based on statutory provisions and a decision by the SSM and the SRB. Such provisions would provide the ECB and the Single Resolution Board (SRB) with guidelines on how available funds should be distributed within the group in the event of a crisis.

In the same vein, Eurofi has proposed an outright group support from the parent company to its subsidiaries located in the euro area, based on EU law and enforced by EU authorities for cross-border groups which want to be recognized as a group.

Such proposals should be discussed without further delay at the EU level in order to find a solution which would promote the integration and the consolidation of banking groups in the euro area and the increase of cross-border flows in the euro area.

- Europe needs to get a solution for the provision of liquidity in resolution.

The case of Banco Popular has shown the importance of liquidity funding in the context of bank resolution. The Single Resolution Fund can play a role in resolution financing, in particular if a backstop is in place but this will always be too little for any systemic bank.

The potential liquidity outflows from a mid-sized bank (let alone a European G-SIB) is likely to easily outstrip the SRF's ultimate size of 120 bn. By way of example, liquidity support needed to restructure the banking group Hypo Real estate amounted to EUR 145 billion.

The Eurogroup agreed in June 2018 to set up work on a "possible framework for liquidity in resolution, including on the possible institutional framework". The 4 December 2019 Eurogroup mandated further work on solutions.

Finding a solution in 2020 would be decisive for making the EU crisis management framework more predictable and efficient. A specific Euro system Resolution Liquidity facility seems a right way forward. Indeed, the ECB should provide liquidity for solvent but temporarily illiquid banks where short term liquidity from the private sector is not immediately available.

- There is also a need to bridge the gap between the resolution of banks considered to be of public interest by the Single Resolution Board (SRB) - which is defined and implemented at European level - and the liquidation of banks that are not (the vast majority of them) and which follow heterogeneous national liquidation rules in Europe. There is a missing link in the chain within the EU crisis management framework between resolution and liquidation. A European continuum between European resolution and the national liquidation of banks should be established.

EU resolution is for the few, not the many. Most banks (98%) will continue to fall under national insolvency proceedings. It would therefore be advisable to set up a European entity steered by the SSM and the SRB with the participation of DG Competition, in which the national resolution authorities would participate. This entity would be in charge of supervising the national liquidation of banks recognised as likely to fail, on an administrative and non-judicial level. It would thus help to ensure consistent treatment of banks and creditors across the euro area.

This entity should ensure not only the protection of deposits held by individuals and companies but also the disappearance of the bank's failing activities and, if necessary, its effective exit from the market. The aim is also to avoid perpetuating the mismanagement of a bank in difficulty and making it continue unnecessarily. Once a bail out is decided by a member State, this European entity should ensure in particular that the public support is justified in particular with regard to competition law and that the bank is cleaned up and, where appropriate, withdrawn from the market.

- Following this progress, it would then become possible to move forward on the Third Pillar of the Banking Union. Implementing the EDRIS solution defined above (4. 1) would allow progress to be made in this direction while leaving open the possibility of further progress.

Member States where the national Deposit Guarantee Scheme (DGS) has not reached the targeted level of accumulated funds requested by the Deposit Guarantee Scheme Directive (2014) would need to fulfil the requirements to participate to such a solution. The directive requires EU countries to ensure that, by 3 July 2024, the available financial means of a DGS reaches a target level of at least 0.8 % of the amount of the covered deposits of its members (or about € 55 billion).

Maintaining national Deposit Guarantee Schemes seems also essential at this stage to build and reach an agreement on any further EU solution as long as insolvency laws have not been harmonised in Europe.

# Stablecoins, digital assets and electronic payment prospects and challenges

## Essential crypto asset characteristics

The ECB has chosen to define crypto assets<sup>1</sup> as “a new type of asset recorded in digital form and enabled by the use of cryptography that is not and does not represent a financial claim on, or a liability of, any identifiable entity.” This definition stresses two essential aspects of crypto assets: (i) the focus is not on the use of technologies that are currently needed for crypto assets’ existence but are not specific to it; and (ii) the value of a crypto asset is only supported by the expectation that other users will be willing to pay for it in the future, rather than by a future cash flow.

In particular, this means also that assets in digital form can be recorded by means of DLT without necessarily differing from their non-DLT equivalents in terms of economic impact and legal nature. Cryptographic techniques, in these cases, are used in order to replace any trusted bookkeeper in the recording of crypto assets with a view to: (i) ruling out any unexpected increase in crypto assets issued on a distributed ledger; and (ii) getting the network of users to agree on who owns what. In addition, DLT approaches feature a specificity which is to scatter the validation processes of the recording of the issuance of assets and asset transfers among a set of providers who do not necessarily have to trust one another and may even have conflicting incentives.

## Addressing even more demanding consumer needs stimulates the creation of new payment means

Consumers need “instantaneous, continuous, and standardized payments” in the context of always increasing interlinking through the internet and GSM. Such a demand is to a large extent already met by an increasing number of diversified payment services providers.

The BIS considers<sup>2</sup> that, although an increasing number of countries have payment systems that provide inexpensive and near instant domestic payments, challenges in current payment services remain for addressing these emerging needs. It stresses that, in particular, cross border payments remain slow, expensive and opaque, especially for retail payments. Indeed, additional compliance costs – multiple regulatory regimes, more complex and numerous AMLTF processes – and more burdensome processing arrangements (lack of standardisation) reduce processing efficiency, while reduced payments volumes (compared to domestic transactions) jeopardise necessary investments. As a result, cross border retail payment costs are estimated to be up to 10 times domestic ones, taking into account forex costs, and completing such payments may take up to seven days. In addition, there are 1.7 billion people globally who are unbanked or underserved with respect to financial services.

In this context, web-based technologies, notably blockchain, enable provision of new payment services, be they business-to-consumer or peer-to-peer; in order to mitigate volatility risks, “stablecoins” may prove more attractive. Indeed, stablecoins

which share many features with crypto assets seek to stabilise the price of the “coin” by linking its value to that of a pool of assets.

## Stablecoin risk specificities

These approaches have to address their specific weaknesses. Many regulators<sup>3</sup> consider that stablecoins are, at this stage, far more fragile than settlement assets with legal tender status. Indeed they consider that: (i) they are not entirely stable since their price stability depends on the value of a basket of assets; (ii) they may offer no complete guarantee of a refund in the event of fraud; (iii) they often have an only partially regulated nature; and (iv) they often lack a formal governance structure.

According to the 2019 G7 report on stablecoins<sup>4</sup>, such schemes are significantly exposed to legal, financial, and operational risk in addition to compliance risk concerning money laundering and terrorist financing, competition law, and consumer and investor protection. These features expose related holders to uncertainty and possible losses. Consequently, the financial system may also be exposed to these risks, and related spill-over effects may eventually transmit them to the real economy. Actually, the impact of a possible price crash may be passed on to the creditors of the holders and other entities.

The ECB considers that, more generally, holders of crypto assets, investment vehicles and retail payments represent the main potential linkages between the crypto asset market and the financial systems, and more broadly the economy. In particular, new as well as existing intermediaries provide the channels that facilitate the interconnections between crypto assets, financial markets and the economy.

## Stablecoin regulatory and supervisory challenges

Although it is the responsibility of the private sector to design stablecoin schemes that do not bring undue risks to payment systems, regulatory and oversight authorities have to define the appropriate comprehensive risk management requirements while preserving the potential for technological innovation offered by crypto assets and stablecoins.

Provided that a number of identified issues are familiar, existing regulatory and oversight frameworks only require adapting to address them. However, adaptation of local national regimes should fit into a larger regulatory framework to be adopted at the global level. There is indeed a need for overall consistency to prevent regulatory arbitrage. The “same activities, same risks, same rules” principle is, in this respect, a bedrock.

Finally, public authorities must coordinate across agencies, sectors and jurisdictions to make innovation in payments affordable by ensuring a globally consistent response to mitigating all identified risks.

It is also necessary to address risks that fall outside existing frameworks. To that end, three specific areas should notably be regulated and supervised:

<sup>1</sup> ECB 2019 - Understanding the crypto-asset phenomenon, its risks and measurement issues - [https://www.ecb.europa.eu/pub/economic-bulletin/articles/2019/html/ecb.ebart201905\\_03~c83aeaa44c.en.html#toc3](https://www.ecb.europa.eu/pub/economic-bulletin/articles/2019/html/ecb.ebart201905_03~c83aeaa44c.en.html#toc3)

<sup>2</sup> Investigating the impact of global stablecoins - <https://www.bis.org/cpmi/publ/d187.pdf>

<sup>3</sup> Stablecoins - a good or a bad solution to improve our payment systems? Denis Beau Deputy Governor Banque de France - <https://www.bis.org/review/r200115c.htm>

<sup>4</sup> Investigating the impact of global stablecoins - <https://www.bis.org/cpmi/publ/d187.pdf>

- the legal qualification of a stablecoin, which should provide legal clarity on the nature of the claim to all participants in the stablecoin ecosystem, among which are issuers and holders;
- the conditions under which a crypto asset can be exchanged for another one, in commercial bank money or in central bank money;
- the venues and arrangements used to exchange them, since these schemes rely on novel and untested technologies and new entrants to financial services.

**Central Banks Digital Currencies (CBDC) may represent an alternative solution... at domestic or regional levels**

For addressing these fast-raising, notably cross border, instant and cheap payment needs, it is envisaged that central banks will issue digital currencies available to the general public. In this scenario, business-to-consumer or peer-to-peer payments would likely be cash-like, convenient, resilient and widely accessible by-design, although many technical and architectural design options remain to be settled<sup>5</sup>.

However, since there is no global legal and technical infrastructure, central banks will have to address in way or another currency conversion and provide cross border liquidity services at the international level. They also have to achieve the necessary adjustment and harmonisation of operating hours, access criteria, clearing and settlement procedures, messaging across national central banks or national payment schemes, and get countries' payments systems interoperable.

Finally, they also will have to shoulder compliance tasks and costs related to preventing money laundering and the financing of terrorism, while addressing legal issues. This is not to mention the business case of such CBDC, which still have to be described.

**Closed loop arrangements, notably those that reach global scale, favour the development of supranational stablecoins**

Fulfilling all of these constraints probably provides a technical and competitive advantage to closed loop digital currencies given that, in addition, GAFA's business models behind certain of these initiatives (ability to leverage the data collected) may facilitate making their business case sustainable.

Indeed, closed loop digital currencies are provided by a single payment service/arrangement which may not necessarily be "domestic" but rather supranational. Web-based digital currencies are not necessarily physically located in a specific jurisdiction but are actually essentially "distributed". Related "terms and conditions of use" are applied by providers similarly worldwide. This architecture is characterised by a de facto extraterritoriality. It also raises the question of the capacity of a judicial authority to enforce the law.

Finally, since proposed transactions involve a digital currency rather than various currencies, the need to develop contact points with existing currencies, and more generally financial systems, is reduced, which lowers processing and forex costs.

**Stablecoins may trigger a fundamental shift toward new value-storage forms**

The BIS report also stresses that stablecoins, notably those that reach global scale, could challenge and pose risks also to monetary policy and the international monetary system, and raise a fair competition concern. The report considers that these risks are of a systemic nature.

Indeed, closed loop stablecoins supported by BigTechs benefit from unprecedented global customer bases and represent, to a large extent, a mandatory crossing point which provides them with huge network effects. The high probability of accessing your counterpart through related stablecoin arrangement encourages its use, which in turn increases the attractiveness of the payment scheme and its efficiency. These schemes possibly becoming de facto essential facilities represent an important issue for regulators, since effective and fair competition is a precondition for developing innovation, choice and optimal cost.

Furthermore, since these new transaction arrangements reduce the necessity for consumers to have a bank current account and possibly propose them new value storage opportunities, the roles of banks and related business models are expected to be dramatically transformed. This should be compounded by the expected reduction of the cost of transactions.

Eventually, current lending mechanisms – and subsequently monetary policy transmission channels – may change due to the withdrawal of banks whose deposits will progressively melt away. This would also be the case should Central Banks Digital Currencies develop, the Bank of England stresses.

Both aspects deserve attention and preventative monitoring by regulators and central banks, since the continuity of lending availability and maintaining lively competition requires prompt reactions to prevent any irreversible negative change in the financial system.

**In parallel to stablecoin challenges, regulators should also factor into EU regulations the most recent evolutions of the competition landscape as well as the emerging sovereignty concern**

While cryptocurrency and, more recently, stablecoin challenges are gaining pace, existing payment schemes are also swiftly evolving and raising parallel regulatory and supervisory challenges.

PSD2 has been focusing on competition enhancement. The discussions are now widening the scope from open banking to open finance in order to include the full scope of all financial products, ranging from insurance to savings and pensions. There is also the question of whether enhanced portability of all customer data should also fuel innovation.

Favouring the evolution of business models specific to payment transactions is also essential. In this respect, the Interchange Fee Regulation (IFR), initially principally focused on eventually capping interchanges, has reinforced existing providers rather than favour the emergence of additional ones and has not enabled the emergence of EU payment systems. It is probably necessary to update this regulatory approach factoring in the new stakes facing the EU, e.g. the definition of an adequate level of sovereignty in the EU regarding the processing of transactions, or the recalibration of interchange fees taking into account the recent emergence of effective new contenders based on different business models challenging existing payment schemes. These elements may be prerequisites to a wide and swift adoption of the recently launched TARGET Instant Payment Settlement (TIPS). Achieving a balanced business case is certainly also essential to the take off of the European Payment Initiative.

Indeed, a recent but essential topic in the EU is to preserve European sovereignty. This has been highlighted by the current health crisis context, which illustrated the need to avoid any

<sup>5</sup> BIS - Raphael Auer & Rainer Böhme - The technology of retail central bank digital currency – 2020 [https://www.bis.org/publ/qtrpdf/r\\_qt2003j.pdf](https://www.bis.org/publ/qtrpdf/r_qt2003j.pdf)

<sup>6</sup> It's time to talk about money- Bank of England - Jon Cunliffe - <https://www.bankofengland.co.uk/-/media/boe/files/speech/2020/its-time-to-talk-about-money-speech-by-jon-cunliffe.pdf?la=en&hash=A39E014DBBA2C5E88D1B8339E61598CBD62BCA3E>



possible knock on effects resulting from excessive dependency on non-European providers (e.g. IT, Cloud providers, payment schemes and processors, etc).

### **Digital assets – Tokens**

#### ***Benefits and specific risks***

Distributed ledger technology (DLT) is thought to have useful applications in particular for securities and their settlement. Transforming securities into digital tokens – representations of value not recorded in accounts – could make ownership records more transparent and settlement much faster.

However, in addition to the risks tokens pose to investor protection and market integrity, among which the most significant risks are fraud, cyber attacks, money laundering and market manipulation, and in addition to the technological challenges posed by tokenising securities, their management raises challenges.

Indeed, the validation and update of transactions would not be centralised anymore in a CSD and some large intermediaries, but rather addressed by all the parties. Furthermore, although DLT techniques reduce the size of securities inventories to be held by market makers, the key smoothing and financing roles of these intermediaries are also questioned, despite their contribution to the efficiency of the overall settlement processes. Finally, increased speed also increases the possibility of settlement failures.

#### ***Regulatory challenges posed by tokens***

A key question is whether the existing regulatory framework applies to such instruments. In addition, there may be areas where crypto assets require interpretation in order to allow for an effective application of regulations. In particular, an important aspect is the legal status of crypto assets, which determines whether financial services rules are likely to apply. Where regulation does not apply, regulators need to consider whether it should and, if so, how.

One should add that uncoordinated regulatory initiatives at the national level could trigger regulatory arbitrage and, ultimately, hamper the resilience of the financial system to crypto asset market based shocks. Finally, it is very unlikely that a large scale coordinated move will take place any time soon and will thus need to cooperate with existing account based cash and securities systems.

In the current regulatory framework, crypto assets can hardly enter EU financial market infrastructures (FMIs). Crypto assets cannot be used to conduct money settlements in systemically important FMIs. To the extent that they do not qualify as securities, central securities depositories (CSDs) cannot undertake settlement of crypto assets. Even if crypto assets based products were to be cleared by central counterparties (CCPs), these would need to be authorised and satisfy existing regulatory requirements, albeit at additional costs and with no clear benefits to EU CCPs.

#### ***Reduced financial stability issues so far***

According to the ECB Internal Crypto-Assets Task Force, the ECB (ICA-TF), crypto assets do not currently (January 2019) pose an immediate threat to the financial stability of the euro area. Their combined value is small relative to the financial system and their linkages with the financial sector are still limited. At present, crypto assets' implications for and/or risks to the financial stability of the euro area, monetary policy, and payments and market infrastructures are limited or manageable.

The sector nevertheless requires continuous careful monitoring since crypto assets are dynamic and linkages with the wider financial sector may increase to more significant levels in the future.

# Ensuring operational resilience in the Covid-19 crisis context

## Operational resilience has a broader reach than IT disruption or recovery and resolution

The theme of operational resilience relates to issues that have been the focus of the industry and regulators much before the Covid 19 outbreak, such as business continuity planning, outsourcing, cybersecurity or recovery and resolution. In a recent public speech, Christine Lagarde, the Head of the European Central Bank (“ECB”), has emphasized that the ECB “had a duty to be prepared and to act pre-emptively” to strengthen resilience at the Industry level. The principle of operational resilience is indeed not new. In 2013, in its *Guidance on Identification of Critical Functions and Critical Shared Services*, the FSB warned that failure to provide a critical function or a critical service would be likely to have a material impact on third parties, give rise to contagion or undermine the general confidence of market participants. In 2014, the European Parliament stated in the “BRRD” that Operational continuity is fundamental to maintain services that are essential to the real economy or not to disrupt financial stability due to the size, market share, external and internal interconnectedness of institutions<sup>2</sup>. Resolution tools were defined in order to fail orderly, i.e. to enable failing Institutions to maintain core business lines without disrupting Financial Stability. In 2015, the EBA outlined in its *Comparative report on the approach to determining critical functions and core business lines in recovery plans* that critical functions were of systemic importance, low substitutability and whose discontinuity might have significant impacts on third parties and on the market<sup>3</sup>. Recovery plan had to be set up to ensure continuation of Critical Function under a stress situation.

In July 2018, the Bank of England, the Prudential Regulation Authority (“PRA”) and the Financial Conduct Authority (“FCA”) published a discussion paper that addressed directly the theme of operational resilience with a broader reach than IT disruption or recovery and resolution. This Discussion Paper defines operational resilience as “the ability of firms, FMs and the sector as a whole to prevent, respond to, recover and learn from operational disruptions<sup>4</sup>”. This ability is required for any firm and for any disruption of service that “has the potential to cause harm to consumers and market participants, threaten the viability of firms and FMs, and cause instability in the financial system<sup>5</sup>”.

## The financial industry rather than identifying most important services and improving their ability to recover, has focused so far on an operational risk capital framework

The Covid 19 crisis shed a new light on operational resilience, showing how much the economy was vulnerable to an external shock and how little it was prepared to respond. The focus, to date, of operational risk management in the financial industry, has been on setting up an operational risk capital framework and on the monitoring and prevention of operational risk. Not enough focus and means have been invested on operational resilience, e.g. the ability to recover and respond assuming disruption will occur. The core requirements of operational resilience represent a substantial undertaking for firms to implement.

First a clear understanding of the most important business services is required. This understanding should rely on the

mapping of the systems, facilities, people, processes and third parties that support those business services.

Second, firms need to identify how the failure of an individual system or process could impact the provision of business services and assess to what extent these systems or processes are capable of being substituted during disruption so that business services can continue to be delivered.

An assessment of vulnerabilities and concentration risk is then possible. An impact tolerance, the level of disruption than can be tolerated on the provision of the business service, should be defined and set by senior management. Tested plans including internal and external communication would then enable firms to continue or resume business services when disruption occur.

A comprehensive operational risk framework would rely on the definition of the appropriate strategy, governance, and operating model including the ownership of business services, the setting of tolerance, scenario development and testing, definition of role and responsibilities and communication strategy. Ultimately, business as usual processes shall be modified to integrate resilience by design.

## Increased scrutiny of supervisors is anticipated

However, for most advanced banks or financial institutions, operational resilience is not totally new. Changing technologies and complexity of cyber threats, increased use of outsourcing and dependence on specific suppliers increase vulnerabilities. The scrutiny of European supervisors on resilience matters is however likely to be increased. Before Covid-19 crisis, UK prudential authority announced that operational resilience stress testing and sectorial exercises would be conducted as well as self-assessments. Lastly, even if a proportionality principle was stated, the British Prudential Authority warned that in some cases impact tolerances metrics might be imposed.

Likewise, at European scale, we should expect greater attention on resilience matters from supervisors. Even before the Covid-19 crisis, in November 2018, the International Conference of Banking Supervisors reminded in the conclusions of a workshop dedicated to Cyber security and operational resilience that cyber resilience “should be embedded in [the] day-to-day activities so as to build processes, services and products that are secure by design.”<sup>6</sup>

However, lack of ready-made guidance to operationalise the resilience was somewhat acknowledged by the BCBS who made clear that it aimed to “provide a more concrete and specific understanding of the main trends, progress and gaps in the pursuit of cyber-resilience in the banking sector”. In the end of 2018, expectations effectively became more detailed with the ECB Guidance on *Cyber resilience oversight expectations for financial markets infrastructure* which aimed at “operationalize the Guidance, ensuring [that Firms] are able to foster improvements and enhance their cyber resilience over a sustained period of time<sup>8</sup>”. A first positive stage has been completed. The same kind of approach will have to be pursued as regard to the broader operational resilience of financial institutions after Covid-19 crisis.

### Some lessons learned from Covid-19 crisis

Some lessons learned from Covid-19 crisis can be leveraged in this perspective:

- **The efficiency of small interconnected teams to manage the crisis.** Small collaborating teams are more responsive to cover a wide range of topics (IT support to remote work, IT maintenance and infrastructure, digital business services to clients, relations with supervisors etc.) and adapt more quickly to evolving situations.
- **The knowledge of the main firm assets.** It is worth using firm's assets all along the crisis to maintain business services running. A detailed and updated inventory of firm's assets may enable to know if any relevant resource can be used to fulfil any operational need during the crisis.
- **The ability to rely on as updated as possible data.** In a crisis context, in which prompt decisions need to be taken by the firm's management, data needs to be as accurate as possible should it has to support smart decisions. This stake is crucial for major groups with multiple branches in various locations.
- **The importance of maintaining an open dialogue with third parties.** A clear and constant dialogue with regulators, public sector stakeholders, business partners, contractors, etc. allows to set up and adjust urgent action plans, if necessary, in a timely manner.

Covid-19 crisis will ultimately serve as an accelerator to identify sound practices to improve the resilience of financial firms. After the crisis, worldwide supervisors will probably rely on financial institutions experience feedback to set up operational rules and guidance.





## NOTES

# About EUROFI

The European think tank dedicated to financial services

- A platform for exchanges between industry players operating in the financial services sector and the public authorities
  - Topics addressed include the latest developments in financial regulation and supervision and the macroeconomic and industry trends affecting the financial sector
  - A process organised around 2 major international yearly events, supported by extensive research and consultation among the public and private sectors
- 

## *Our objectives*

Eurofi was created in 2000 with the aim to contribute to the strengthening and integration of European financial markets.

Our objective is to improve the common understanding among the public and private sectors of the trends and risks affecting the financial sector and facilitate the identification of areas of improvement that may be addressed through regulatory or market-led actions.

## *Our approach*

We work in a general interest perspective for the improvement of the overall financial market, using an analytical and fact-based approach that considers the impacts of regulations and trends for all concerned stakeholders. We also endeavour to approach issues in a holistic perspective including all relevant implications from a macro-economic, risk, efficiency and user or consumer standpoint.

We organise our work mainly around two yearly international events gathering the main stakeholders concerned by financial regulation and macro-economic issues for informal debates. Research conducted by the Eurofi team and contributions from a wide range of private and public sector participants allow us to structure effective debates and offer extensive input. The result of discussions, once analysed and summarized, provides a comprehensive account of the latest thinking on financial regulation and helps to identify pending issues that merit further action or assessment.

This process combining analytical rigour, diverse inputs and informal interaction has proven over time to be an effective way of moving the regulatory debate forward in an objective and open manner.

## *Our organisation and membership*

Eurofi works on a membership basis and comprises a diverse range of more than 70 European and international firms, covering all sectors of the financial services industry and all steps of the value chain: banks, insurance companies, asset managers, stock exchanges, market infrastructures, different service providers... The members support the activities of Eurofi both financially and in terms of content.

The association is chaired by David Wright who succeeded Jacques de Larosière, Honorary Chairman, in 2016. Its day-to-day activities are conducted by Didier Cahen (Secretary General), Jean-Marie Andres and Marc Truchet (Senior Fellows).

## *Our events and meetings*

Eurofi organizes annually two major international events (the High Level Seminar in April and the Financial Forum in September) for open and in-depth discussions about the latest developments in financial regulation and the possible implications of on-going macro-economic and industry trends.

These events assemble a wide range of private sector representatives, EU and international public decision makers and representatives of the civil society. More than 900 participants on average have attended these events over the last few years, with a balanced representation between the public and private sectors. All European countries are represented as well as several other G20 countries (USA, Japan, China...) and international organisations (IMF, BIS, FSB, IOSCO, IAIS...). The logistics of these events are handled by Virginie Denis and her team.

These events take place just before the informal meetings of the Ministers of Finance of the EU (Ecofin) in the country of the EU Council Presidency. Eurofi has also organized similar events in parallel with G20 Presidency meetings. In addition, Eurofi organizes on an ad hoc basis some meetings and workshops on specific topics depending on the regulatory agenda.

## *Our research activities and publications*

Eurofi conducts extensive research on the main topics on the European and global regulatory agenda, recent macro-economic and monetary developments impacting the financial sector and significant industry trends (technology, sustainable finance...).

Three main documents are published every 6 months on the occasion of the annual events, as well as a number of research notes on key topics such as the Banking Union, the Capital Markets Union, the EMU, vulnerabilities in the financial sector, sustainable finance... These documents are widely distributed in the market and to the public sector and are also publicly available on our website [www.eurofi.net](http://www.eurofi.net):

- Regulatory update: background notes and policy papers on the latest developments in financial regulation
- Views Magazine: over 150 contributions on current regulatory topics and industry trends from a wide and diversified group of European and international public and private sector representatives
- Summary of discussions: report providing a detailed and structured account of the different views expressed by public and private sector representatives during the sessions of each conference on on-going trends, regulatory initiatives underway and how to improve the functioning of the EU financial market.

All Eurofi publications are on

**[www.eurofi.net](http://www.eurofi.net)**

Views Magazines, Regulatory Updates,  
Conference Summaries

***eurofi***

The European think tank dedicated  
to financial services

**[www.eurofi.net](http://www.eurofi.net)**