VI. BANKING AND INSURANCE REGULATION

Issues at stake

The Covid-19 crisis illustrates that while the Basel III framework has effectively reinforced the EU banking system, the implementation of the final Basel III package could undermine its capacity to finance the economy, which is why it was postponed for one year by the BCBS. In the EU, given the importance of banks in the funding of the economy, the challenge is finding the right balance between the consistency with the global prudential Basel standards and being able to implement them in a simple and risk-sensitive way.

The soundness of the European banking system is also very much dependent on the completion of the Banking Union. Much progress has already been made, but substantial building blocks are still missing to deliver a sufficiently integrated banking system that each Member State can trust. In this perspective, some suggest adopting a holistic approach to the Banking Union, others are more favourable to step-by-step approaches.

The EU insurance regulatory framework is also challenged by the current context. In the short term, insurance companies will need to play a central role in supporting the relaunch of a suddenly frozen economy in highly volatile market conditions, as well as further contribute to the long-term investments needed to improve the resilience of the EU economy, given limitations in public spending. These objectives question the relevance of the current Solvency II market-valuation and one-year horizon options, which impair any long-term investment and particularly in equities. This also calls for a differentiation between liquidity and solvency needs and a clarification of the responsibilities for investment decisions.

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Basel III implementation challenges

Othmar Karas

Vice-President & MEP, Committee on Economic and Monetary Affairs, European Parliament

The implementation of Basel-III in light of COVID-19

We are living through unprecedented times. The COVID-19 crisis is not only affecting the health of our loved ones but also having a profound impact on our real economy and financial markets. A global challenge of this kind needs to be tackled with common, determined and coordinated action at all levels. Every one of us can, and indeed must, take over responsibility and learn the lessons for the future. If we do, then we will emerge from the crisis stronger. Robert Schuman knew this as long ago as 1950: "Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity."

Of course, the coronavirus is also impacting the EU legislative agenda, including the implementation of the comprehensive Basel-III reforms. Given the announced one-year deferral by the Basel Committee's oversight body, the legislative proposal by the European Commission – initially scheduled for the second quarter of 2020 – will be postponed according to its Executive Vice-President Valdis Dombrovskis. I very much welcome this decision since it increases the operational capacity of banks to support our real economy at these extraordinary times.

Despite the delayed implementation dates for amongst other the output floor, the revised market risk framework and the Pillar 3 disclosure requirements, the EU must remain committed to the implementation of global rules. We have learned from the financial crisis that banking regulation requires an international response and more cooperation, not less. This has proven very successful: Today, European banks are much better capitalised, have more liquidity and a higher leverage than before the financial crisis – which undoubtedly serves us well during the COVID-19 shock.

To this day, the political starting point is the European Parliament's resolution from December 2016, which urged for no significant increase in the overall capital requirements. While a "23.6 percent increase" is of course significant, the assessment by EBA needs to be seen in a differentiated way. Not all aspects are considered, such as the changes to the Pillar 2 framework. Also, the impact strongly depends on the size and complexity of institutions. In any case, not the percentage itself is the most crucial but the consequences in reality are – on financial stability, our economy, the end-users and citizens.

> *While the legislative train on Basel-III is delayed, it continues being loaded with the practical experience from all affected stakeholders.*

Above all, we must ensure that our banking sector remains safe and strong. Its diversity is a strength to ensure less vulnerability to crisis, better access to finance and more competitiveness. Both, small and large banks must continue to be able to finance our real economy, which has a different structure than other jurisdictions such as the United States. Therefore, there will be no political majority in the European Parliament without the SME Supporting Factor on board, which we have successfully extended during the last legislature.

Certainly, the biggest elephant in the room remains the output floor. While its implementation is necessary to live up to our global promise, all options on its calculation remain on the table for the European legislator. Due to reasons of a level-playing-field, the necessary financial integration, comparability and lower implementation costs, its application on the highest level of consolidation seems most justified.

Various other screws will need to be adjusted. We must find a European answer to the treatment of unrated corporates ▶

as well as equity exposures and need to take the European particularities of financing businesses into account – such as commercial and real estate loans, leasing and specialized financing. And we need to continue our progress on better regulation and proportionality while preserving our Single Rulebook and balancing the risk sensitivity, simplicity and comparability of the framework. If done right, all these principles are not contradicting, but complementing. They go hand in hand.

While the EU legislative train on the Basel-III reforms is delayed, it continues being loaded with the practical expertise from all affected stakeholders – taking also on board their experience with the current impact of COVID-19.

Once the Commission's proposal is then on the table, the European Parliament will live up to its responsibility as co-legislator to ensure the legislative train arrives safe and well.

Eva Wimmer

Director-General for Financial Markets Policy, German Federal Ministry of Finance

Finalizing Basel III – A regulatory foundation for a resilient banking system that supports the real economy

The finalisation of Basel III is an important milestone for the European reform agenda following the global financial crisis. In December 2017, the group of central bank governors and the heads of supervision (GHOS) adopted the final Basel III reform package. The aim of this package is to complete the reforms to global banking regulation initiated after the global financial crisis. Its European implementation will strengthen the regulation, supervision and risk management of banks operating in the European Union.

The Covid crisis shows the importance of sufficient capital and liquidity buffers. Buffers help banks to withstand stressed situations and enable them to provide necessary financing to the real economy in times of crisis. We should build on the lessons from the current crisis and implement the final Basel III agreement in a consistent way.

At the ECOFIN meeting in July 2016, European Finance Ministers have already noted that the reform package is not expected to result in a significant increase in the overall capital requirements for the banking sector, therefore, not resulting in significant differences for specific regions in the world. Likewise, Finance Ministers and Central Bank Governors of the G20 concluded in March 2017 that the finalisation of Basel III would not significantly increase overall capital requirements across the banking sector, while promoting a level playing field.

For the German government, in addition to avoiding a significant increase in overall capital requirements and to securing a level playing field in global regulation, it is of utmost importance that the financing of the real economy, including the financing of unrated corporates and small and medium size enterprises, will not be negatively affected, and that the principle of proportionality is respected. The principle of proportionality is now a well-established principle in the Basel framework as well as in the EU regulatory and supervisory framework. It deals with the question how regulatory requirements to non-internationally active banks, especially smaller and less complex ones, can be tailored.

Other important topics include the implementation of the output floor, credit risks related to unrated corporates, commercial as well as retail real estate, equity and specialised lending as well as operational risks.

The aforementioned goals and topics will require further discussion once the European Commission has tabled its legislative proposal. The recent decision by the Basel Committee to postpone the implementa-tion date by one year will give us sufficient time. The Basel Committee reaffirmed its expectation of full, timely and consistent implementation of all Basel III standards. We should use the additional time wisely to enable banks to prepare for the new package as soon as possible. The objective is clear: The final Basel III package should be transposed into European law so that its stepwise implementation starts January 1st 2023 onwards until full implementation in January 2028. This will enhance the resilience of the financial system and will contribute to strengthening the European banking system.

The incoming German presidency is looking forward to the legislative proposal by the European Commis-sion and we will strive to enable constructive exchange and facilitate effective discussions within the Council of the European Union.

Alban Aucoin

Head of Group Public Affairs, Crédit Agricole S.A.

Financing the economy today, a necessity not an option

Successive reports, impact analyses and opinions on the Basel IV implementation, together with their respective figures persistently show negative and even alarming consequences for the European banking sector and for the economy. Whatever the results of these estimates, they are significant and inconsistent with the original G20 and European mandates of no significant increase in capital requirements (+23.6% for European banks).

Furthermore, Basel IV will significantly increase financing costs for European businesses and households, which will bring about costs far exceeding potential benefits. According to a recent study by Copenhagen Economics, the impact of Basel IV may reduce the credit capacity of European banks by €2,900 Bn, business investment by €700 Bn and European GDP by 0.4%.

Meanwhile we are facing a dramatic situation due to the Covid-19 pandemic around the world. The full economic impact is difficult to foresee, but it will be very substantial across the European Union. Taking into account the extent of supply side disruption in the productive capacity of countries and in global value chains (including intra-EU and extra-EU), and the severe drops in demand, we can reasonably expect this crisis to be deeper than the 2009 recession. Its long-term consequences will affect the recovery of our economies and societies, and profoundly change the economic context.

This time around, banks are neither the symptoms nor the causes of the crisis, but part of the remedy. European banks are now well capitalised and sufficiently strong, as a result of the accumulation of requirements (Pillar 2, MREL and additional counter cyclical buffers) which have no international equivalent.

In that regard, they can be relied upon when it comes to providing the necessary services and liquidity support to their clients, especially SMEs. In parallel, European and national authorities have taken extraordinary economic, supervisory and regulatory policy measures, to facilitate the steps banks needed to take to address the emergency efficiently and keep financing the economy to the best of their ability.

In the same vein, the BCBS considered appropriate to postpone for one year the implementation of Basel IV, acknowledging that it would help "to provide additional operational capacity for banks and supervisors to respond to the immediate financial stability priorities resulting from the impact of the coronavirus disease (Covid-19) on the global banking system". Additionally, the European Commission decided to use this extra time to adjust its work programme to the new priorities that would emerge from the crisis. Furthermore, in its 20 March statement, the ECB also announced a higher than expected capital-to-lending ratio to free up prudential capital: "a capital relief amounting to €120 billion could be used to absorb losses or potentially finance up to €1.8 trillion of lending".

This time around, banks are neither the symptoms nor the causes of the crisis, but part of the remedy.

Somehow, both the BCBS and the European authorities admitted that, these additional requirements were likely to hamper banks' capacity to provide the adequate financial support to the economy, in response to the Covid-19 crisis.

The wake-up will be painful. Nevertheless, our collective task will be to rebuild the European economy, while drawing the lessons from this crisis. This will likely mean reviewing current policy priorities to focus on addressing the economic and social impact of the crisis. Banks are ready to keep playing their part and to provide massive funding to reach a stable economic balance. This however requires regulatory stability. The current crisis has proved the adequacy of the current high levels of capital and liquidity, and the appropriateness of the authorities' toolbox.

There is no evidence of a need for a significant capital increase, but there are clear signs of low profitability. The crisis also revealed the negative impact of pro-cyclical regulatory measures. The current situation provides the opportunity to put into perspective the EU prudential framework and the concrete evidence of the Basel IV impact to focus on what is efficient to pull the economy out of recession and support economic growth in a sustainable and less dependent way.

Stefan Simon

Designated Chief Administrative Officer, Deutsche Bank AG

Striking a balance – implementation of Basel prudential rules

The capital and liquidity reforms implemented in the wake of the financial crisis proved their value with the resilience of European Banks in the face of the economic shock caused by COVID-19. The ability of the sector to keep the EU financial system functioning through this period of stress and be in a position to provide credit to clients at their point of greatest need was testament to the work done to enhance the regulatory framework over the past 10 years. The EU banking system was less leveraged, more resilient and significantly better capitalised as a result. Average CET 1 was c.30% higher for large internationally active banks in Europe in 2020 than 2010.

The extraordinary challenge posed by COVID-19 has also highlighted how important it is for banks to be able to mobilise to provide lending support to European businesses. A less efficient, less risk sensitive capital regime might have left the banking sector less resilient and could constrain EU bank's ability to play their part in supporting recovery. The importance of striking the right balance in the implementation of prudential rules and value avoiding unintended increases in capital are clear.

It is equally clear that balance cannot come at the expense of a consistent approach to the application of standards globally. Members of the Basel Committee have an obligation to promote financial stability and enhance the quality of banking supervision in their jurisdictions. When implementing rules agreed at the international level into local legal frameworks it has always been accepted that there may be need for some deviation from literal transposition – the important point is to retain overall equivalence.

As Europe focuses on recovery in the wake of the economic shock caused by COVID-19, it will be all the more important that the final Basel III reforms are implemented without triggering unintended significant increase in capital. The desire of the Basel Committee to enhance the comparability of prudential models and reduce variability of outcomes through the final Basel III did not assume a significant shortfall in levels of capital within the banking system. However, that is exactly what the European Banking Authority's impact assessment of summer 2019 tells us will be the result of implementation in Europe, with an average increase of over 24% in the risk weighting of EU bank balance sheets. Even if a lower average of 10-15% is assumed, as suggested by the European Commission, some banks would be still seeing a much larger increase than that. Even an increase of only 10% would be seen as significant and would have direct consequences for the real economy and the proposals analysed by EBA would see European businesses find it more expensive to hedge financial risk, or to finance investment, undermining growth and investment that we all hope to see following the shock of the pandemic in 2020.

As Europe focuses on recovery in the wake of the economic shock caused by COVID-19, it will be all the more important that the final Basel III reforms are implemented without triggering unintended significant increase in capital

Addressing these consequences will not require divergence from the globally agreed Basel framework, but calibration of specific rules to preserve existing risk sensitivity. In the absence of external ratings for the vast majority of EU corporates, it makes sense to look for other reference points – parent ratings, or internal model risks buckets – in order to avoid having to apply a blanket RWA that does not effectively differentiate between risks.

Equally, better aligning the capital cost of derivative exposures under the standardised approach to counterparty credit risk with the reality of risk – as has been done in other regions - would seem like a sensible approach. Avoiding the double counting of risks currently addressed through EU specific capital add-ons and aligning the scope of application for the output floor with international approaches – a so called 'parallel stack approach', would provide a further opportunity to maintain risks sensitivity.

Europe has put in place much of the new Basel framework whilst preserving sensitivity to EU specific risks. That system has so far proved resilient and we need to ensure that balance between risk sensitivity and resilience is preserved as the final elements of Basel III are implemented.

Dan Sørensen

Managing Director, Nykredit Bank

Time to reconsider the implementation of Basel III Finalization

The regulatory tightening of the financial sector following the financial crisis of 2008-9, with Basel III 'pre-finalisation' standards at the forefront, has made banks far more resilient and ready to face the next crisis. Right now as a result of the Corona virus pandemic, this crisis has occurred with a paralyzed real economy. This crisis may prove to be one of the fastest growing global recessions ever with long-lasting negative economic consequences.

It is therefore now that the updated framework on micro level (tightened requirements of development and use of internal risk models, better through-the-cycle provisioning and management of distressed exposures and sufficient buffers of highly liquid assets) as well as on macro level (better and larger capital base, building buffers in good times, buffers for systemically important banks and a stable funding structure) must stand the test and prove that banks are now part of the solution and not part of the problems in a global recession.

Looking forward, the final piece of new global standards in form of Basel III Finalisation is yet to be implemented in Europe. It is positive that the BCBS has decided to postpone the global implementation. However given the current 'live stress test' scenario, it should be strongly considered to assess the extent to which the already implemented Basel III 'pre-finalisation' framework will prove sufficient to deal with severe crisis situations.

The Basel III Finalisation standards have not been calibrated taking European specificities into account. In fact, European specialized low risk banking business models might end up being less resilient in a crisis. European banks have a much larger share of low-risk lending on their balance sheets compared to e.g. US banks, something that will be severely punished by the new 72.5% output floor which will greatly increase REA levels and thus capital requirements in spite of no clear risk reduction effects. An example is Danish mortgage lending with especially low risk and therefore even more susceptible to this. Danish credit institutions will need another EUR 10bn in capital – corresponding to a 34% increase in capital requirements.

Thus, with the prospect of such a massive increase in capital requirements, for many banks it would be best to drop the low-risk business activities and instead onboard far more risky exposures into the lending book.

In spite of this, EBA has made clear that they recommend a full implementation of the Basel III Finalisation standard with no accommodations to the European context and applying the output floor to the full stack of European capital requirements. This seems ill advised.

> *Specialized low risk banking business models might end up being less resilient in a crisis.*

There is no clear reason why the European financial sector – and thereby the real economy – should be treated so harshly in spite of the lower risk on balance sheets. A better solution could be implementing the output floor as a parallel backstop requirement based on the Basel capital requirements only rather than the full stack of European requirements. Such an approach would even be closer to the letter in the Basel standard and would retain the incentives for real risk management in European low risk lending.

The reforms implemented immediately after the financial crisis were well-founded and addressed fundamental lack of risk management in certain parts of the financial system. With Basel III Finalisation, this fundamental motivation for risk management is undermined and the ability of banks to make quick and flexible adjustments and support of the real economy in a crisis is reduced.

Based on the current shock to the global economy, it is time to reconsider the implementation of the Basel III Finalisation framework.

Jérôme Reboul

Deputy Assistant Secretary, French Treasury,
Ministry of Economy and Finance, France

How to implement Basel III finalized without deviating from the 2016 political mandate?

The upcoming legislative proposal from the European Commission will aim at transposing the December 2017 Basel III agreement into EU law. One of the stated objectives of the agreement is to limit excessive variability in the calculation of risk-weighted assets.

At the same time, G20 leaders in Hangzhou in 2016 and EU Finance Ministry in the Ecofin of July 2016 clearly set their expectations that the finalized Basel III agreement should not result in a significant increase in the overall capital requirement for the banking sector and in significant differences for specific region of the world. Finding a balance between simplicity, comparability and risk-sensitivity will be the main challenge of the European implementation of Basel III. Two main topics will need to be addressed.

First, the issue of prudential incentives.

In order to limit the aggressiveness of risk-weighted assets that stem from internal models, the Basel Committee on Banking Supervision agreed to implement a capital floor - known as the output floor -, aiming at complementing the risk-weighted capital ratio and the finalized leverage ratio. The output floor will constrain the use of internal models, partly overlapping with the TRIM exercise from the ECB and the IRB Repair Roadmap from the EBA, while reducing the risk sensitivity of the prudential framework, one of its most important pillars.

Low-default portfolios, that have hence historically received favorable risk-weighting, will be the most heavily penalized by the floor. The one-size-fits-all characteristic of the output floor may lead to an unsatisfactory and prudentially-counterintuitive outcome. This all-encompassing feature of the output floor might prove damaging taking into account the different banks' balance-sheet structures between jurisdictions.

Second, the issue of the capital impact.

Additionally, according to the EBA impact assessment, this output floor will be the main driver in the increase of capital requirements in the years ahead for the European banking sector that are estimated to be around + 24% overall. It is moreover noticeable that the impact of Basel III finalized will be unevenly distributed, the European Union being the only jurisdiction suffering from a substantial increase in own fund requirements. This directly related to the political choice that was made years ago to authorize internal models subject to strict supervisory approval and review.

Consequently, taking into account this two-fold departure from the political mandate, the postponing of the release date of the European Commission's legislative proposal should enable stakeholders to reflect on the most appropriate way to implement Basel into EU law in order to help mitigate the impact of Basel III finalized on the capital position of the European banking sector in order to stay within the remit of the 2016 political mandate. ●

Sovereign exposures and low interest rates

Rolf Strauch

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

Fiscal rules and market discipline – complementing each other

The EU fiscal framework provides a line of defence against fiscal profligacy. The rules aim to limit fiscal deficits and prevent excessive government debt that risk destabilising the monetary union. Since the creation of the Stability and Growth Pact, economic and financial conditions have evolved considerably. The rules have been fine-tuned and have become more complex. Now there is an opportunity to review them. The European Commission has launched a public consultation to collect feedback and ideas.

Market discipline can help limit unsustainable public finances, but failed to do so in the run-up to the sovereign debt crisis. Before 2008, sovereign credit risk was not priced in appropriately, as government bond spreads were compressed. Markets believed that the fiscal rules would ensure sustainability or countries in distress would be bailed out. The mispricing of risk was one of the deficiencies dis-incentivising adequate fiscal policies.

In times of stress, markets can swing into the other extreme and spreads can widen abruptly. Even if market volatility is not due to fundamentals, it can have negative effects on a sovereign and aggravate a crisis. Erratic and irrational moves, particularly when driven by herding behaviour, can lead to market failure. Additionally, perceptions of redenomination risk can exacerbate contagion in the euro area. A constellation of different mechanisms can lead to pro-cyclical price spirals and market closure in crisis times. Liquidity may evaporate quickly in a sovereign bond market and this may lead to liquidity shortages across markets.

We should foster complementarities between fiscal rules and market discipline. On the one hand, market reactions can contribute to fiscal discipline because market developments inform policymakers about the consequences of their decisions. On the other hand, a rule-based fiscal framework can tame market capriciousness by managing expectations. An effective framework should encourage proper risk pricing by markets.

Fiscal rules can serve as a sign-post for markets, and flag risks to investors. More predictable and transparent rules can help the appropriate pricing of sovereign risk and temper the binary perceptions of "risk-on" vs "risk-off" mood or risky versus safe assets. Investors can anticipate and internalise ("price in") the policy reaction when rules are transparent and credible, even without disciplinary action. This works the better the more transparent and consistent rules are, and the more credible the enforcement.

More well-behaved and risk-guided markets support policy responsiveness to markets. Policy adjustment often comes too late when market moves are extreme. Signals may be there earlier, but are often blurred and the bar for policymakers to react can be high. In other words, policymakers are better informed about market signals and their implications with more predictable and credible rules giving clearer signals to investors. This creates better conditions for adequate policy responsiveness to fiscal vulnerabilities and less pro-cyclical fiscal policy.

The ongoing review provides an opportunity to improve fiscal rules. For instance, gearing rules towards observable variables can improve the clarity of the guidance both for policymakers and for markets. It also increases transparency. A number of institutions propose an expenditure rule to set operational targets, combined with a debt rule, as a fiscal anchor. This could be a way forward to explore further.

At the same time, other steps are needed to deepen Economic and Monetary Union (EMU) and increase its robustness to shocks. The completion of banking union and more capital market integration would support private sector risk-sharing. A central fiscal capacity and a European safe asset would support financial stability in the euro area and also the international role of the euro. ●

Eduard Müller

Executive Director, Austrian Financial Market Authority

"Gone concern" or "concerns gone" in the sovereign-bank-insurance loop?

Usually, there is no safer asset than government debt, hence why banks and insurance firms are among its top investors and holders. This creates a reciprocal dependency between governments and the financial sector. But where do we stand now, ten years after the Euro Area sovereign debt crisis?

Government debt stock in bank and insurance books has not decreased much since 2010, but progress has undoubtedly been made. Banks and insurance firms today have bigger capital and liquidity cushions. Tougher regulation and supervision of non-performing loans have led to a visible risk reduction, until recently somewhat aided by benign economic conditions. Importantly, the leverage ratio, implemented in the EU by the CRRII, represents an explicit own funds requirement for all assets, without risk-weights. Thus, from 2021, sovereign exposures will be encompassed by the leverage ratio own funds requirement, with banks holding larger stocks ▶

having to hold more capital. Furthermore, high concentrations of sovereign exposures on bank balance sheets undergo supervisory scrutiny during the annual SREP exercise, which feeds into the Pillar II requirement. Finally, with the Banking Union, we now have a deeply integrated supervisory and resolution system in the Euro Area, with only a common deposit insurance system missing. The European Stability Mechanism (ESM) will undoubtedly soon provide an important backup for the Single Resolution Fund and enhance the credibility of a resolution of a systemically important bank.

All measures considered together, and in light of their being fully implemented, is concern about an unaccounted sovereign risk still justified? Further analysis and data collection by EBA and ECB may allow conclusions to finally be drawn whether and what further regulatory treatment of sovereign exposures might be warranted. The fundamental question of whether a gone concern or going concern perspective is taken will shape the answer. Under a gone concern perspective, wouldn't we seek insurance against our own potential failure? By basing our regulatory framework on a going concern perspective for the Euro Area, we may be closer to a reasonable framework for treating sovereign exposures than we think.

Dis-incentivising very high concentrations and strong home bias in sovereign exposures remains an issue to address. In the short-term we could increase regulatory and supervisory scrutiny of concentration risks in Pillar II. In the medium and long-term, a Pillar I concentration risk charge to further foster diversification of sovereign portfolios should be sought at international level, while pursuing the idea of sovereign-bond backed securities, providing a much needed well-diversified safe asset to European banks and asset managers. We have achieved much, and have gone far in implementing the Banking Union, which will help tremendously to weather the current COVID-19 crisis. The Banking Union should be now completed in small, mutually reinforcing steps, based on risk-sharing and discipline.

We may be closer to a reasonable framework for treating sovereign exposures than we think.

Supervisors must play an important role and should support this by providing data and analysis and ensuring a reasonable and transparent treatment of sovereign concentrations in the SREP process and Pillar II requirements.

Pedro Marques

MEP, Committee on Economic and Monetary Affairs, European Parliament

Complete the Banking Union to address the sovereign-bank nexus

It is a given that economies face risks and sometimes those risks materialize into an effective crisis. Either the economic crisis is originated in the financial sector, as it happened a dozen years ago, or it begins with a public health crisis, as we are experiencing now, the fact is that sooner or later a new crisis occurs.

This does not mean that crises are acts of God, something completely beyond our control and that there is nothing we can do. In fact, there is much we can do, as the timing, size and consequences of each crisis may depend on the way we manage and mitigate risks *ex-ante*.

In the financial sector, one of the risks considered among the most serious is the nexus between sovereign and banks risks, known as the "doom loop".

No matter if the original shock is initiated in the banking sector (forcing the government to issue debt to recapitalize banks) or in the sovereign market (when perceived risks of sovereign bond generates potential bank losses), the feedback relation will amplify the magnitude of the crisis in both, with spillover effects over the economy and the consequent loss of jobs and other major social consequences.

The tools to address sovereign-bank nexus are comprised in the Banking Union's architecture.

Lessons learned from the financial crisis gave an impetus to the creation of the Banking Union (BU), aimed at reducing the banking sector's risks and creating

a level playing field across the euro area. The BU, however, remains incomplete.

Although the effective implementation of its' first pillar, the Single Supervisory Mechanism, along with significant efforts from the Member States resulted in a sharp decrease of risks in the banking sector (e.g., the euro area NPL average came down from 6,5% in December 2014 to 2,9% in September 2019), the EU's inability to complete the BU has one consequence: risks are still out there.

In terms of the BU's second pillar, there are justified concerns that the Single Resolution Fund (SRF) does not have the necessary means to address the resolution of one or more big banks, so it is necessary to create a backstop for it, which should probably be the European Stability Mechanism. An SRF with the necessary firepower is one of the most important tools to placate the loop between banks and sovereigns, but the lack of agreement in the Council is stalling the decisions.

Finally, the third pillar, the European Deposit Insurance Scheme (EDIS), is simply missing. The creation of the EDIS would assure that all depositors receive the amounts guaranteed by the European Directive with no need to use taxpayers' money (and without affecting the sovereign).

It is not necessary to reinvent the wheel. The most effective tools to address sovereign-bank nexus are already defined: they are included in the BU's architecture and just have to be completely implemented. If we can complete the BU and work towards the creation of a European safe asset, to allow banks to reduce their balance sheets' exposure to sovereign debt, there simply won´t be any doom loop anymore.

Andreas Dombret

Global Senior Advisor,
Oliver Wyman

A European Safe Asset: don't put one step before the other

The sovereign-bank nexus has been at the core of nearly all economic and financial crises in modern times[1]. The same households and businesses that borrow from banks are paying taxes to finance the state. Banks hold sovereign paper for liquidity and investment purposes, and in smaller countries play an important role in keeping public debt markets liquid. It will therefore never be possible to "solve" the nexus by eliminating it. However, it can be damped.

Capital requirements and loss absorbency (MREL) for banks have increased markedly, and with the BBRD a comprehensive resolution toolset has been created. With the Single Resolution Board and Fund, now backstopped by the ESM, the necessary institutional landscape has been established, also allowing Euro countries to combine their firepower.

Still not solved is the effect distressed sovereigns have on their banks, which could suffer losses on public debt they hold, and whose funding costs depend on "their" sovereign. Safe or "risk-free" assets are underpinning many financial products, liquidity rules require banks to hold HQLA, which they often do with a "home bias". Despite sovereign yields across the Eurozone having converged also as result of ECB's purchasing programs, lower-rated sovereign debt remains a welcome profit source in today's "low for long" environment.

The fragmentation of the Euro system's sovereign debt market adds to other hurdles for banks' cross-border business models, for example limiting the use of Dutch deposits to fund Italian loans. Further consolidation in the banking union requires diversification. For sovereign holdings, concentration risk must be reduced, similar to long-standing practice for large exposures to private sector creditors. Differentiated risk-weights and concentration limits on sovereign exposures are thus needed to prevent banks from overexposing themselves to a particular country.

> *Banks, the economy and the sovereign will always remain linked to each other.*

In this context, a European Safe Asset ("ESA") has been suggested as a theoretical concept to further complete the currency union. Under the proposed approach of "ESBies"[2], investors indirectly hold a diversified basket of member state debt. However attractive, important side effects need to be considered. The volume of ESA issuance will be determined by market demand, potentially resulting in higher-grade debt such as Bunds being absorbed through ESAs, while more risky paper remained standalone and exposed even more. While ESAs could well weather idiosyncrasies in a smaller member state, a synchronized downturn or stress in a larger member state would cause ESAs threatening to destabilize the entire Eurozone, then requiring broad, untargeted monetary or fiscal support measures. This resulted in risk sharing among member states currently not foreseen in the EU Treaty. Also, market prices would be distorted and lose their signalling capability if a very large investor buys sovereign paper at a political price.

Key question is how large the ESA market will be compared to overall Euro member state public debt issuance. A smaller volume brings a welcome increase of the safe asset pool and HQLA[3]. With an increasing volume however, effective characteristics of ESAs get closer to those of "Eurobonds". A robust fiscal coordination mechanism, such as the Stability and Growth Pact, remain required in any case together with meaningful monitoring framework. A reinforced ESM would go into the right direction. Other considerations, like providing more fiscal flexibility at member state level, do not. Today, we should be aware of the risks of putting one step before the other. Policy makers should keep this in mind in waging the options of further strengthening the banking and currency union.

1. Laeven / Valencia (2018): Systemic Banking Crises Revisited.
2. Brunnermeier et al. (2016): ESBies: Safety in tranches
3. Grandia et al. (2019): Availability of high-quality liquid assets and monetary policy operations: an analysis for the euro area, ECB Occasional Paper Series.

Alexandre Birry

Global Head of Research - Financial Institutions, S&P Global Ratings

Banking-as-we-know-it won't prevail if long-lasting negative rates do

The current coronavirus pandemic poses much greater immediate challenges to financial stability than ultra-low or negative rates. The wide-ranging package of monetary policy measures implemented--which ultra-low rates are only part of--will hopefully help tackle some of the more imminent threats. But it remains true that, if prolonged, ultra-low rates can affect financial stability. In a European context, once the situation normalizes, durably low rates could upend the financial intermediation model. The role of banks would change as a result, and so would that of capital markets and supervisors. Ultra-low rates and flat yield curves question banks' traditional -and oft fundamental- maturity transformation profitability model. Borrowing short-term to lend long-term doesn't pay for itself the way it used to. Assuming this monetary backdrop is here to stay, banks will have to continue to adjust their business models. One likely consequence is that banks will generally need more scale. Not just in terms of size, but also breadth of activities. This would allow banks to reduce their dependence on balance sheet intensive products such as deposits and loans.

Instead, they may develop alternatives such as asset management or other forms of off-balance sheet financial intermediation, putting stakeholders with excess savings in direct contact with stakeholders in need of funding for instance. In the context of durably slower economic growth, economies of scale are likely to remain key to banks' business model sustainability, as further cost discipline is required to buffer pressured earnings and meet shareholders' expectations.

Scale will also allow banks to invest in the technology required to meet customers' evolving expectations. What does it mean in terms of financial stability? One consequence of greater scale and consolidation is the possible emergence of even more systemic institutions. As banks become larger and more diversified to adapt to the environment, their complexity and respective importance to the local economy increase.

Against this backdrop, further progress with bank resolution--which is still very much work-in-progress-will be key to avoiding a worsening of the sovereign-bank feedback loop. Another consequence is the need for effective European capital markets, if banks' role is increasingly to facilitate direct financial intermediation. The success of the Capital Markets Union (CMU) project will therefore be critical. In addition to alternative revenue streams, CMU (including deeper securitisation markets) also offers opportunities for banks to manage their capital and credit risk more effectively. Also, lower-for-longer interest rates could reinforce the reliance of the European economy on debt. The strong preference of European corporates for loan and debt financing instead of equity financing is likely to continue unless the CMU becomes reality.

A third, related, consequence could be the acceptance that banks' role in mutualizing credit and market risks will be diminished to the extent that non-bank private sector stakeholders (eg. pension funds, insurance company, households) increasingly assume these risks directly. This would ultimately reshape the distribution of losses during crises.

> *Low-for-long can help fund transitions that are critical to the long-term stability of the financial system in Europe.*

As a result, supervisors' role as well will likely continue to evolve. As part of the risks of the financial system migrate outside the banking system, the remit of supervisors broadens. This comes on top of the need for greater use of macro-prudential tools as durably low rates typically inflate asset prices and risk appetite in the absence of a crisis.

That said, low-for-long can help fund transitions that are critical to the long-term stability of the financial system in Europe; first, the transition to greater resolvability, by allowing banks to issue at low cost substantial amounts of loss-absorbing instruments and meet TLAC and MREL requirements. Second, substantial amounts of funding are required to finance the energy transition to mitigate climate risk. Low-for-long can make this transition more affordable, and offers banks some much-needed growth relays in an otherwise low-growth environment. ●

Costs and risks of not achieving the Banking Union

Irene Tinagli

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

The cost of not achieving the Banking Union

The COVID-19 crisis and its devastating health, economic and social consequences have overshadowed all discussion about the future evolution of the banking union. Yet it was in recent weeks that we realized once more how important is this project, even though it is still incomplete. SSM and EBA have taken various initiatives to indicate a common path for the whole jurisdiction, thus avoiding that national measures end up fragmenting the European banking and financial system. However, this crisis will most likely show how the lack of determination in completing the Banking Union in accordance with the agreed timelines will seriously jeopardised its key benefits. Today the Banking Union means that supervisory and resolution decisions are mostly European, whilst the ultimate guarantor of financial stability remains national, with limited tools to act. This asymmetry might have serious consequences in future possible banking crisis cases, in which decisions will ultimately be redirected to Member States. Few things can be more destructive to citizens' trust in the European Institutions than threats to financial stability, perceived as risking their savings.

The completion of Banking Union is in many aspects a way to restore European citizens' confidence in the European institutions, build the necessary trust between Member States and address the rise of Euroscepticism. With the benefit of almost eight years of hindsight, it is now clear that several links and stabilising elements are missing in the Banking Union. These need to be urgently tackled.

At the top of the list, there is of course a common deposit protection system. As the ECB has shown in a study on the Commission proposal, with proper risk-based banks' contributions, an almost negligible cross-border subsidisation occurs. The fear that this kind of mechanism could imply significant transfers across countries in case of a new banking crisis is therefore unjustified.

The delay in the set up a common deposit protection system has consequences also in the realization of other steps in the field of banking union. One of these is definitely the harmonisation of EU banks' liquidation regimes. First of all, because without EDIS the asymmetric social and economic impact ensuing from the failure of a bank with systemic relevance at local level would remain. Secondly, because in case of failure of a cross-border systemic relevant bank, the national DGSs would have to reimburse depositors in the subsidiary established in their respective jurisdiction, even though they are neither supervising nor resolving/liquidating the parent company. This problem risks of calling into question the single point of entry/multiple point of entry resolution model, to further strengthening of the supervisory powers of the host national competent authorities, and to make the introduction of capital and liquidity waivers extremely difficult.

> *Today, BU means that supervisory and resolution decisions are mostly European whilst the ultimate guarantor of financial stability remains national.*

Additionally, the entry into force of the BRRD has meant that, as of today, many institutions would only be deemed resolvable if bail-in would be extended to the level of senior debt or even deposits. This, in turn, has had destabilising effects, by amplifying the incentives for a bank run at the earliest sign of distress. Although this problem has been recently addressed with the BRRD review, it is simply not realistic to expect that compliance with Minimum Requirements for own funds and Eligible Liabilities can be achieved by all credit institutions in a very short time frame – especially given the current and future situation in the financial markets due to the COVID-19 crisis - without seriously aggravating their financing costs and profitability. Therefore, resolution authorities need to be able to rely on alternative sources to support resolution actions, such as resolution funds, especially in the current period of transition during which loss-absorbing capacity is not yet fully available.

I truly hope that the challenges brought about by the COVID-19 crisis will help us get out from the risk reduction versus risk sharing debate, to get back to overall objectives of the Banking Union and to move closer to the finish line that was agreed many years ago.

Markus Ferber

MEP, Committee on Economic and Monetary Affairs, European Parliament

A Banking Union for a stronger Europe

For a successful European economy that can tackle the challenges of the 21st century, such as digitisation and the transition towards a less carbon-intensive growth model, substantial investments will be needed - by the public sector as well as by the private sector. Those investments require financing via capital markets and bank lending alike. Well-functioning and competitive capital markets and European banks as well as a Single Market for banking and financial services are a prerequisite for that. Arguably, such a Single Market must contain a Banking Union and in turn banking groups that are truly active across the entire Single Market.

Over the past couple of years, we have made quite some progress towards that goal: We have established a single rulebook, effective supervisors such as the European Banking Authority and the Single Supervisory Committee, have set up a resolution regime and agreed on high standards for deposit protection. This already sets an effective framework for the Banking Union, but we also need to acknowledge that European markets are still somewhat fragmented and that the Banking Union is not yet complete.

So what could the next steps towards the completion of the Banking Union look like? To put it quite clearly, a fully mutualised EDIS is not a prerequisite for the completion of the Banking Union. Having high common standards for deposit protection as well as certain safeguards in place however is important. These objectives can also be achieved by a reinsurance scheme that provides liquidity between national systems in times of crisis. Other than being the logical evolutionary step, a reinsurance scheme seems to be more viable politically in both the Council and the Parliament as well.

In order to allow for an informed, fact-based and sensible discussion about the way forward, the Commission would be well-advised to finally adopt its implementation report of the existing Deposit Guarantee Scheme Directive that was already due in summer of 2019. A thorough assessment of the status quo of the implementation that also identifies possible problem areas could lift the discussion on more solid ground.

At the same time, risk reduction measures in the banking system should continue. A framework that would facilitate selling and buying of non-performing loans on secondary markets is still missing, which prevents banks from cleaning up their balance sheets. Progress on that front is therefore urgently needed. The same goes for the issue of the regulatory treatment of sovereign exposures. As long as sovereign bonds are treated as essentially risk-free assets, the doom loop of failing banks and failing states cannot be effectively broken.

There are other elements that are holding back the Banking Union though: the lack of a harmonised bank insolvency framework poses challenges for the Banking Union in general and the resolution regime in particular. After all, the resolution regime works on the basis of the "no creditor worse off" principle, which uses the respective national insolvency regime as a reference point. As long as there is no progress with regards to the harmonisation of insolvency law, we will not be able to get rid of the inconsistencies in the resolution regime.

An established Banking Union should make cross-border activity easier for all banks. Increased cross-border activity should therefore allow European banks to grow inside the Single Market and benefit from economies of scale thus improving their competitiveness on a global level. Internationally competitive European banks are in turn an important factor for an export-focussed model of economic growth and therefore for the competitiveness of the European economy as a whole. Therefore, there is much to win if we get the Banking Union right.

Robert Holzmann

Governor, Oesterreichische Nationalbank

What are the costs and risks of a delayed compared to a half-baked completion of the Banking Union?

Against the background of the current coronavirus pandemic and its economic impact the importance of joint initiatives to complete the Banking Union in a sensible manner is once again highlighted.

In response to the economic and financial crisis of 2008 the European Commission initiated the project of creating a three pillared Banking Union back in 2012 in order to reinforce financial stability by reducing financial fragmentation and by breaking the link between banks and their national sovereigns.

While it was possible to achieve progress on the first two pillars in a relatively short period of time with the establishment of the SSM in 2014 and the operationalization of the SRM in 2016, the finalization of the third Pillar – EDIS – is still in the making. Despite progress in the Banking Union, fragmentation is still a defining feature of the EU banking market. Fragmentation certainly has commercial motives - depressed bank valuations, the declining value of banks' retail franchises and many IT legacy issues discourage consolidation within and across borders. Even more so, policy makers have to contribute their part in completing the banking union. At this juncture, it must be understood however, that both inaction with respect to the completion of the Banking Union, as well as "face saving" half-baked compromises in this regard can entail risks and costs for the Euro area.

Let us turn to the costs of a delayed completion of the Banking Union first. In a truly integrated banking market banks would face a single set of rules and the free flow of capital and liquidity would contribute to lower costs of financial intermediation. This would in turn embolden the ability and willingness of banks to expand across borders and reap optimal returns to scale, thereby increasing the capacity of the system to absorb shocks and supporting banks' profitability. Given that European companies, in particular the large SME sector, rely heavily on bank lending to finance investment and working capital this clearly also has macroeconomic implications.

This brings us to the risks of completing the Banking Union in a way that is unfit to address the underlying challenges. These challenges relate to ensuring the right balance between home and host supervisors, achieving swift further risk reduction and breaking the bank sovereign nexus. What could go wrong? Consider cross border banking groups, whose intragroup capital and liquidity cannot flow freely today. Allowing capital and liquidity requirements to be waived could create significant externalities, as the current ring fencing comes for a specific reason - banks are still "global in life" but "national in death". Risk reduction is another case in point. If we fail to implement the right incentives to ensure a lasting effect of risk reduction on banks' balance sheets, risk sharing could prove to be the bedrock for future risk taking. A similar argument could be made with respect to EDIS. The lack of progress on EDIS is grounded on the fact that the level of riskiness differs across countries' banking systems, as does the extent to which banks finance their own sovereign.

All this shows that any solution that does not tackle the afore mentioned issues will lead to a clearly suboptimal completion of the Banking Union. The current situation caused by the coronavirus underlines the necessity of finding a coordinated answer to this problem. The immediate focus has to be on enabling the banking and financial systems to fulfil their vital role in financing the real economy also in turbulent times. Once the corona crisis has gone by, we however will have to put in place a number of requirements in order to allow an integrated functioning of banking groups while at the same time addressing legitimate concerns of home and host authorities. Banks should continue their pre-coronavirus activities to address pockets of vulnerability, build up loss-absorbing capacity and reduce undue concentration in sovereign exposures. Member States and public sector authorities should establish and enforce credible liquidation regimes for banks with predictable and fair outcomes for creditors at the different levels within a banking group. They should also introduce a last resort fiscally neutral liquidity provision mechanism for bank resolutions, enhance depositor protection in all Member States through the staggered introduction of EDIS and smooth differences in the legal practice of corporate and private insolvencies thus facilitating recoveries. In addition, alternatives to internal MREL within banking groups, e.g., cross-border guarantees based on EU law, could be explored. Progress on all these areas is interdependent.

To conclude, we need to complete the Banking Union and we need to do this in the right way. As the impact of the corona crisis teaches us, taking coordinated action and finding a common European answer is key in this regard. Otherwise financial market fragmentation in the EU will persist leading to higher costs for financial intermediation, limiting the free flow of capital and liquidity across borders, ultimately affecting economic growth and missing out on reaping the benefits of a truly single market. But we also have to take into account, that there are underlying reasons for the currently existing fragmentation in the European banking market, which need to be tackled. ●

Carlos da Silva Costa

Governor, Banco de Portugal

Safeguarding financial stability at local level within the Banking Union

Whilst we must not underestimate the remarkable progress achieved in recent years, we should acknowledge that Europe's financial architecture still needs to be completed and strengthened. Without a pan-European banking system, EDIS, and adequate resolution and liquidation mechanisms, financial crises tend to be local. The responsibility of ensuring financial stability and depositors' confidence lies with individual sovereigns, which have limited instruments and room for intervention. As we stand, effective risk-sharing mechanisms have not been put in place. The sovereign-bank doom loop – the trigger for creating the Banking Union – persists. Indeed, supervisory and resolution decisions are mostly European, whereas the ultimate guarantor of financial stability remains national: banks are European in life but remain national in death, creating a mismatch between control and liability.

As it is clear now, not all countries were ready to implement the Bank Recovery and Resolution Directive (BRRD) as scheduled. This implied that over recent years, some countries have had to resort to alternative instruments to safeguard financial stability – these decisions were met with outcry and criticism as they were perceived as attempts to circumvent the existing rules. It could be argued that the current setup made bank liquidations an easy way out for European authorities as the ensuing financial and political costs lie with national authorities. It should not be forgotten that few things can be more destructive to public trust in European institutions than threats to financial stability. In this regard, the conclusions reached by Denmark and Sweden on the (public) analysis of their possible participation in the Banking Union deserve careful consideration by having clearly identified the risk of conflict arising between the local objectives of financial stability and in the Banking Union as a whole.

Against this background, the harmonisation of EU banks' liquidation regimes has been heralded as one way forward. However, in the absence of an appropriate legal framework, liquidation might imply the immediate interruption of lending support, as well as the suspension of payments; it may have disruptive effects for creditors, depositors and other stakeholders, ultimately reinforcing the sovereign-bank doom loop.

Instead of moving immediately towards such harmonisation, efforts must be made to establish an enabling framework for the orderly management of failing banks of locally systemic importance, combining elements of the resolution and liquidation frameworks, with a view to minimising losses and protecting depositors and non-financial borrowers. Such an enabling framework should include the definition of high-level principles to be agreed by all Member States for application at national level. For those banks assessed as not having (European) public interest, room for manoeuvre should be available in view of national preferences.

...few things can be more destructive to public trust in European institutions than threats to financial stability.

Recourse to alternative measures as foreseen in the Directive on Deposit Guarantee Schemes or to public funds, as an ultimate backstop, should be considered in this regard. It also goes without saying that further stabilisation mechanisms – a fully-fledged EDIS, the provision of liquidity in resolution, a common euro area safe asset – and addressing home-host tensions are also needed and urgent.

This is even more so, as pressure for consolidation to increase profitability and efficiency of the European banking sector is increasing, and raises the question of how to reconcile further integration with safeguarding financial stability at local level in the current incomplete and imperfect set up.

On the one hand, supervisors and regulators should provide a stable view of the supervisory and regulatory frameworks allowing market participants to make informed decisions. On the other hand, without risk sharing and pan-European banks, sovereigns need to find the means to protect competition in their local markets and to safeguard the flow of funding to the economy when branches and subsidiaries of foreign banks exit during a downturn (as observed during the previous crisis).Summing up, decisive political will to move forward with the completion of the Banking Union is required. As the impacts of the coronavirus reverberate, this must now also be a priority for policy-makers and relevant institutions. Failure to do so can call the future of the European project into question.

Vitas Vasiliauskas

Chairman of the Board, Bank of Lithuania

Completion of the Banking Union calls for a comprehensive approach

Completing the banking union should remain a key priority on the European agenda. Reaching this goal would help mitigate the sovereign-bank loop, facilitate enhanced competition via expansion of cross-border banking and create additional channels for private risk sharing across the euro area. However, developing the banking union should not come at the expense of the financial stability of individual jurisdictions.

Efforts to finalise the banking union depend on solving a number of complex issues. These include creating a fully-fledged European Deposit Insurance Scheme (EDIS), dealing with some of the inherent inefficiencies in the current regulatory framework and enhancing the crisis management toolkit. In this respect, completion of the banking union should be pursued in a comprehensive manner and feature a package approach.

Some argue that in order to achieve a breakthrough in facilitating the expansion of banking activities across jurisdictions we need to introduce cross-border capital waivers. It is true that ring-fencing practices may to some extent be viewed as hindering the deepening of a single market for financial services. Yet, we also have to recognise that relaxing prudential regulation requirements in the current setting of an incomplete banking union causes financial stability concerns for host jurisdictions. With no EDIS in place, it remains primarily the responsibility of national deposit guarantee schemes to bear the financial burden if a subsidiary fails. Therefore, we need to ensure that facilitating the expansion of cross-border banking does not result in negative consequences for the financial stability of individual jurisdictions.

Against this background, any move towards establishing a mechanism for cross-border capital waivers should be accompanied by implementing adequate safeguards to credibly address the concerns of the host jurisdictions. A possible way forward could be to ensure that subsidiaries eligible for the waiver do not exceed a certain threshold, at the very least the threshold for significance set out in the Single Supervisory Mechanism Regulation. Additionally, the waiver should not be absolute and should have a built-in floor (e.g. 75%), which would in practice limit the reduction of capital held by the subsidiary.

Yet, even implementing the appropriate safeguards will not suffice to fully address the underlying financial stability concerns. This requires a return to the very fundamentals of the banking union's architecture - that is, finally putting in place its third pillar. A fully-fledged common deposit insurance scheme is essential to ensure that measures to enhance cross-border activities do not reduce the overall resilience of the euro area financial system. Ensuring that depositor protection is independent of a bank's establishment location would weaken the link between banks and national sovereigns, while at the same time providing a strong impetus for the expansion of pan-European banking.

> *Developing the Banking Union is key, but it should not come at the expense of the financial stability of individual jurisdictions.*

Furthermore, in order to enhance the financial stability of the single currency area, the current crisis management framework needs to be reinforced. Agreement on creating a common backstop to the Single Resolution Fund represents an important step in the right direction. Nevertheless, it may still not fully address the liquidity needs of a large bank or in the event of a systemic crisis. Therefore, liquidity in resolution remains an important open issue in the current crisis management framework and deserves policymakers' robust attention.

On a broader note, the expansion of cross-border banking in the European Union largely depends on eliminating the existing non-prudential barriers. These include primarily divergent national insolvency and taxation regimes. Without a higher level of harmonisation in these domains, we will still fall short of reaching a truly integrated European banking market. ●

Banking Union home-host dilemma

Edouard Fernandez-Bollo

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

Banking Union beyond home and host

Almost six years after the establishment of European banking supervision, we still hear people talking about "home" and "host" jurisdictions and authorities within the banking union. This distinction certainly does not match the reality of shared decision-making and responsibilities within the Single Supervisory Mechanism. It does, however, reflect the continued existence of specific features in national markets, and to some extent also the regulatory framework, which continues to allow for national ring-fencing policies.

The current situation is economically and politically sub-optimal. In economic terms, ring-fencing measures hinder the efficient allocation of capital and liquidity within banking groups. They prevent European banks from fully benefiting from economies of scale and the diversification of risks within the banking union. In political terms, ring-fencing measures reflect insufficient trust between Member States stemming from past experience. Thus, any serious attempt to break the current deadlock has to start by acknowledging the legitimate arguments and concerns on all sides. While closer cross-border banking integration could bring significant benefits, it should not come at the expense of local financial stability.

Achieving the right balance may require some targeted legislative amendments to provide sufficient safeguards that the parent will provide financial support in the event that the financial situation of a subsidiary deteriorates. This may take the form of enhancing the framework for intra-group financial support agreements. However, private sector actors should not wait for public authorities to act on this front, but should make use of all the opportunities available within the current regulatory framework and discuss with supervisors how best to enhance confidence in intra-group support.

Differences in national bank insolvency regimes across the EU represent another potential obstacle to the smooth functioning of the banking union. While it seems unlikely that national insolvency frameworks will be fully harmonised in the medium term, certain targeted improvements may be feasible, for example as regards the treatment of creditors in the insolvency hierarchy. A key principle of the Bank Recovery and Resolution Directive (BRRD) is that no creditor should incur greater losses in resolution than it would have done under normal insolvency proceedings (known as the "no creditor worse off", or NCWO, principle). However, in the absence of a harmonised regime for creditor hierarchies, the NCWO principle would result in different outcomes across the banking union in the event of a cross-border group being resolved.

Another source of uncertainty relates to the situation that arises when a bank is deemed failing or likely to fail but does not enter resolution. The laws determining what happens in such cases currently differ from country to country, and this divergence needs to be addressed. Concretely, the concept of "orderly winding-up", cited in Article 32(b) of the revised BRRD, could be made more precise in order to ensure that national implementation results in a more harmonised treatment of failing banks across the banking union. There may also be a case for further clarification on the links between a failing or likely to fail decision (in the event of non-resolution), the reimbursement of deposits and the withdrawal of the banking licence. Progress on all of these fronts would allow us to move to a banking union in which a distinction no longer needs to be made between "home" and "host". ●

Martina Drvar

Vice Governor, Croatian National Bank

Material matters: parent institutions and home supervisors attention needed

Local materiality (for example, the largest bank in Croatia presents only 2% of its parent's balance sheet) requires parents to enforce (i) adequate compliance check of the group governance and risk management policies through adequately scoped internal audit visits and home supervisors to support (ii) sufficiently granular recovery plans and (iii) frequent on-site inspections. Home supervisors need reassurance that highly centralized banking activities at the consolidated group level will ensure stress less provision of service for local economy.

Authorization of supervised activities rather than authorization of supervised legal entities could endorse branchification, lowering the regulatory burden for banks and contributing to more efficient ▶

financial servicing of European citizens. High-level standards for (i) intragroup transactions and (ii) key functions insourcing activities strengthen and secure the level of group integrations. Home supervisors should run regularly recovery plans' dry runs at the solo level of locally important banks, OSIIs, to confirm credibility of recovery options, while their on-site inspections should be tailor-made to tackle also local material issues. This will increase oversight visibility of parent institution and home supervisors at the level of OSIIs.

With the confidence in high-quality organization of banking activities established at the consolidated level and appropriate level of host supervisory attention, there would be less need for ring fencing against potential liquidity and solvency problems of the European banking groups. In the banking union space, even if there will be consensus around EDIS in the near future, the other two pillars have to improve further with the help of regulatory initiatives. SSM's supervisory practice remains challenged by the absence of accounting powers and implementation of national options and discretions (NOD).

Accounting powers would provide SSM with ability to shorten the time lag in certain jurisdictions for recognition of adequate provisioning of NPLs and collateral evaluations, important for aligned resolution interventions, while NOD need to be exercised at the level of the ECB as single rule maker (the most relevant example is limiting intragroup exposures at national level). SRM on the other hand, aiming to create effective resolution plans, could increase the level of parent institutions' ability to display their preparedness and contractual readiness to support their activity regardless of different European jurisdictions and distress conditions through the high-quality and highly operational recovery plans.

This better alignment of those attention levels directed and delivered from the both parent' and home supervisors' level would definitively improve the integration of banking in the EU.

Maria Stolpe

Head of Group Public Affairs, Nordea

Trust in the Single Market

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

Since the beginning of the creation of Nordea twenty years ago, the vision was to create one Nordic bank, One Nordea. But despite the EU efforts to create a truly single market in Europe, operating as a cross border bank was difficult with the combination of an integrated cross-border operating model and national legal entities. Nordea saw a need for structural changes to achieve One Nordea business and operating model, improve resolvability, simplify implementation of new EU regulation, and simplify governance.

Consequently, Nordea made two major changes to its legal structure: in 2017 the group merged its primary banking subsidiaries into one, creating significant branches in other Nordic countries and in 2018 the bank re-domiciled to Finland, moving into the Banking Union.

You could say that Nordea has done all in its power to structurally transform into the "perfect" cross-border EU bank. Has the regulatory side of the equation delivered at the operational level?

The simplified structure has indeed strengthened the drive for scale advantages and common processes and systems. The resolvability is improved; resolution entities now coincide with critical entities in the operating model - reducing authorities' execution risk. In principle, Nordea, including the branches in the Nordic home markets, is now subject to one set of regulation, incl. one ICAAP process, one SREP process, and the need for a unified legal structure continues to be relevant with additional regulation coming into force.

However, as the EU single rule book is still incomplete, the expected regulatory advantages has not come to fruition.

To function as a universal bank, Nordea must operate branches as well as subsidiaries across the four Nordic countries. Therefore, the operating model is susceptible to divergence in regulatory definitions, and regulatory changes to accounting definitions. Examples incl. differences in definition of default, which has implications for credit risk modelling, and differences in IFRS9 implementation. Meanwhile, macroprudential requirements are still not harmonised, distorting the level playing field in capital and operations, and regulatory guidance on structure of branch supervision is vague. This reflects issues in prudential supervision, while the less harmonized legislation relating to conduct and compliance create even further issues.

Nordea has done all in its power to structurally transform into the "perfect" cross-border EU bank.

Experience shows that the many supervisory discretions distort the single market and prevents cross-border banks from being fully efficient, also in a branch structure. Even in the Nordics, where regulators have a history of mutual trust, cooperation and coordination, perhaps more so than in any other place in Europe, deviation in local practises and duplication of safeguards fundamentally hampers further integration.

This must be overcome to better enable cross-border banking in the EU.

EU bank resolution framework

Elke König

Chair, Single Resolution Board (SRB)

A centralized administrative liquidation tool for banks

This year marks the SRB's fifth anniversary – an appropriate time to reflect on how the crisis management framework has worked so far and consider areas for improvement.

The public interest assessment (PIA) – i.e. the evaluation of whether a bank may be wound up under national insolvency proceedings or should be resolved to maintain its critical functions and protect financial stability – has triggered a lively debate. These criteria are laid down in the SRM Regulation and the SRB has published its policy on its website[1]. In a nutshell: resolution is for the few, not the many. For smaller, less significant banks, insolvency will be the procedure at play if and when they fail.

Our experience to date has laid bare the need to find a solution for those medium-sized banks that are too "small" to meet the PIA, but possibly too "large" to be placed in insolvency. The SRB has been clear[2] that the harmonization of insolvency regimes for banks is a necessary end-goal. However, it is unlikely to be achieved in the short-term. The creation of a centralized administrative liquidation tool may be more feasible in the short-medium term, and would address many of the issues identified for medium-sized banks, with insolvency tools remaining available for smaller banks.

Such a liquidation tool could be created by amending the BRRD, SRMR and DGSD, and could provide for the powers to transfer (some) assets and liabilities in an orderly liquidation, much in line with current resolution tools. In the Banking Union, this could be entrusted to a central authority. As a first step, the SRB's toolbox could be enriched with a "pre-liquidation tool", allowing the application of resolution tools to save the good part of a bank without entering into liquidation, or without requiring a specific liquidation regime at European level.

The FDIC is a useful comparison, as it highlights the advantages of the purchase and assumption tool (P&A) for liquidation, which was used for the majority of US bank failures in the last decade. The FDIC's experience also shows the benefits of having a centralized authority with harmonized resolution and insolvency procedures, P&A tools and Deposit Guarantee competences.

By contrast, in the current patchwork of DGSs operating in the Banking Union, only some allow transfers of deposits as "alternative measures" to pay-outs, raising challenges around arbitrage, level-playing field and coordination. A centralized authority could enhance coordination across DGSs and enable a more effective management of bank failures. As the US experience shows, the use of transfer tools could reduce the cost of failure and overall impact on the DGS system.

Finally, it would help reduce moral hazard, by removing the need for Member States to provide liquidation aid, thereby better protecting taxpayers' money. This does not come free. However, based on adequate capital levels and clear rules, authorities should be able to find solutions early enough to secure functions that are critical to the franchise and minimize losses.

A centralized liquidation regime in the EU would address the current gap in the framework for medium-sized banks and improve the overall system: a further step towards the completion of the Banking Union that policymakers ought to explore further. ●

1. https://srb.europa.eu/sites/srbsite/files/2019-06-28_draft_pia_paper_v12.pdf
2. https://srb.europa.eu/en/node/622

Martin Merlin

Director, Banks, Insurance and Financial Crime, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Towards a more effective crisis management and completion of the Banking Union

In the face of the unprecedented COVID-19 pandemic, affecting all economic sectors, the European institutions and agencies intensively coordinate with Member States to ensure adequate crisis management and to prepare for the recovery of the European economy. The exact extent of the economic consequences of this crisis (and the second-round effects on the banking sector) are still unknown but the post-financial crisis framework puts us in better position to withstand the test. Yet, the need to complete Banking Union is more acute than before.

At political level, there is a broad consensus about the need to improve the bank crisis management framework to increase ▶

its efficiency, have appropriate common safety nets, preserve financial stability and as a result facilitate further cross-border integration.

A coherent approach to crisis management might facilitate progress towards completing Banking Union.

The Commission will continue to engage with Member States to bring about a consistent framework, which can rely on effective tools and appropriate funding catering for the failures of all banks, irrespective of their size and business model and whether the failure is managed in resolution or insolvency.

To ensure a consistent treatment of banks and creditors, several issues will require careful examination. These include namely the conditions and the procedure to grant precautionary recapitalisation, the interaction between resolution and insolvency procedure, the role of deposit guarantee schemes and the application of the public interest test.

A more coherent approach to crisis management might facilitate progress towards completing Banking Union and achieving a common deposit insurance scheme. A comprehensive, robust and well-functioning Banking Union should be at the core of a resilient European Monetary Union and is essential to strengthen the international role of the euro and, more generally, the European Union's economic sovereignty. It will also be necessary to ensure solidarity across the EU and to support economic recovery following the current crisis.

Dino Kos

Chief Regulatory Officer,
CLS Bank International

Resolution regimes: There is progress, but more needs to be done

After the 2008 global financial crisis, policymakers focused on implementing and enhancing resolution regimes governing global systemically important banks ("G-SIBs"). The objective was to prevent two untenable outcomes: a taxpayer-funded bailout; or a Lehman-style bankruptcy. Much progress has been made in various ways, including changes in legislation and the development of resolution plans. While some policymakers assert that G-SIBs can now be safely resolved, others find more work is needed. A key resolution objective is to ensure the bank in resolution can retain access to systemically important financial market infrastructures ("FMIs") such as CLS, which is the primary settlement service for the global FX market and settles a daily average of USD5.5 trillion in payments. Because of the credit and liquidity benefits CLS provides, a G-SIB in resolution losing access to CLS would likely adversely impact the resolution's success.

Fortunately, resolution of a G-SIB is designed to be a rare occurrence under these new regimes. So how can the robustness of such regimes be tested? One way is through a well-designed "war game" that tests key aspects of a resolution scenario. CLS recently conducted a war game based on the resolution of a hypothetical G-SIB. The scenario benefited from the participation of many CLS members and input from central banks and certain resolution authorities.

While the war game confirmed progress in some areas, it also revealed shortcomings and potential impediments to resolvability that merit attention, including:

- Multicurrency liquidity challenges – Nostro agents of a bank in resolution are less likely to fund on that bank's behalf in the relevant currencies without prefunding or collateral. Despite G-SIBs' extensive international activities, there continues to be an overwhelming focus on ensuring sufficient liquidity in the home currency during a bank resolution, with less consideration as to how to ensure funding in relevant foreign currencies. Per the Financial Stability Board's June 2018 Funding Strategy Elements of an Implementable Resolution Plan, resolution plans should address how funding obligations in all relevant currencies will be met, including any potential shortfalls. This may be challenging over a resolution weekend.
- Procyclicality concerns – The majority of market participants are still likely to have procyclical responses (e.g., significantly reducing or effectively eliminating credit limits) to a bank's entry into resolution, which may jeopardize the resolution's success. In addition, authorities' use of "moral suasion" on market participants in order to bolster confidence in the resolution may not be as effective as expected.

Testing exercise reveals shortcomings and potential impediments to resolvability that merit attention.

- Enhancing communications – Timely and effective communication is critical to fostering market confidence in a resolution, especially from the resolution authority and central banks. For example, the hypothetical G-SIB's nostro agents indicated their desire for information from their own regulators regarding the resolution. Communication plans and information-sharing arrangements (e.g., crisis management groups) should consider how to address these needs.

Successfully addressing these issues will require coordinated, proactive efforts across a variety of stakeholders.

Mark Venus

Head of Recovery and Resolution Planning, BNP Paribas

Liquidity in Resolution: the case for constructive certainty

For centuries, the doctrine of 'constructive ambiguity' played a key role in central banks' approach to failing banks. Uncertainty as to whether the liquidity lifeboat would arrive was felt to discourage reckless skippers at the helm of banks from sailing too close to the wind, or indeed to the rocks.

But the rules of navigation have now changed.

Banks are now equipped with double hulls, in the form of enhanced capital requirements and behind that an additional protective sheet of MREL or TLAC to give them the ability to recapitalise. They are like self-righting boats. To assist, we have built repair dockyards, in the form of resolution authorities, with all the necessary tools : bail-in, transfer strategies, asset separation vehicles, restructuring plans.

However, we have a problem in the Eurozone. We have built a dry dock, and banks, like any other vessel after repair, need liquid(ity) in order to float properly and go back to sea.

The absence of a liquidity provider for banks in resolution is the missing piece in the Eurozone resolution framework. Banks in resolution are the archetype of the banks that Walter Bagehot (in Lombard Street: A Description of the Money Market) saw as being deserving of support by a 'lender of last resort'. They are solvent, because their losses have been absorbed and they have been recapitalised, but they may be illiquid. They are stuck in dry dock.

Why can banks in resolution be solvent but illiquid? The essential reason is information mismatch. The dockyard, or resolution authority, knows perfectly the state of the hull and that they have carried out the necessary repairs. The bank is solvent once again. But prospective passengers, or private sector liquidity providers, will have an obvious desire to see for themselves that the bank can float before they venture aboard with their cash.

This is where we need to import into the Eurozone the concept of 'constructive certainty'. The markets needs to know that there is a dependable liquidity provider to enable banks to successfully emerge from resolution. If this is the case, the probability that private sector liquidity will become available is all the higher.

Liquidity provision in resolution is not the same as liquidity provision in the run-up to resolution. That function is a far more risky proposition, from which central banks understandably shy away. The debate as to who should provide the liquidity in resolution in the Eurozone has been going on for too long, and appears to have reached deadlock. This debate was resolved in the US and UK long ago.

> *They may be illiquid, they are stuck in dry dock.*

Some confuse the provision of liquidity with the provision of capital and claim it constitutes State Aid. Others say that the ECB cannot provide liquidity because it would be incompatible with the monetary financing prohibition, and that the provision of liquidity in resolution is a government task and should be carried out by Treasury. But there is no Treasury for the Eurozone. The ESM may be the nearest thing to that, but any ESM schemes proposed to date have proved to be too cumbersome to be of practical use.

The current COVID crisis has shown that the ECB can act decisively in crisis conditions to provide liquidity to the entire banking sector. Surely it should be able to do so in response to the need to enable single banks in resolution to successfully leave dry dock, and it should say so. ●

Giles Edwards

Sector Lead, European Financial Institutions, S&P Global Ratings

Continued bank bail-outs stretch the credibility of Europe's resolution intent

Following the financial crisis, European authorities introduced resolution legislation and tightened state aid rules to ensure creditors, not taxpayers, incur most of the costs of bank failures. The handful of banks that failed since the start of 2015 do not provide a comprehensive examination of how the rules will be applied. However, while resolution tools have on occasion been used to good effect, in other cases we see that some EU governments have continued to support failing and failed banks, sometimes resorting to creative methods to adhere to the letter of the law.

Given also that these bail-outs occurred even outside a system-wide stress scenario, it is little surprise that bank investors see considerable doubt over some European governments' commitment to this reform program. In S&P Global Ratings' view, these effective bail-outs have stretched ▶

the credibility of the EU's resolution agenda, though not yet to breaking point. While governmental and regulatory decisions remain unpredictable, the market will inevitably lack confidence in the effectiveness of the resolution process, and the scope and timing of any government support. We see four main, interconnected factors behind persistent government bail-outs:

1. There is still limited appetite to impose losses on certain senior and retail creditors.
2. Most banks are not yet resolvable. Resolvability is a multi-faceted concept, but options are heavily constrained without adequate resources to recapitalize banks and bolster liquidity while market access remains difficult.
3. The fragmented mix of regional and national decision-making within the Eurozone.
4. Some governments may see bank bail-outs as lower risk than the largely-untested resolution and orderly liquidation tools. Predictability in the use of resolution powers will increase as more banks build a sufficient layer of bail-inable debt that is subordinated to operating liabilities and deposits.

However, this step alone will be insufficient. We see also a need for:

1. Removal of some of the guesswork: expanding resolution authorities' ex-ante communications that try to guide market expectations, whether on their concept of resolution, on bail-in buffer requirements (including any unsubordinated element), and on resolution strategy for individual banks or types of banks, particularly the middle tier that would targeted neither for open bank resolution nor for liquidation.
2. Consistent rules, including a harmonized insolvency framework as this appears to be a key cause of inconsistency today.
3. Consistent actions, or at least logically inconsistent ones (since the fact-set will differ from case to case). This might be enhanced by reducing the number of decision-makers in the banking union.
4. Strong ex-post explanation of decisions around the use (or non-use) of resolution powers, subject of course to constraints arising from the inevitable legal proceedings.
5. Time. Whatever the quality of preparation, whatever the consistency of actions on smaller banks, parts of the market will still doubt regulatory intent until resolution is used for a major bank.

Andreas Dombret

Global Senior Advisor, Oliver Wyman

Much still needs be done!

At the time of writing, Europe is entering a Corona lockdown. The impact on our economies and the subsequent challenges for the banking system in the Eurozone are yet to emerge.

Gladly, important progress has been made since the last financial crisis. Banks, urged by the international regulators, have successfully built up absorbing capacity. A statutory resolution framework, run by dedicated authorities, is now firmly in place, and banks are progressing towards resolvability.

However, much still needs be done. Policy priorities in the Eurozone include liquidity in resolution, resolution decision-making, harmonization of insolvency regimes and a European Deposit Insurance Scheme.

Starting with liquidity in resolution: By 2023, the Single Resolution Fund is expected to have accumulated €60bn of contributions from the European banking system. This represents a big step forward but potentially will not be sufficient to fund multiple failures of significant banks. In addition the Eurogroup has designated the European Stability Mechanism, or ESM for short, as a backstop.

Until then and beyond the capacity of both schemes, temporary central bank funding remains paramount. The instrument currently in place is Emergency Liquidity Assistance, or ELA for short, where the main responsibility and risks continue to ly with the national central banks.

As a result, the ESM and the national central banks will need some involvement in resolution planning when it comes to projecting potential funding needs. A common standard on collateral eligibility for ELA would help ex-ante preparation by banks and could come with a requirement for a positive Governing Council approval of ELA instead of the current objection rule.

Now to decision-making for resolution. This is already a complex undertaking, involving the Council, the Commission, the Single Resolution Board, national resolution authorities as well as the European Central Bank - and it will become even more complex with the ESM Board of Directors and several national central banks. I find it worthwhile and quite important to reflect on this complexity and consider simplifications in the decision-making. In my opinion the provision of ELA needs to be with the ECB, and speedy decision making may well be a priority.

Failing banks not passing the „public interest test" and that therefore are not resolved are to be wound down under insolvency rules. The fact that the applicable rules are national and not yet harmonized can create rather different outcomes for investors and are likely to create improper pressure on governments to bail-out debt holders. This is important as no creditor can be worse off in resolution than in insolvency. A European bank insolvency law would of course reduce the complexity of the resolution of banks and increase transparency for investors.

The final piece remains a European Deposit Insurance Scheme operating on a "least cost basis". This would allow for optimal use of resources when losses in insolvency would be higher than a solvent wind-down of the bank. These initiatives will require joint efforts by law-makers, regulators and industry experts, and some will take longer to reach political consensus.

Europe cannot afford to be complacent and needs to get all of the above done. I remain optimistic but joint efforts are of the essence.

EDIS: is a political agreement nearer?

Pablo Hernández de Cos

Governor, Banco de España

Common policies against common shocks

History tells us that crises happen. Some of them can be more easily anticipated. The Coronavirus outbreak, which is spreading around the globe, has little to do with economic fundamentals or the quality of economic governance. In addition to the huge stress it is placing on healthcare systems, it combines elements of supply and demand shocks which require measures to prevent the closure of firms and to support firms' and households' expenditure. It has also caused a confidence shock in financial markets, unleashing fire sales, a hurried search for liquidity and flows towards safe havens. This situation is likely to be transitory, but the speed and the scale of our response to the crisis and our ability as policymakers to work together will determine the strength of the recovery.

These events underline the need to strengthen EMU with a comprehensive package of common safety nets, robust joint policy tools, and a reinforced and effective coordination of national policies. Notable among common actions are those aimed at effectively materialising the capacity to share budgetary risks within EMU, and more broadly the EU. Joint fiscal actions in the face of this common shock would not only ensure maximum efficiency in our response, but also embody the solidarity values underpinning the European project. A common safe asset would be ideal, providing a neutral source of funding and simultaneously sending a strong signal of unity and goodwill. The world is watching. If not now, when?

We also need to conclude the Banking Union. The sizeable monetary policy and liquidity provisioning measures already taken will surely mitigate the risks in the banking sector. But we should not be complacent when it comes to raising a firewall against further deterioration of the crisis.

Regarding the current resolution framework, we need to accelerate the entry into force of its final stage. A fully centralised resolution mechanism will weaken the doom loop because it alleviates the burden of bank resolutions for national sovereigns. Given the observed progress in risk reduction, Member States should summon up the political resolve to bring forward the full mutualisation of the SRF, duly reinforced by the ESM as the common backstop. This is an essential step that would ensure that the SRM/SRF is fully operational.

A stable banking system also requires a credible safety net for depositors, especially during confidence crises. It is what prevents liquidity shocks such as the current one from morphing into banking crises and, eventually, bank runs. More generally, it allows for higher private risk-sharing, by increasing confidence in the European banking framework.

The current institutional arrangements of the Banking Union do not provide the required level of credibility. Banking activity transcends national frontiers, but the guarantee on deposits is still borne by Member States. The two pillars already in place have reduced moral hazard concerns by transferring supervisory and resolution power to common institutions. On the one hand, the Single Supervisory Mechanism provides a strong and neutral institutional framework for bank supervision across Member States. On the other, the Single Resolution Mechanism covers the uniform enforcement of resolution frameworks when a bank is failing or likely to fail. But, by retaining responsibility for deposit protection at the national level, an additional and important problem may arise, namely one of discredit of the banking framework. The alignment of power, responsibility and accountability is what provides the necessary legitimacy of any institutional arrangement.

Current circumstances are highlighting even more the need to strengthen our Union. Completion of the Banking Union and the deployment of mutualised fiscal instruments will contribute to the stability of the European Union, enhancing the necessary private risk-sharing channels and helping European citizens to overcome current and future crisis.

Jonás Fernández

MEP, Committee on Economic and Monetary Affairs, European Parliament

EDIS: completing the Banking Union

The banking union project began in the summer of 2012, after a first semester in which the capital outflows of some countries – only balanced out by the Target2 program – had nearly led to a rupture of the monetary union. Thus, it can be stated that the banking union was launched at a critical moment for the Eurozone, during which the general banking risks were absorbed by sovereign governments. This triggered a surge in public deficit and hence the debt in some countries.

These increments in public liability fed an uncertainty in the markets concerning their ability to repay, and, therefore, the sustainability of pegged interest rates and the integrity of the monetary union. In order to minimize the risks of rupture, countries had to adopt pro-cyclical fiscal policies, in the short-term, and these policies narrowed the possibilities of recovery due to the absence of a common budgetary instrument that would be able to counter public national deficit reductions in a supplementary way. Precisely for this reason, the "banking union" was commenced, with the aim to avoid similar spiraling in each member state and to prevent the transfer of general banking risks to national sovereignty.

The journey began with the creation of the single-rule book, a European supervisor (SSM) and the design of a shared mechanism in order to manage the banking crises (SRM and SRF). However, this boundary between sovereign and banking risks has not been completely due to the maintenance of national deposit insurances, which continue to be managed by national authorities. It is not consistent that the national tax-payers would assume the risk of a banking crisis whose regulation is not the competency of the national legislature, as not even the supervisory organisms are controlled by their respective parliaments.

The European Commission presented its regulatory proposal for the creation of a European deposit insurance scheme in 2015 – nearly 5 years ago. While progress on the negotiations in the Parliament and the Council has been scarce, the excuses have been abundant.

Within this period, I have identified at least two types of obstacles to the negotiation. The first argument is based on the necessity of reducing the general banking risks in all national systems before merging the assurance at the European level. The second argument centers on the heterogeneousness of the current deposit insurance models, including various systems within a certain countries.

To tackle the former of these two problems, the Union has continued legislating to raise capital and liquidity requirements and clarifying resolution payment models. A massive task certainly lies ahead as there cannot possibly be a new requirement at each juncture of the process before beginning the negotiation of the EDIS. Naturally, this would seriously erode the levels of confidence among negotiators. In order to resolve the latter of the problems, and to provide a reasonable amount of time to achieve larger amounts of risk mutualisation, the S&D Group in the European Parliament has proposed an alternative model to the European Commission text, referred to as the "bi-insurance model".

> *S&D has unveild a new EDIS proposal to solve some political disputes: «bi-insurence model».*

The proposal of the S&D Group entails the maintenance of current national insurance schemes alongside a European scheme. The banking entities must contribute to both funds, subject to a limit of 0.8% of covered funds. In the case of "accident", the national insurance would cover the liquidity requirements until their exhaustion before being supplied directly to the entity or depositors by the European insurance. As such, it is not a model of the reinsurance of national systems, but rather a 'double insurance' of the entities themselves.

Under this system, the level of mutualisation would depend on redistributing the contributions of each entity to each insurance scheme and, naturally, must be an open issue in the negotiations. In such a system, with a previously agreed level of mutualisation, the framework of security deposits would cease to depend – whether explicitly or implicitly – on the respective national treasuries. And this, in turn, would allow us to achieve the original objective of the banking union.

Georg Huber

Head of the Representation to the EU, Deutscher Sparkassen- und Giroverband (DSGV)

Banking Union already established

The European Commission argues that the Banking Union is incomplete without a European Deposit Insurance Scheme (EDIS) as its third pillar and that EDIS would contribute to the financial stability in the EU. However, the Banking Union is already complete with the introduction of the Deposit Guarantee Scheme Directive (DGSD). The DGSD ensures that all depositors in the EU enjoy the same level of protection by introducing a common set of rules. The DGSD requires that all Member States progressively fill up their guarantee schemes to the required target level. Consequently, the DGSD makes EDIS redundant.

Many alternatives to the Commission's original proposal have been discussed since its publication in 2015. The Commission itself presented a two-phased insurance scheme in its Communication on Completing the Banking Union in 2017. However, the communication only is a variation of the original proposal, since the objective of centralization and full mutualisation remains.

> *EDIS conceals hazards to the financial stability in the European Union.*

The DGSD takes account of the diverse banking sector in the EU Member States allowing options of national discretion. Hence, this enables Deposit Guarantee Schemes (DGS) to use their funds for alternative and preventive measures. In sharp contrast, EDIS would prohibit such measures. This is especially detrimental to Institutional Protection Schemes (IPSs) that are recognized as DGSs in accordance with the DGSD.

Small and locally active credit institutions, such as the German Savings Banks, have been using IPSs for decades. IPSs protect member institutions and avert emerging or existing financial difficulties for these institutions by deploying alternative measures. In order to be able to use funds for that type of measures, it is indispensable that decision-making powers remain with national DGSs. Contrary to that, EDIS would deprive national DGSs and IPSs of these powers, since it would not only centralize and mutualize funds, but also centralize decision-making powers on the EU level. There are inherent differences between IPSs and EDIS. While the latter is merely a paybox that is triggered in an event of a bank's insolvency, IPSs prevent such a situation by ensuring their members' solvency and liquidity. This allows the continuation of business relationships at all times.

EDIS would abolish national DGSs. This would have severe negative effects on small and regional credit institutions, their clients and ultimately on the EU`s financial stability.

Especially in times where we see a fundamental shock to the whole European economy, it is important to understand the risks that are attached to EDIS. Firstly, EDIS would decouple risks and responsibility. Credit institutions with a high-risk affinity would be encouraged to continue to do so knowing that they would be supported by EDIS. This would be at the expense of banks having less risky business models. Another issue to be adressed is the sovereign-bank nexus, which may prove to be a significant burden in the difficult economic situation to be faced. In the same vein, it is almost inevitable that the ratio of Non-Performing Loans (NPLs) will increase as a consequence of the Corona pandemic, which will probably exacerbate - despite recent efforts - the very significant differences from one member state's banking system to another.

In light of the above, three conclusions have to be drawn:

- EDIS conceals more hazards to the financial stability in the European Union than it does provide appropriate tools to prevent a bank crisis.
- the diversification of funds in the different DGSs in the EU member states is an important feature to avoid the spreading of a potential loss of confidence in the banking sector within all of the EU.
- Looking at the third pillar of the banking union alone is not the right way. More elements have to be analysed in order to set up the banking union appropriately.

Looking ahead, there is no doubt that with the DGSD a well-functioning deposit protection framework already exists in the European Union. Not only it ensures the EU's financial stability, but also takes account of unique national features. ●

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Solvency II revision: long-term investment challenges

Gabriel Bernardino

Chairman, European Insurance and Occupational Pensions Authority (EIOPA)

The role of insurers in building a stronger and sustainable Europe post COVID-19

The insurance sector plays a fundamental role managing risks from citizens and businesses and mobilising savings and investing them, thus developing the European economy and stimulating growth. The sector represents some of Europe's largest institutional investors and, in line with the nature of its liabilities, acts as a long-term investor.

In this sense, the insurance sector is key to achieving the objectives of the Capital Markets Union (CMU). As Europe's largest institutional investors, insurers have the financial strength to provide widespread benefits for the economy, acting in a counter-cyclical manner and investing with a sustainable, longer term perspective.

This role of insurers will be crucial for the European economic recovery post COVID-19.

Insurers are currently facing a 'low for long' interest rate scenario and Solvency II needs to reflect this new market reality. In this environment, the risk of adverse returns is gradually being transferred from the insurer to the policyholder by shifting the supply of insurance products from those with guaranteed returns to so-called unit linked products.

In this context, the 2020 Solvency II review should seek to strike a better balance by fully exploring the scope for differential treatment of liabilities according to their liquidity, and for the capital requirements of assets also to better consider the liabilities which they back. The assets backing illiquid liabilities are less vulnerable to short term fluctuations in market values. Recognising that feature will improve the risk-sensitivity of the framework and facilitate long-term guarantees and long-term productive investments.

EIOPA is currently testing a more favourable, yet prudent, treatment of long-term and illiquid liabilities compared with those of shorter duration, and the assets that back them, in particular long term equity.

On the volatility adjustment, an area for review is the recalibration of application ratios with the aim that insurers are rewarded for holding illiquid liabilities rather than being penalised for holding liquid liabilities.

On the risk margin, EIOPA is exploring ways to reduce its size and volatility, especially for the long term liabilities, based on the fact that the future capital requirements are not fully independent.

With regard to equity risk, EIOPA is testing the criteria for the ability to hold equity long-term, by making a link with long-term illiquid liabilities and taking into account that equity investments are managed on a portfolio basis rather than on an individual asset basis.

These adjustments are intended to improve risk-sensitivity, facilitate the design of truly long-term illiquid liabilities and incentivise long-term investments. In this way, the insurance sector will be better placed to invest with a sustainable, longer-term perspective which, in turn, will boost growth for Europe's economy and provide better perspectives for Europe's long-term savers.

In a post-COVID-19 world, long term investment is more important than never. Insurers can and will play an important role in the building up of a stronger and sustainable Europe. ●

Clément Michaud

Chief Financial Officer, Crédit Agricole Assurances

Choices to make for the European Commission

At the end of the year, when the Commission will draft its review of the Solvency II directive, it should ask itself the right questions.

Over the past quarters, the Solvency II framework has shown its structural weaknesses. Indeed, the directive acts as a pro-cyclical tool, with volatile solvency ratios, which forces companies to immediately sell long-term assets to preserve their equity ratio. Insurance is intrinsically a long-term business. Solvency 2 is short sighted by assessing a long-term financial environment with a mark-to-market approach. Moreover, the consequences of the accounting standards IFRS 9 and IFRS17 might negatively impact the long-term positioning of the sector. ▶

The Commission, especially in a negative rate environment that requires major changes for the profession, should use a framework that encourages the insurers who commit to long-term financing and reduces volatility, by introducing tools such as dynamic VA for standard formula, or market assumptions based on historical average values instead of spot values. The Commission should resist to any change that increases capital needs by more strident prudential rules, which are encouraged by EIOPA.

To pursue the ambitious roadmap for the years and decades to come, drafted by Mrs. von der Leyen, in which the transition towards a carbon-neutral economy and digitalization are emblematic objectives, all stakeholders should act along the same lines. With the right Solvency II framework, we are convinced that insurers could play a key role in this transformation.

For a stronger Europe, we should also be more realistic regarding the international markets. Regulators in other countries sometimes seem to prioritise the functioning of their economy over the implementation of international accounting or prudential norms. As an example, IFRS17 will not be applied everywhere, which will be detrimental to the EU companies in the global market place. Therefore, we should use our time to consolidate our current standards through a qualitative rather than a quantitative exercise.

Therefore, our recommendations to the Commission are three-fold:

- Preserve the stability of the European prudential framework. The directive review is crucial in this respect. There is no need to put in question the entirety of Solvency II but to correct shortcomings towards a less volatile system. For example, the dynamic VA should be extended to the standard formula. Likewise, implementing other new norms in parallel such as IFRS17 that aggregates the same inconveniences should be avoided.
- Evaluating the anticipated benefits of the proposed regulatory changes for the long-term funding of our economy and proposing easy-to-implement measures in this realm.
- Consider that additional capital charges is not the most appropriate solution to solve problems. The Coronavirus pandemic causes dire economic challenges and demonstrates that the EU economy requires stabilisers and the insurance sector is definitely one of them.

The shock absorption will require time, yet the success of European programmes and projects passes by a robust insurance market which is able to overcome and foresee beyond the current turbulence.

Cyril Roux

Chief Financial Officer, Groupama

Who's to decide how to invest insurers assets?

Much has been written about the way insurers should invest the funds they receive from their policyholders. Viewpoints differ, based in particular on the stakeholders most prominent in the mind of the respondent. For insurance regulators, the primary stakeholders of insurance undertakings are the policyholders: monies should be invested by insurers in order to safeguard policyholders' interests. This is akin to the view of asset managers and their regulators. In their minds, fiduciary duty trumps other considerations and investors' interests should come first.

In this worldview insurers are financial intermediaries managing policyholders' money and are answerable to them. On the other end of the spectrum, fractions of national and European political forces view insurers' balance sheets as too large not to try and commandeer for macroeconomic purposes. Insurers should thus be incentivized or brought to invest in the asset classes deemed most useful for European or national policy-making – if not taxed altogether.

In European circles, these asset classes include infrastructure and Green deal investments. The French government focuses on equity financing of local start-ups and equity stakes of French listed companies, so as to avoid foreign takeovers, neuter American activists, and ultimately maintain the State's ability to weigh on business decision making, including the number of staff employed domestically. Left unsaid but weighing prominently on insurers' balance sheets is the financial repression leading to the large overweight of sovereign credit thanks to its nil capital charge under solvency II. This plays out very differently by country: the Italian life insurance industry would be crippled by the eventual restructuring of the BTP, whereas the solvency of the German one depends on the eventual "return of the return" (on its sovereign holdings).

The bank-sovereign loop hasn't been much defused, but the less commented insurance-sovereign loop is also severe. To escape the heavy, shifting and sometimes contradictory regulatory and political interventions, and to steer their clients towards products with positive expected real returns, while alleviating solvency requirements, life insurers have touted unit-linked products in lieu of with-profit funds or "gestione separata". In so doing they give their clients a financial education similar to that given by asset managers, adding the insurance cover (such as annuities in the decumulation period) and the associated costs.

While the costs are mingled and opaque in traditional life insurance, they are separate and visible in unit-linked products. While decried, costs associated with intermediation and advice, asset-liability management, data, research, portfolio management, execution, servicing, risk management, compliance, reporting and disbursements have to be borne by the client.

This reality must also form part of the education of the clients who entrust their funds to financial intermediaries.

Mireille Aubry

Head of Prudential Regulation Standards & Foresight, COVEA

Making a clear distinction between liquidity and solvency in the Solvency II 2020 Review

The overweighting of liquidity needs is a major bias that is a source of dysfunction in the Solvency II regime. It is the result of a failure to adequately take into account the going concern perspective of the insurance undertaking as well as a lack of recognition of the key role own funds play in the management of liquidity risk itself.

A good liquidity ratio does not guarantee good solvency. Conversely, there is a positive impact of the solvency ratio on liquidity. These two observations alert us to the importance of distinguishing between liquidity and solvency and the non-reciprocal influence of one on the other. It should be remembered that the need for liquidity is not a major risk for an insurer (unlike a bank), which benefits from stable and long-term resources that are also based on a reverse production cycle. The insurer collects insurance premiums before any commitment to pay guarantees, and payments are positioned at maturities that can be very distant. In this respect, it should be noted that the risk of massive surrenders is particularly over-estimated in Solvency 2, in disconnection with the historical series of surrenderable contracts and statistics including during the last financial crisis. Finally, it should be noted that the surrender risk, where it exists, may be greatly reduced by the presence of discretionary profit sharing released in case of lapses.

Besides, an overweighting of liquidity can be a source of under-optimisation of overall financial performance. This under-optimization constitutes a risk that negatively impacts the insurer's future profitability and solvency as well as the performance of the guarantees offered to policyholders and is potentially very significant in the long term.

Insurance undertakings' own funds constitute a provision of liquidity in the event of unexpected adverse events that could potentially increase cash outflows, particularly in relation to policyholder liabilities. In the context of a general asset, in addition to directly absorbing losses and thus providing liquidity by absorbing losses, own funds are represented by assets whose regular inflows (coupons, dividends, rents, redemptions, etc.) also provide liquidity to avoid forced sales of assets representing best-estimate provisions in the event of contingencies on the outflow date of payment flows related to insurance liabilities. In a total balance sheet approach, where the assets representing own funds are themselves subject to a risk and capital requirement calculation (recursive loop), it is extremely important to include own funds in all their dimensions and to recognise their contribution to the management of the liquidity risk of commitments.

> *A good liquidity ratio does not guarantee good solvency. Conversely, there is a positive impact of the solvency ratio on liquidity.*

Own funds also change the "volume of technical provisions" by taking on a role of provisioning for "unexpected" losses. It should be noted that, even if the calculations of required capital are based on "instantaneous" shocks, this set of losses in no way corresponds to an immediate cash outflow, but has a run-off period close to that of best-estimate provisions, or even longer in the case of non-life companies, where the run-off period of best-estimate provisions is itself truncated and does not reflect their much longer actual duration as a going concern.

Martin Merlin

Director, Banks, Insurance and Financial Crime, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Removing regulatory obstacles to insurers' contribution to a sustainable growth

The European Commission is committed to lead the global effort to fight against climate change. Our European Green Deal aims to make the EU the world's first climate-neutral continent by 2050. To achieve our ambitions of a sustainable economic growth, Europe needs more stable capital in order to finance energy infrastructure, environmental-friendly facilities, eco-innovation technologies, but also research and development, which can boost growth, innovation and competitiveness.

With trillions of assets under management, the insurance sector is a mainstay of the European financial industry. Due to the long-term nature of their liabilities, insurers can contribute to the European Green Deal and the Capital Markets Union.

The new Commission is committed to identifying the barriers that are keeping insurers' allocations to long-term investments low, and to determining which policy levers can help overcome these barriers. In this regard, some stakeholders claim that the prudential framework has fostered insurers' short-termism in investment decisions.

On the other hand, the downward trend of investments in long-term assets dates back to the late 1990s, and therefore cannot be only driven by prudential rules, as confirmed by recent studies on insurers' investment behaviour.

In fact, the prudential regulation should neither unduly favour nor hinder long-term investment, but provide the right incentives for robust risk-management while avoiding excessive risk-taking. Last year, the European Commission amended Solvency II to lower capital requirement for long-term investments in equity, including in small and medium sized enterprises, provided that insurers have implemented appropriate asset-liability management.

In the context of the forthcoming broader review of the Solvency II Directive, the Commission will further explore whether the prudential framework appropriately reflects the long-term nature of the insurance business, and whether it influences insurers' long-term and sustainable investment behaviour.

> *The European Commission will have to "green" all European legislation, by leveraging on the EU taxonomy.*

This assessment should not be limited to a mere discussion as to whether capital charges on investments – be they green or long-term – should be reduced, although this is of course part of the debate. In fact, under the current uncertain financial conditions, insurers' ability to contribute to our political objectives may depend more heavily on whether the prudential framework is efficient in mitigating the impact of short-term market volatility on insurers' solvency position. The review of the so-called "long-term guarantee measures" should therefore play a pivotal role in future debates.

In any case, in view of the high volatility of equity investments, as currently observed with the Covid-19 crisis, European regulators should carefully consider financial stability implications of any further capital relief on long-term investments, which would not be supported by quantitative evidence.

Reviewing the prudential framework will not be sufficient to achieve our climate objectives. The European Commission will have to "green" all European legislation, by leveraging on the EU taxonomy currently under development, in order to support insurer's effective contribution to the financing of the shift to a low-carbon economy and a sustainable growth.

Ilijana Jeleč

Member of the Board,
Croatian Financial Services Supervisory Agency (HANFA-CFSSA)

Financial sector as a key driving force in achieving EU sustainability goals

The financial sector has a key role in achieving the EU's overall sustainability goals through its demand-side investment potential on one hand, and creation of supply in the form of product development based on environmental and social factors on the other hand. The European Commission has adopted the Action Plan: Financing Sustainable Growth as a preparation for the future that ensures stability, a healthy planet, fair, inclusive and resilient societies and prosperous economies.

As early as 2014, European regulators set a milestone through the Non-Financial Reporting Directive, which requires the largest, as well as public-interest entities, to publish non-financial data related to environment and social responsibility. This seeks to achieve transparency in managing sustainability risks, given the growing demand for financial products that take into account social and environmental aspects of the investment. An additional boost for investing in sustainable projects will be the introduction of an EU taxonomy, as well as an agreement on green and brown taxonomies that will facilitate investor evaluation of projects in terms of sustainability.

> *We need a broad base of interaction oriented towards innovation to achieve long-term sustainable solutions.*

The insurance industry helps the community understand, prevent and mitigate risks, including those associated with natural disasters and climate change, by taking on and managing them. On the other hand, the demand of insurance and pension funds as a reflection of the desire

to achieve long-term and stable returns with significant capital potential is at the same time a considerable challenge. Therefore, it is not surprising that Solvency II, as the basis of the regulatory and supervisory framework for the insurance industry, directs a significant part of it towards sustainability issues.

Supervisors have already started directing the industry towards anticipating, in particular, climate change risk, through guidelines and recommendations on the use of scenario analyses in the underwriting system and risk management system through the ORSA process. What lies ahead is a detailed exploration and analysis of ways to better assess and integrate environmental risks into supervisory processes and practices, while the future supervisory efforts should focus on improving the quantity and quality of disclosed information, which may in part encourage the changes in investor practices. At the same time, the establishment and operation of green financial markets should continue to be promoted and facilitated as they do not retain their focus solely on creating value for shareholders, but extend it to all stakeholders by promoting the economic, environmental and social aspects of investments.

Government policies aimed at promoting sustainability, establishing a tax relief system and removing barriers to investment in sustainable projects and innovative and new technologies are also indispensable. In the perspective of complexity and breadth of sustainability dimensions, we need a broad base of interaction oriented towards innovation to long-term sustainable solutions, in which each member of the financial sector plays a role in the transition to a sustainable and prosperous economy, environment and society.

Alberto Corinti

Member of the Board of Directors, Italian Insurance Supervisory Authority (IVASS)

EU insurance firms and their expected role to channel premiums into long-term savings

In line with its traditional objectives, insurance is a process providing efficient protection against risks. In this context, insurance firms can certainly represent a driver for long-term savings and a mechanism for a stable and sustainable funding of the economy. However, we can neither expect that insurance plays a role in transforming short-term savings into long- term investments, nor in supporting the economy without a proper assessment of the associated investment risks.

Any financial mediation role of insurance should always be the product of a sound insurance process and should not become an objective per se. We have to acknowledge, however, that regulations might not always strike the right balance between prudential objectives and social and economic ones. Solvency II is a good prudential framework, but some consider it an obstacle to the release of financial guarantees and to the investment in long-term assets, particularly in the current scenario of low interest rates.

My view is that the Solvency II framework relies on features, such as the market consistent valuation, that we should not abandon, as they ensure proper and early risk identification and assessment. At the same time, however, the framework needs adjustments to avoid unduly penalizing long-term business. The first adjustment relates to the need to reduce balance sheet volatility, which could produce solvency indicators that do not reflect the long-term nature of the business.

The review of LTG Solvency II measures should allow increased stability of the balance sheet without jeopardizing the predictive characteristics of its indicators. Elements like the Volatility Adjustment, for example, should be better designed to reflect the capacity of firms to protect themselves from short-term spread volatility and to earn a risk premium on longer durations, avoiding unjustified capital relief.

Another area for improvement is the elimination of any undue capital charge penalization. Much has already been done in this field, but proper calibration needs an on-going monitoring and regulators should regularly review their conclusions in line with market developments. At the same time, a proper risk measurement should always inform the definition of financial requirements. Also proper capitalization is key for long-term business. The revision of interest rate capital charge is necessary in this regard.

Besides prudential regulation, insurance product design too is relevant in order to foster long-term guarantees and investments. For example, increased flexibility in the allocation of profits in certain life contracts or the increase of the illiquidity features of certain contractual liabilities could represent important factors to sustain long-term business.

Any financial mediation role of insurance should always be the product of a sound insurance process.

Finally, we should not forget that a number of other factors not related to the regulation are also necessary. For example, the availability of well-structured long-term financial instruments in transparent markets is a precondition for incentivizing insurers to invest in long-term assets. Prudential regulations can only be part of the solution.

It is certain, however, that the focus should be centered on solutions that could soften, within prudential limits, the impact of the current low interest rate scenario on insurers and allow them to continue to play their role as providers of protection and long-term investors. A regulatory approach that simply provides disincentives to the release of long-term financial guarantees is not, I think, a desirable solution.

Petra Hielkema

Director Insurance Supervision,
De Nederlandsche Bank

Finding the right balance: market valuation versus long-termism

There is a broad agreement that insurance companies play an important role in facilitating the real economy. With assets under management equal to EUR 11.5 trillion, or around two-third of the European GDP, their investment base is large. Given that insurers can invest over the life cycle these parties are regarded as important providers of long-term financing to governments, companies and financial institutions. However, we must be aware of the key role of insurance companies: to help policyholders manage their risks efficiently through the provision of a variety of insurance products. In a discussion on enabling insurance companies' long-term and equity role one should not ignore this. This brings me to the regulatory framework Solvency II and its main role: policyholder protection.

One big achievement of Solvency II is mark-to-market balance sheet valuation. While this forces institutions to be more concerned with short-term market movements, it is an important condition for proper risk management. Without mark-to-market valuation, the economic position of insurance companies is not fully reflected in their regulatory ratios and this becomes especially worrisome in a gone concern situation. Therefore, the alternative of having no mark-to-market valuation could be worse. This, however, clearly shows the trade-off. On the one hand, market valuation is an important condition for proper risk management and policyholder protection. On the other hand, the long-term investment horizon of insurers is not fully supported by mark-to-market valuation. In that sense, it is about finding the right balance.

There are some considerations that I would like to share in this regard. Firstly, the achievements of Solvency II so far. As mentioned previously, one big achievement is the introduction of mark-to-market valuation. A limitation is the potential short-termism that is inherent to market valuation. The Long-Term Guarantee package that was introduced with Solvency II provides a counteracting force by reducing the volatility in the Solvency II ratios, thereby acknowledging the role of insurers as long-term investors. Second, the aim of Solvency II. Its aim is not to steer the investments by setting capital requirements. The current discussion on supporting financial institutions' lending to green finance provides a nice example.

While I am fully supportive of the goal to create incentives for green finance, this should not happen at the cost of policyholder protection. Relieving capital requirements for insurers' green exposures may indeed provide a good stimulus in greening the system. However, as there is currently no evidence that green assets are less risky, this undermines the concept of a risk-based framework and potentially increases risk at the cost of policyholder protection. And as concluded by EIOPA in their recent Opinion on Sustainability within Solvency II, EIOPA did not receive any evidence that the Solvency II framework provides a disincentive that hinders investments in sustainable assets. That brings me to my last point.

Third, a broader perspective on investment opportunities. Insurers are indeed important providers of funding to the economy. The discussion is often focused on enabling insurers' role as equity investors, while it should be seen in a broader perspective. There are more opportunities, e.g. the provision of direct loans, for example mortgages, that will fit the characteristics of their liabilities and are less prone to price fluctuations. To conclude, in finding the right balance, Solvency II has been a big step in the right direction. Of course, we are still in its early years and Solvency II is not yet perfect. But we know also that Solvency II gives us opportunities in finding this balance. ●

Sébastien Raspiller

Head of Department, French Treasury,
Ministry of Economy and Finance, France

Lifting the barriers to investments to achieve our common goals for Europe

Over the past years, we have reached a global consensus on the importance of long-term investment for our economy. Indeed, long-term financing in equity is necessary to innovate and develop technologies that will ensure the future growth of Europe. The European Central Bank recently concluded in this regard that equity funding is more appropriate than bank lending to support new technologies, and underlined that this is all the more the case for innovation related to green technologies, since these kind of development are intangible and firm specific, several characteristics which could discourage banks to intervene. Moreover, the current economic context calls for a breakthrough regarding the financing of our economy, which will be key for the recovery in the aftermath of the Covid-19 crisis.

On this basis, the European Commission and the co-legislators decided to launch the Capital Market Union and the Green ▶

Deal, which encompass the long-term investment issues through the deepening and efficiency of European markets and the financing of the transition to a sustainable economy. However, these initiatives alone will not succeed if we do not lift the existing barriers to long-term investments. In this regard, the shortening of the time horizon of our European prudential and regulatory framework over the last years is preventing our financial undertakings from playing their natural role in the economy.

This is especially the case for the insurance sector's prudential framework, Solvency II. By focusing on short term risks, neglecting the capacity of undertakings to hold their assets in a long-term perspective, it hinders the investment capacity of these entities, although they are long-term investors by nature. Indeed, their business model relies on the inversion of the production cycle – they collect premium first and pay potential claims later – which allow them to invest for the long run, in front of life and non-life contracts. Besides the financing of the economy, long-term investors are stabilizers for the financial system as a whole: they act as a counter-cyclical force, with the ability not to sell in times of crisis. This key role in the economy, which is also the very purpose of our prudential regulations at the EU level, also has to be recognized and the current crisis illustrates this need for our economy.

Against this backdrop, following the recommendation stemming from the Next CMU report, the 2020 review of Solvency II should be the opportunity to better take into account the very nature of long-term investment. This means that the specificities of equities which are not to be sold, or at least which could be kept in difficult times, need to be recognized in the prudential framework. The long term equity investments module introduced in the 2018 review of the delegated acts is a step in the right direction in this regards.

Beyond, we also need to encourage the use of long-term products by consumers which intend to invest for the long-run. This is for instance what France did last year with the creation of a single and simple pension product for both insurers and asset managers. Such products could also, in combination with the necessary adaptation of our European regulations, foster long-term investments in our economy.

Insurance comprehensive systemic risk framework

Jonathan Dixon

Secretary General, International Association of Insurance Supervisors (IAIS)

Global framework for the supervision of insurance groups and systemic risks

The supervision of cross-border insurance groups is now facilitated by the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame), adopted by the IAIS last year. ComFrame is a comprehensive framework for effective group-wide supervision of Internationally Active Insurance Groups (IAIGs), to help supervisors address group-wide risks and avoid supervisory gaps. ComFrame will provide supervisors with a common language for the supervision of IAIGs. By coordinating supervisory activities and exchange of information about IAIGs, the practical implementation of ComFrame should result in more efficient supervisory processes, for the benefit of both supervisors and IAIGs.

ComFrame builds on, and expands upon, the high-level standards and guidance set out in the Insurance Core Principles (ICPs), which generally apply to the supervision of all insurers and insurance groups.

As part of ComFrame, the IAIS is developing the Insurance Capital Standard (ICS), which aims to provide a globally comparable risk-based measure of capital adequacy of IAIGs. In November 2019, the IAIS agreed on ICS Version 2.0 to be used during a five-year monitoring period for confidential reporting to group-wide supervisors (GWSs) and discussion in supervisory colleges. The purpose of the five-year monitoring period is to monitor the performance of the ICS over a period of time, and not the capital adequacy of IAIGs. Earlier this year, GWSs identified IAIGs based on the international activity and size criteria as provided in ComFrame. GWSs committed to publicly disclose the identification of IAIGs at the earliest possible opportunity, noting that in some cases this disclosure may require legislative changes or regulatory action.

The IAIS is currently focused on supporting Members' efforts in the implementation of ComFrame. In future years, the IAIS will shift its focus to the robust assessment of the timely and globally-consistent implementation of ComFrame.

In delivering its commitment to contribute to global financial stability, last year the IAIS also adopted the Holistic Framework for the assessment and mitigation of systemic risk in the insurance sector. This framework recognises that systemic risk can arise both from sector-wide trends with regard to specific activities and exposures, as well as from a concentration of these activities and exposures in individual insurers. The Holistic Framework consists of: 1) an enhanced set of supervisory policy measures and powers of intervention for macroprudential purposes, incorporated into the ICPs and ComFrame; 2) an annual IAIS global monitoring exercise and collective discussion on the assessment of the potential build-up of systemic risk and appropriate supervisory responses; and 3) a robust assessment of the globally consistent implementation of the enhanced supervisory measures.

ComFrame and the Holistic Framework help provide the tools insurance supervisors need to assess and respond to the impact of COVID-19 on the global insurance sector, including on IAIGs. ComFrame provides a globally consistent framework for both assessing (through, for instance, supervisory review and stress testing) and coordinating (through supervisory colleges) a cross-border supervisory response at the level of the insurance group.

The Holistic Framework will be employed by the IAIS to undertake a targeted assessment of the impact of COVID-19 at the global level and to facilitate a collective discussion among insurance supervisors from around the globe on a coordinated supervisory response.

Dimitris Zafeiris

Head of Risks and Financial Stability Department, European Insurance and Occupational Pensions Authority (EIOPA)

ICS 2.0: a big opportunity for European insurers

The Insurance Capital Standard (ICS) has been developed since 2014 by the International Association of Insurance Supervisors (IAIS) with the purpose of creating a common language for supervisory discussions of group solvency of internationally active insurance groups (IAIGs) to enhance global convergence among group capital standards. A major milestone in the development of the ICS was achieved on 13 November 2019 with the agreement of the so-called ICS version 2.0. Indeed, since then, the ICS has entered a 'monitoring period' and, for the next five years, it will be used for confidential reporting to the group-wide supervisor, for discussion in supervisory colleges, and for further analysis by the IAIS.

The agreed ICS fulfilled all the major objectives specified by European supervisors and insurers. This success results from the continuous and intense engagement of all European supervisory authorities and numerous European IAIGs, for more than 5 years. Key elements of Solvency II, such as the market-adjusted valuation of the prudential balance

sheet, are already fully acknowledged within the reference ICS. In addition, internal models have been allowed as additional reporting methodologies for them to be further discussed. Solvency II will be a practical implementation of the ICS in most of its areas, which prevents parallel layers of regulation in the future or any degradation of the strong and successful European prudential framework currently in place.

The United States is currently developing an Aggregation Method (AM) to a group capital calculation that is not part of ICS Version 2.0. The IAIS aims to be in a position by the end of the monitoring period to assess whether the AM provides comparable outcomes to the ICS. If so, it will be considered an outcome-equivalent approach for implementation of ICS as a prescribed capital requirement. The IAIS has already agreed that the comparability assessment will take into account the prudence of the AM in relation to the ICS, recognising that the latter will be a minimum standard. Therefore, the AM will have to be more prudent than the ICS throughout all economic and financial market conditions over the usual business cycle.

The purpose of the monitoring period is to monitor the performance of the ICS over a significant period. The active participation of IAIGs in the monitoring period is of the utmost importance to provide effective feedback on the ICS (covering both the reference ICS and additional reporting - on internal models for instance). EIOPA therefore strongly encourages European IAIGs to participate in the monitoring period, including the use of internal models, to ensure their specificities will be as well taken into account as possible in the next steps of the ICS development. ●

Joseph Engelhard

Senior Vice President, Head Regulatory Policy Group, MetLife

Carpe Diem and give thought to the future

On April 2, 2019, U.S. Federal Reserve Board Vice Chair Randall Quarles outlined his vision of how best to build on post 2008 reforms to strengthen the financial system and address the so-called “too-big-to-fail” issue. Cautioning that “the causes of financial crises rarely announce themselves ahead of time”, he called for a focus on emerging risks through the broader perspectives and range of views of “search parties” organized with the intention of sharing and discussing concerns to determine if and how they should be addressed in advance.[1]

Today we live the situation Vice Chairman Quarles urged us to be prepared to meet and we call on our standard setters to seize this unannounced opportunity to integrate learnings from the impact of COVID-19 into standards under development.

This will ensure that global standards, necessarily developed on the basis of historical evidence and theoretical constructs, reflect real-time issues and offer more effective models of how to manage solvency and systemic risk in the insurance sector. One example is the IAIS Holistic Framework due to be implemented this year.

Its sector-wide monitoring exercise (SME) would be a strong foundation for the creation of the kind of search party Vice Chair Quarles describes.

Most importantly, the IAIS intention to hold regular public/private discussions of current trends and potential concerns arising from the SME, would encourage early identification and correction of emerging threats to the financial system and broader economy. We applaud the IAIS for taking this step.

Another example is the IAIS global Insurance Capital Standard (ICS) that enters its five-year monitoring phase this year.

> *Today we live the situation Vice Chairman Quarles urged us to be prepared to meet.*

What better opportunity than the current situation for the IAIS to understand the impact of the ICS, particularly its market-adjusted valuation approach, on insurers’ ability to manage through short-term volatility in capital markets and the potential unintended consequences it could have on availability of product and markets worldwide?

There are likely to be many detailed and valuable insights afforded by the sector’s experience of this evolving and uncertain situation that we continue to live through and learn from.

Once the air begins to clear, we urge the IAIS to engage with industry to leverage the great potential for the current unprecedented and unfortunate situation to provide insights and understandings that could improve standards that will impact the industry for many years to come. ●

1. April 2, 2019 remarks to European Bank Executive Committee Forum, “The Future of Banking: The Human Factor”, Brussels, Belgium

Andrew Mais

Insurance Commissioner,
Connecticut Insurance Department

The Aggregation Method: an outcome-equivalent approach to implementing the ICS

As a founding member of the International Association of Insurance Supervisors (IAIS), and by virtue of the size and diversity of the U.S.'s highly competitive insurance market, the NAIC and U.S. state regulators actively participate in and have been a critical and leading voice in international standard setting activities. As we work with our international counterparts, it is important that the elements of an effective international insurance supervisory framework are adaptable to the U.S. insurance market in particular and respect jurisdictional imperatives in general.

Last November, the IAIS reached agreement on a way forward on the Insurance Capital Standard (ICS), which is to be used during a five-year monitoring period. At the same time, the IAIS agreed on a definition of comparable outcomes and an overarching approach and timeline for the development of criteria to assess whether the Aggregation Method (AM), being developed by the U.S. and other interested jurisdictions, provides comparable outcomes to the ICS.

While U.S. state insurance regulators will not be implementing the ICS, we remain committed to an approach to group capital analysis which can and should be viewed as comparable to the outcomes achieved by the ICS, namely the AM. The AM builds on existing proven capital regimes to provide a measure of group capital adequacy. The starting point is existing legal entity regulatory capital requirements and scaling to a common level.

Nevertheless, we remain interested in ICS Version 2.0 as part of IAIS activities and join other jurisdictions in wishing to avoid a "one-size-fits-all" approach to group capital adequacy. During the monitoring period, other approaches within the ICS construct are being actively considered, such as a GAAP Plus approach to valuation and an internal model approach to capital requirements. The impact of such approaches on providing comparability will need to be considered as part of the process.

The AM embodies principles underlying the ICS - indifference to corporate structure, minimization of procyclical behavior, promotion of sound risk management and transparency – while being grounded in existing legal entity requirements. We have long questioned whether the "market adjusted valuation" (MAV) approach in the ICS Reference Method is consistent with these principles. The environment created by COVID-19 will provide a test of whether MAV provides the appropriate risk management incentives during periods of market volatility. In our view, the AM is not only comparable, but superior to the current ICS as it provides more transparency into the capital structure and local risks within a group and uses less volatile accounting methods.

> *Committed to an approach to group capital analysis which can and should be viewed as comparable to the outcomes achieved by the ICS, namely the AM.*

The IAIS began collecting data on the AM in 2018 and will continue to do so through the ICS Monitoring Period. The next milestone for the AM will be the IAIS' assessment regarding comparable outcomes. If comparable, the AM will be considered an "outcome-equivalent" approach for implementation of the ICS.

The IAIS has made clear that the AM will not be precluded at the outset from being comparable nor given a free pass. The question is not whether aggregation can produce comparable outcomes but what form a comparable AM will take. As this work continues forward, we are committed to working with our colleagues at the IAIS and in other jurisdictions in reaching this determination.

Improving AML / CFT

José Manuel Campa

Chairperson, European Banking Authority

Strengthening AML/CFT supervision in the EU

Money laundering and terrorist financing (ML/TF) need to be stopped. They undermine the trust of citizens in financial institutions, negatively affect market integrity and threaten the stability of the financial system.
ML/TF cannot be fought in isolation. Governments, public authorities and the private sector all have a role to play. This is why, since its inception, the EBA has been working to foster a consistent and effective approach to anti-money laundering and countering the financing of terrorism (AML/CFT) by authorities and financial institutions. Financial crime respects no borders and a weakness in one area of the single market opens up the entire single market to abuse.

The high-profile scandals of the last few years have shown that Europe's AML/CFT defences must be strengthened. As a first step, the European legislature gave the EBA an enhanced objective to prevent the use of the financial system for the purposes of ML/TF. It also gave the EBA new powers to lead, coordinate and monitor EU supervisors' fight against ML/TF, which we are rolling out in 2020.

Leading the way in effective supervision

The EBA will continue to lead EU AML/CFT policy work in the financial services sector, and support effective implementation through training and assistance to competent authorities. In 2019, we introduced staff led reviews of competent authorities' approaches to the AML/CFT supervision of banks. Each review concludes with feedback on which aspects of a competent authority's approach work well, and which aspects could be improved.

We published our aggregate first round findings in February. They suggest that change is underway, but that many competent authorities continue to find AML/CFT supervision difficult. As a result, the EBA is carrying out targeted revisions of its core AML/CFT guidelines whilst maintaining the cycle of implementation reviews.

Coordinating cooperation

We will be coordinating information flows and working to strengthen supervisory cooperation, which is key to effective AML/CFT supervision, especially across borders. This is why, in 2019, we created a framework to foster cooperation and information exchange including the establishment of AML/CFT colleges, which we will support in 2020.

We are also setting up a central database that brings together information currently held by individual competent authorities. As part of this we will be working to ensure all relevant information is shared effectively, whether it be on emerging geographical or product risk or the impact of new technologies.

Monitoring

The EBA's database will also allow us to obtain a clear view of the ML/TF risks in the EU, and take action where warranted to strengthen EU supervisors' response to those risks. For example, the EBA can ask a competent authority to investigate or consider taking corrective measures should there be indications that a financial institution might be in breach of its AML/CFT obligations.

The EBA is uniquely placed to work with, strengthen and coordinate the work of AML/CFT authorities across the EU. We are committed to using our resources and powers to contribute to making the EU's financial system a truly hostile place for financial crime, as well as ensuring the EBA is well placed to contribute to the establishment of any new EU AML authority in the future. ●

Martin Merlin

Director, Banks, Insurance and Financial Crime, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Shaping up a comprehensive AML policy

The current unprecedented global crisis has certainly shifted attention to the need to use all the adequate tools to bring back stability and growth. Anti-money laundering is certainly not the first field that springs to mind among the many issues that we need to tackle in the very near future. Still, our commitment to have in place a truly comprehensive and coordinated EU approach to preventing and fighting money laundering is unfaltering. Over the last year or so, we have clearly identified the missing pieces of the puzzle needed for this approach.

The Commission remains dedicated to delivering the backbone of an effective AML policy, including harmonisation, enforcement and supervision, confident that the values that underpin an effective anti-money laundering framework go hand in hand with solid growth.

There is increasing realisation that more efforts are needed to improve the current minimum harmonisation in the EU anti-money laundering regime. Today, we are faced with different compliance and supervisory cultures and inadequate cross-border collaboration. A reinforced and more effective EU regime will need to deliver on transparency, traceability, and accountability. It should capture new ▶

business models and emerging risks in a fast-changing financial environment and be sufficiently flexible to fit the cross-border dimension of financial activities.

Delivering on these aims means building on the existing rules, with precise objectives in mind and with the ambition to have in place a truly integrated action. They will be spelled out in a soon-to-be adopted strategic document, inviting experts to contribute their views to the process.

Improving the EU's anti-money laundering policy will have to tackle the need to have in place common rules, directly applicable in all corners of the Union. This implies having in place a Regulation. A framework combining a full and targeted harmonisation of issues such as obliged entities, customer due diligence and maybe sanctions, with more flexibility allowed to distinct Member States in other areas may be the most effective way forward. This would constitute a single anti-money laundering rule-book setting out the full spectrum of requirements.

Dedicated action in the areas of supervision, enforcement, inter-agency cooperation and global outreach will complete the picture. An EU-wide supervisory system would also need to take shape. Given the many recent case studies that proved the current supervisory system to be flawed, an integrated, effective and truly deterrent institutional architecture would be required. At the heart of the new system, it is essential to have a central, independent supervisory Union body. In close cooperation with the national supervisors, the Commission is seeking to clarify how the Union can bring added value where risks are most felt, so that we are able to collectively map out risks and direct supervisory efforts and resources.

Dedicated to delivering the backbone of an effective AML policy.

International influence and representation of the Union, including in the FATF, the dedicated forum, needs to also be strengthened. This way, we ensure that we are able to export our high standards in areas such as beneficial ownership transparency, bank account registers or smooth onboarding processes and turn them into the global standard. ●

Jesper Berg

Director General, Danish Financial Supervisory Authority (Finanstilsynet)

The potential of technology – a common front in fighting ML and TF

In recent years, much has been done to combat money laundering (ML) and terrorist financing (TF), by strengthening our toolbox and regulatory framework and increasing our supervisory intensity. But more can and must be done, not least to strengthen the first line of defence.

In December last year, the Council adopted conclusions on strategic AML-priorities, highlighting many important aspects and possible measures. Some elements have attracted much attention, such as the possible creation of an EU AML supervisor, others less – and I would like to focus on one of those less prominent but nonetheless vital and necessary steps forward – the exploration of opportunities and challenges in using technological innovation to combat ML.

This does not mean that we should stop focusing on strengthened supervision and coordination. Supervisory colleges add clear value as for a for information sharing – and they should be mandatory to create for all financial institutions with cross-border entities. Other initiatives to strengthen supervisory cooperation could also be envisaged. For instance, we have established a common Nordic-Baltic working group to intensify and formalize regional supervisory cooperation. It is key that new initiatives add value to our supervisory tasks. But increased supervisory cooperation cannot stand alone.

Current CDD processes are vital, but also cumbersome for both customers and banks. The use of technology should be a key priority.

We also need to strengthen the first line of defence in financial institutions, not least the customer due diligence (CDD) processes they carry out to know their

customers – a crucial prerequisite for them in assessing whether customers' transactions are unusual and suspicious. Current CDD processes are vital, but also cumbersome for both customers and banks. Vital because it is the first step in the value chain on which subsequent actions are taken, and cumbersome due to friction in getting access to information and lack of automated processes. The use of technology and better access to and use of existing infrastructure and databases or the creation of a new, shared European platform can improve financial institution's AML/CTF efforts and should be a key priority.

It could deliver higher quality CDD, allowing suspicious behaviour and patterns to be identified earlier and resources to be allocated more efficiently. One step would be to support the financial sector in building such a common infrastructure, where information can be safely shared and assessed, ideally at a European level. This is easier said than done. The creation of such a platform, and the extent and consequences of the underlying elements, such as what information it should contain, needs to be thoroughly assessed. And the legal complexity and possible regulatory obstacles must also be carefully considered, such as the sharing of personal data. It is a difficult but necessary agenda.

Giving financial institutions further access to databases or establishing a shared European platform would simplify and increase the quality of CDD-processes and add value to the efforts in the first line of defence.

The Commission will soon publish an EU AML action plan. It is a window of opportunity for us to launch new initiatives to help build a common infrastructure, which enables data sharing across the EU. This could be a true game changer and make a real difference.

Līga Kļaviņa

Deputy State Secretary on Financial Policy Issues, Ministry of Finance of Republic of Latvia

Main challenges in the field of AML supervision and operational implementation

At the time of writing the world is experiencing spread of COVID-19. Besides the tragic human consequences all around the globe, slowdown of economy will affect all the sectors and financial sector might be exposed to the new challenges. Governments across the EU are announcing financial stimulus and economic response packages and institutions – EC, ECB and ESM are massively launching financial stimulus in hundreds of billions EUR to retain confidence of the markets and euro currency, as well as to protect economy and jobs. Financial sector actors will be vested with the tasks to transmit the financial means and support the economies and ease the liquidity shortage while maintaining the sound banking principles. EBA has already announced the postponement of the EU-wide stress tests and invited national competent authorities make full use of flexibility embedded in existing regulation thus supporting bank focus on performing their core activities in extraordinary circumstances.

One should admit that last two years banking sector, especially in the geographies with misused financial system, has gone through substantial de-risking process when it comes to AML/TF issues. These questions are high at the agenda of new European Commission agenda who adopted "zero tolerance" approach and have to launch infringement procedures against several MS that have not transposed AMLD5 as of beginning of year 2020, which already encompasses many safeguards and enhanced practices to combat illicit financing. Still persistent divergence in interpretation, implementation and application of AML/CFT legislation, among others future looking proposals, leads to the need of Regulation provisions. This would result in more precise and less prone to interpretation legislation.

Apart from anticipated global shift in the behavioral patterns of consumers and businesses, inevitable outcome of the COVID-19 situation is the removal of still existing artificial barriers to online and digital services. It will facilitate the demand for an alternative, fast and cheap payment system to the ones provided by the banks and at the same time, there will emerge the need to acknowledge the new services, products and discuss the possible use of them; while protecting customer and financial system. Probably one of the technical solution that could eliminate the risks of anonymous users and subsequent AML/CFT implication could be the facilitation of digital identification or any other means of trustworthy electronic verification systems. Though Latvia is one of few pioneer countries using handy digital app (Smart-ID) which grants access to digitalized financial and state provided services, system might serve its purpose if it is compatible and used in the EU. When it comes the digitalization and harmonization of systems, much depend on the countries digital culture, IT literacy and financial resources to launch such projects.

> *New "post-COVID" environment might challenge many aspects, but safety and security is a result of collective consensus and effort.*

Numerous studies and post mortem analysis proved that EU-level AML/CFT supervisory authority could be of value added for the overall EU financial services architecture thus facilitating the implementation of possible single AML/CTF rulebook across the sectors. Integrated system of central and local level supervisors could use the utmost of common best practices, expertise and resources. Moreover, possible expansion of its scope to non-financial sector would provide more broad coverage since AML/TF neither stops by the border nor it attributed to the specific sector of financial services. New, "post-COVID" environment might challenge many aspects of our lifestyle, but safety and security of the individuals is a result of collective consensus and effort.

Tristan Van Der Vijver

Head of Compliance, Payments and WUIB, Western Union

Two sides of the same coin: fighting crime in a single market

Over the many Eurofi seminars we attended Western Union has consistently called for harmonised anti-money laundering and anti-terrorism financing rules. Therefore, I am absolutely delighted that these proposals today find the political attention they deserve.

Western Union has always been at the forefront of developing new AML solutions at a global level. The remittance industry in general and Western Union in particular is committed to delivering fast, secure and convenient cash and electronic transfers to every corner of the globe. Today we operate in across more than 200 countries and territories.

Our single largest cost of doing business is compliance with AML rules: identifying customers correctly, monitoring the purpose of transactions and reporting suspicious transactions. These tasks are fundamental to all our safety and security. Western Union will not compromise on that.

Nonetheless, we question the efficiency of today's regulatory and supervisory AML framework which unintentionally contributes to fragmentation, duplication and is not always as efficient as it could be. Why is that?

Looking only at the European Single Market, each Member State imposes slightly different requirements on companies. Reporting templates are not harmonised and cooperation between national authorities or across borders within the EU remains sub-optimal. This prevents the financial services industry from adopting a single EU-wide approach to AML and to deploy and scale new technologies effectively and efficiently across Europe

At Western Union, we welcome plans by the European Commission to move towards more harmonisation of the AML rules, as well as to a clearer supervisory and reporting framework.

Ideally, we would like at a minimum to see four measures in this new legislation:

- A common suspicious transaction filing system;
- Harmonised customer due diligences requirements;
- The introduction of EU-wide electronic identification; and
- Better information sharing between public and private sectors. ●

Tony Blanco

Secretary General and Member of the Executive Board, La Banque Postale

Improving cooperation, information-sharing and use of new technologies

Banks have been involved alongside member states in the anti-money laundering (AML) fight for almost 30 years. They have continually invested huge amounts in IT and compliance tools and adapted their internal processes to regulatory requirements provided for in the 5 subsequent directives. By setting up dedicated services for investigations, they are the main providers of information to FIU (financial intelligence unit).The strengthening of both banks obligations (KYC, beneficial owner, PEP) and resources allocated to this fight went together with greater intensity of supervision and sanction by the supervisory authorities (€ 16 billion in fines paid by European banks between 2012 and 2018).

> *Capture the opportunity for a more effective and efficient AML approach at European level.*

Thus, given the amount of sanctions, AML-CFT fight has become one of the major concerns for bank executive managers. However the current situation is clearly sub-optimal: financial institutions have to monitor billions of transactions to identify those that would be problematic, with a disappointingly low conversion rate: a bank could get tens or hundreds of thousands "hits" / year, that would translate into only a few thousand SAR (suspicious activity reports) to the supervisors, which themselves would typically lead to only a few tens of legal investigations. Not only

that, but the current quest for "zero failure", without a shared framework to think about relevant trade-offs between cost and impact, leads to ever more requirements and controls, with diminishing returns.

Furthermore, the current AML rules, methods and supervision remain fragmented. Current gaps in directive ▶

transpositions are particularly detrimental as the strength of the whole AML system depends on its weakest part. And, last but not least, data sharing is limited, and the power of AI is not yet widely leveraged.

So what are the possible actions that could lead to a more effective and efficient system?

- Cooperation and information sharing: not only between authorities, as provided for in the 5th directive, but also to all the actors involved in this fight, especially banks. For example, shared resources and common platforms implementation, gathering suspicious activity reports or aggregating customer knowledge information could be considered.
- Prioritization and trade-offs: public authorities could identify the main threats on which institutions should focus on. Implementing performance indicators with regard to specific goals would make it possible to ensure the commitment of financial players and help develop and share best practices.
- Fully leveraging new technologies: notably by exploiting the full potential of data science in processing and sharing KYC information, or by using IA and machine learning to sort critical transactions and identify patterns in AML activity. Authorities should support a wider use of such future-proof tools and monitor initiatives to identify best practices or potential regulatory barriers.
- Harmonization of European regulation and supervision: to ensure greater alignment between countries, some aspects of the AML legislation should probably take the form of a regulation rather than a directive as the former is directly applicable. And a greater standardization of supervision rules and practices could also be explored to reinforce the harmonization of supervision.

Che Sidanius

Global Head of Financial Crime and Industry Affairs, Refinitiv

Europe's Anti-Money Laundering Framework needs further reforming

Following the spate of money-laundering breaches by European banks and further digital developments in the last two years, it has become apparent that the current EU framework needs to be profoundly reformed if the fight against financial crime is to yield meaningful successes in the future. The EU has gone some way to improve the current situation in its last mandate by revising the Anti-Money Laundering Directive (AMLD), where supervisory powers are now more anchored in the European Banking Authority (EBA), and by developing an AML action plan; however, there remains five key areas where more could be done to strengthen the effectiveness of the current regime - with little or no added costs for supervisors or businesses.

The money laundering scandals in Europe involving credit institutions have demonstrated that more needs to be done in terms of risk assessments and customer due diligence. However, it is also important to note that financial crime is not simply an issue of compliance, it also has significant consequences from a financial stability perspective. Whilst Europe has formed very significant and important initiatives to create a prudential and market regulatory framework to prevent the next financial crisis, the possibility of a large financial institution becoming insolvent due to money-laundering is a real possibility. Money laundering has become one of the most important potential sources of financial instability.

This new legislative mandate offers EU leaders a unique opportunity to reform its AML framework and become a global leader in the fight against financial crime which, as we explain further below, also links to Europe's ambitions on leading the climate change and digital revolutions.

Money laundering and other types of financial crime do not happen in isolation. More often than not, they are global in nature and part of a much wider criminal operation – with real societal impact, ranging from the funding of terrorism, to modern slavery and child-related crime and even environmental degradation. As such, Europe needs to be a global leader also on the fight against financial crime if it aspires to be a global leader on the fight for a greener and more sustainable future. As often the first line of defense against financial crime, the private sector has a key role to play in helping reduce current financial crime figures, if utilized properly – i.e. if there is more collaboration between both the public and private sector.

> *Making the fight against financial crime more effective*

Obligated and non-obligated firms, such as third-party vendors, hold valuable information for law enforcement authorities. However, communication flows are often a one-way street between the private sector and Financial Intelligence Units (FIUs).

Building on the work of, for example, Europol's Financial Intelligence Public-Private Partnership or the UK's Joint Money Laundering Intelligence Taskforce (JMLIT), the EU could be at the vanguard of fighting financial crime if it established some form of similar public-private information sharing arrangement at EU level. This has been called for by the European Parliament in recommendations from its special committees on tax and terrorism (e.g. TERR and TAX3).