Views
The EUROFI Magazine

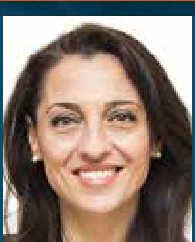
BERLIN | SEPTEMBER 2020

Olaf Scholz
Federal Minister of Finance
and Vice Chancellor,
Germany

Together for
Europe's recovery

The Eurofi Financial Forum 2020
Berlin | 9, 10 & 11 September

F. Hufeld
How to face multiple challenges at the same time



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The Eurofi Financial Forum

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This bi-annual Views Magazine comprises contributions from a wide range of public and private sector representatives on the challenges and conditions for relaunching growth post-Covid, on-going industry trends such as digitalisation and ESG and key on-going policy initiatives in the financial sector.

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Challenging times for the EU and its financial industry

The Eurofi Berlin event and the publication of this Magazine are taking place at a particularly challenging time, since the pandemic is not over in the world and in Europe.

The way forward to address the COVID-19 economic crisis and the “Next Generation EU“ recovery plan proposed by the EU will provide major topics of discussion during the Eurofi Berlin event.The move towards fiscal cohesion and solidarity is real and reassuring. But money alone will not ensure recovery. Investment and national reforms are also essential components for a green and innovative Europe.

One particular challenge at this point in time, beyond recovery, is to relaunch productive investment and sustainable growth in the EU. Real Gross Domestic Product growth and productivity gains in the euro area have failed to catch up with US, China and Japan over the past two decades and the pandemic crisis further increases investment needs. We have to invest in an innovative and carbon neutral Europe. However, lasting low interest rates develop preference for liquidity over productive investment. The main economic and financial threats at the EU level in the wake of the Covid-19 pandemic are another challenge. So far, potential risks to global and European financial stability remain under control but we are not out of rough waters. At the top of the list of threats lie high levels of public and private debt in a number of Member States. Central banks played a crucial role in stabilizing the financial system. But monetary policy and money creation cannot do everything and cannot solve the problems arising from excessive debt. In addition, pushing too hard and too long on the monetary pedal generates financial vulnerabilities, leads to serious distortions and eventually creates the conditions for future crises. To solve the problems arising from excessive debt, governments must stand ready to take corrective action in order to ensure a path towards primary fiscal balances consistent with fiscal sustainability.

Moreover, if Europe wants to provide citizens, businesses and society at large with the tools to turn current challenges into opportunities, the EU needs a vibrant single market for financial services. Throughout the crisis, the EU banking sector has proved to be part of the solution to the crisis but the economic fallout will be a further challenge for the sector and will put additional pressure onto a European financial system which was already facing headwinds (negative interest rates…) and structural challenges (digitalisation…). In such a context, full implementation of Banking Union, without any fragmentation, making the Capital Markets Union a reality, increasing the digitalisation of the EU financial sector and maintaining the diversity of the banking sector are key priorities for ensuring an effective funding of the economy and enhancing EU financial sovereignty.

How to address these different challenges will be at the centre of the discussions of the Berlin event, as well as key on-going trends such as ESG and digitalisation. In preparation for this, the Eurofi secretariat has prepared several papers on these issues for the Eurofi Regulatory Update and the speakers participating in the Berlin Forum have been invited to express their views on these questions in this Magazine.

We are grateful to the 160 speakers who have provided us with input on these issues, and we are sure that you will read their thoughts and proposals on these challenging questions with great interest. ●

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

David Wright

President, EUROFI

EUROFI Berlin will be a dual event - physical and digital- a first of its type for us.

It has to be this way - fully respecting the German Federal and State health and safety COVID requirements for all those able to attend in person; on line direct transmission of all the sessions for those of our Members unable to travel so they can follow our proceedings.

A huge amount of preparatory work has gone into the preparation of this EUROFI event in Berlin, far more than usual. The German Presidency of the European Union could not have been more welcoming, more helpful, or more efficient. EUROFI's small secretariat, led by Didier Cahen, have worked like Trojans to ensure that this event can take place. I thank them all most sincerely and all EUROFI members for their continuous strong support.

In Berlin, although our usual attendance numbers will be reduced, there will be many high level participants from EUROFIs' membership and from the public sector - Ministers of Finance, European Commissioners, Members of the European Parliament, the European Central Bank and Member State Central Bank Governors, EU Regulators plus senior staff representatives from them. Their support for this event and all other EUROFI events is greatly appreciated.

How many times have we heard over decades from European sceptics and haters that the end of the European Union is nigh? Can 't work. Doesn't work. Fragile. Failing. Weak. Divided. Anti-democratic. BREXIT - the beginning of the end, pillars crumbling - the rest will follow......

As is always the case with this corpus of ill-informed, ignorant, perennial naysayers, they are being proven manifestly wrong again, adding more material to their score of repeated and failed European diatribes.

Barely a few week ago in July the European Union delivered the biggest Economic Recovery Plan in its history plus a new Multi-annual budget - a total package nearing €2trillion to support EU policies and to build recovery from COVID for many years hence. In addition, the ECB has stepped up yet again with its massive bond buying programmes to stabilise European financial markets in the context of the worst economic crisis we face for 90 years since the Great Depression. The ESF and EIB also have launched new, substantive support programmes. In sum, >€3 trillion. Is this an EU that is failing?

As a passionate European I have been impressed by many aspects of this cumulative European response to the pandemic crisis.

First, the Franco-German framework - a sine qua non - for the Recovery Plan.

Second, the great act of leadership and statesmanship by the President of the Council, Chancellor Merkel.

Third, the outstanding preparatory work of the European Commission.

Fourth, the solidarity demonstrated in the outcome - notably by allocating direct, earmarked grants to those Member States who are facing severe difficulties due to the structure of their economies.

Fifth, a collective understanding that due to the pandemic crisis, indeed the single market was in some danger, inter alia with uncontrolled subsidies being granted, potentially seriously distorting competition. A common understanding also that it makes eminent European sense to cooperate and work together on the difficult scientific, pharmaceutical and logistic pandemic challenges.

Sixth, a willingness to contemplate boosting the EUs own resources with new levies, taxes and border adjustment charges - even though these will be very difficult to agree.

Seventh, the coherence of the overall package - notably directing the Recovery Package and the MFF towards the European Commissions' broader political goals of sustainable development, modernising European infrastructure, innovation, competitiveness and mastering the digital revolution.

Eighth - that BREXIT, per se, played no shaping role except that it probably helped.

Finally, that these agreements demonstrate politically, unequivocally, and again, that the European Union is durable and far greater than the sum of its parts. It means something to be European.

In spite of all these positives the job is not yet completed. The political agreements still have to be approved by the European Parliament and translated into concrete, sound programmes and, most importantly, implemented rapidly In the Member States.

There is no time to lose because the EUs' economic recovery is very significantly dependent on the delivery of these projects. National employment and business support programmes notably for SMEs will begin to taper down in the autumn with potentially very serious long-term economic damage.

Member States must also step up, play their part and continue to reform their economies. Reforming them rationally in line with the emerging post-COVID world and the new European political priorities. Changing lifestyles. Changing work. Changing policies holistically to incentivise pro-environmental behaviour. But also changing excessive dependencies in some of their societies by adopting necessary structural reforms coupled with rigorous, sensible, sustainable, productive public sector spending.

I also believe that it is essential that the European Union finds the same political will to drive forward and complete Capital Markets Union (CMU). The recent High Level Group, chaired outstandingly by Thomas Wieser, in which I played a part, has set out the main contours and policies to deepen, widen and integrate the EUs' capital markets at every level. This is not rocket science, but it is a multi-faceted series of actions that are necessary and urgent. In its report, we stated that without CMU, the EUs' political priorities cannot be delivered.

Now is the moment, under the German Presidency, to draw up a politically binding EU Tripartite institutional CMU agreement; to agree the measures needed at a sufficient level of granularity; with a demanding timetable; and a rigorous delivery monitoring mechanism.

Do this and I believe confidence in the EUs future could rapidly grow exponentially - attracting international investors, building confidence with vibrant financing to develop our intellectual property and SMEs to become world beaters from inside the EU, not outside.

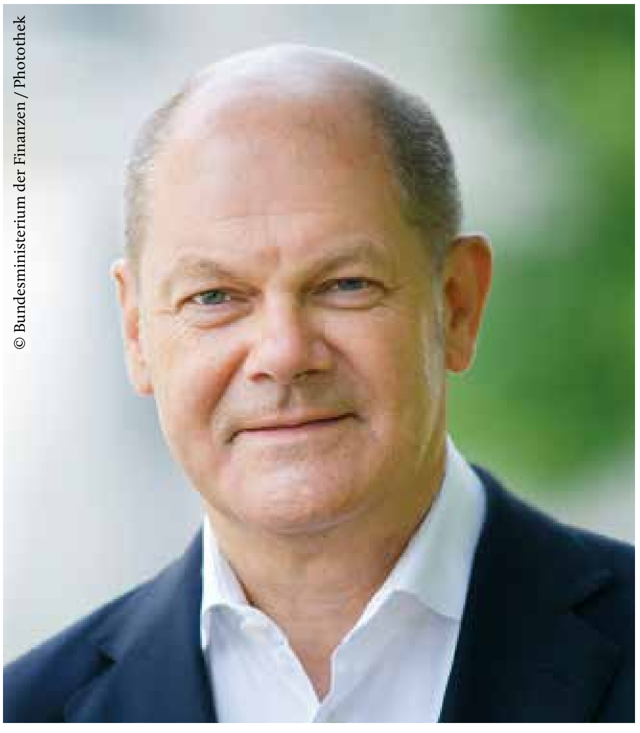
There is now a massive political and economic opportunity for the EU to seize. Building on the Economic Recovery and MFF packages; driving forward sustainable development; fully integrating the EUs capital markets. Leading multilaterally, globally. For the good of all Europeans.

With the collateral benefit of making the sceptics eat yet more humble pie on their road to Dantés' inferno. ●

Q&A

Olaf Scholz

Federal Minister of Finance and Vice Chancellor, Germany



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Together for Europe's recovery

WHAT ARE THE PRIORITIES OF THE GERMAN PRESIDENCY IN THE ECONOMIC AND FINANCIAL AREA TO FACE UP THE ECONOMIC CRISIS?

The pandemic and its economic fallout are still weighing on Europe. Now it is for us to stand together to overcome the economic crisis caused by the COVID-19 pandemic. We are determined to swiftly implement the recovery package proposed by the European Commission, including both, the financing mechanism via EU own resources and the next Multiannual Financial Framework. As Council Presidency, our aim is to make financial resources from the recovery package available by the beginning of 2021. Beyond the immediate crisis reaction, we aspire to increase the competitiveness of the European Single Market by bringing forward key initiatives. This includes progress on an effective minimum taxation of multinational companies, the completion of the banking union and capital markets union.

WHAT ARE THE PRIORITIES OF THE GERMAN PRESIDENCY TO EFFECTIVELY PROGRESS TOWARDS MORE CROSS-BORDER PRIVATE RISK SHARING THROUGH THE BANKING UNION AND THE CAPITAL MARKET UNION? WHAT ARE THE RELATED PRIORITY MEASURES IT WOULD LIKE TO SEE ADOPTED BY THE END OF THIS YEAR?

The need to deepen and complete the European banking union is undeniable. We must move forward with key banking union projects, as well as the complementary project of capital markets union. It is in all our interests to have a fair, well-designed and secure banking union that guarantees stability and enhances growth in all member states, while at the same time protecting taxpayers' money. We have already made substantial progress, but we are only half way through.

During our Presidency, we aim for progress in four key areas. We want to strengthen crisis management and supervision, enhance the framework for banks doing business across borders as well as lay the basis for an appropriate regulatory framework for the treatment of sovereign exposure and a common deposit insurance scheme. In addition, further risk reduction in the banking sector remains key, as freeing up capital bound by non-performing loans is vital in facilitating bank lending to European businesses. Our clear goal is to reach progress in all these areas and lay the basis for legislative proposals by the European Commission.

Well-functioning and integrated European financial markets are key to support a swift recovery from the current crisis. We therefore welcome the European Commission's initiative for a Capital Markets Recovery Package. We will work hard to reach swift progress in the negotiations in the Council and with the European Parliament during the German Council Presidency. Digitalisation is another key aspect to bring European capital markets forward and foster cross-border private risk-sharing. We therefore look forward to the EU Commission's regulatory proposals for crypto-assets and digital operational resilience in September and will ambitiously negotiate these proposals. Beside those important regulatory initiatives, two high level conferences during the German Council Presidency will stimulate discussions on sustainable finance and the Solvency II review.

IS ENSURING THE FINANCIAL SOVEREIGNTY/ INDEPENDENCE OF THE EU A RELEVANT OBJECTIVE IN THE CURRENT MACRO-ECONOMIC AND POLITICAL CONTEXT (E.G. BREXIT) AND IF SO, WHAT DOES IT IMPLY IN TERMS OF PUBLIC POLICY?

Financial sovereignty and independence of Europe remain a centrepiece to preserve the European way of life and our values, especially in light of the changing world order. Being dependent for financial services on either the US or China is not an option. If Europe does not want to be pushed around on the international stage, we will have to preserve and enhance EU financial sovereignty.

The Corona Pandemic underlines the importance of sovereignty of the EU in a number of areas. It highlights the need for a common European approach, so that the EU and its member states find themselves better prepared for future pandemic crises. This is why we have argued for and agreed on a recovery instrument for the EU in a spirit of solidarity between Member States, which should boost a sustainable and resilient recovery of all economies in the EU. This is one important step towards deepening the Economic and Monetary Union, which together with completing the banking union and the capital markets union should also strengthen the international role of the euro.

REGARDING THE EU ECONOMIC GOVERNANCE, WHEN SHOULD THE STABILITY AND GROWTH PACT BE RESTORED? DOES IT NEED BEING RENOVATED ONCE THE CRISIS IS OVER? WHAT MEASURES WOULD FINALLY MAKE IT EFFECTIVE?

EU finance ministers have reacted timely and determined to the economic consequences of the Corona Pandemic. A key element in allowing member states to take swift and decisive action to counter the crisis was to activate the General Escape Clause. This ensured the required flexibility to take all the measures necessary.

Yet, the basic principles of the Stability and Growth Pact remain valid: sound government finances are a prerequisite for strong sustainable growth. Once the recovery gains a foothold, we will have to consider the issue of complexity of the Pact. To increase acceptance and national ownership we need both, less complex rules and more transparency in their application.

Considering economic governance in Europe, the agreement by the heads of states on the new Multiannual Financial Framework is a major breakthrough, especially the recovery instrument with a volume of 750 billion Euros. With this decision, Europe is taking joint responsibility for its own destiny. By inviting member states to propose investment and reform plans that will be approved by the Council, the recovery fund will strengthen our joint economic coordination in Europe. ●

Q&A

Valdis Dombrovskis

Executive Vice-President for An Economy that Works for People, European Commission

A stronger Europe post COVID-19: economic and financial policy aspects

HOW TO ENSURE THAT THE NEXT GENERATION EU INSTRUMENT WILL FINANCE PROFITABLE PRODUCTIVE INVESTMENTS, EFFECTIVELY INCREASE THE SUSTAINABLE RECOVERY AND THE RESILIENCE OF EU ECONOMIES AND EVENTUALLY CONTRIBUTE TO THE REIMBURSEMENT OF EU FINANCINGS BORROWED BY THE EU COMMISSION?

Next Generation EU is very powerful in two specific ways.

First, with EUR 750 billion in addition to the EU's 1.1 trillion medium term budget, it is very significant in terms of amounts. Moreover, the EU will for the first time raise such a significant amount on the financial markets. That will have various positive effects. In addition to the direct effect of the additional investment, it clearly shows the determination of the EU to act in solidarity and reinforces the attractiveness of the euro as global currency.

Second, the focus of Next Generation EU is to make our economies fit for the future, while repairing the damage of the crisis. In particular, with the Recovery and Resilience Facility – the biggest instrument – the money will be used for investment and reforms that will make our economies more resilient, competitive and better prepared for the challenges posed in particular by the green and digital transitions.

To facilitate repayment, the Commission will propose new own resources. Examples mentioned include a carbon border adjustment mechanism, a digital levy and others. I know those will be sensitive debates. We have to take the time necessary to develop solid proposals that could eventually convince everybody about the advantages of taking a step forward also in that direction.

WHAT ARE THE MAIN IMPLICATIONS FOR THE FINANCIAL SECTOR OF GROWING PUBLIC INDEBTEDNESS IN SOME MEMBER STATES? HOW TO ENSURE AN EFFECTIVE AND VIABLE FISCAL FRAMEWORK IN THE MEDIUM TERM? WHEN SHOULD THE STABILITY AND GROWTH PACT BE RESTORED? DOES IT NEED RENOVATING? WHAT MEASURES WOULD FINALLY MAKE IT EFFECTIVE?

We are not in the same situation as a decade ago. Ever since the 2008 financial crisis, we have been working to rein in risk in the European banking sector. Currently banks are much better capitalized and capable of withstanding bigger shocks. Non-performing loan (NPL) levels have come down substantially, especially where they were very high. As a result, banks are now part of the solution.

Of course, the current crisis is testing us. Member States and the EU have taken sizeable measures to mitigate the immediate health impact, protect jobs and incomes of citizens, support companies, and manage the impact on the banking sector.

While this has helped to contain the rise of NPLs, more structural measures may be needed. History taught us that in order to successfully deal with NPLs, one needs speed and determination. We will pursue a comprehensive strategy, focused on a mix of complementary policy actions in bank regulation and supervision, reform of insolvency and debt recovery frameworks and development of secondary markets for distressed assets. Those measures will need to be taken both at the EU and Member State level.

Because of the economic support measures I previously mentioned, the pandemic will also entail a sharp increase in public debt across the continent. It was agreed to activate the general escape clause of the Stability and Growth Pact. The clause does not suspend the procedures of the Pact, but it gives Member States the flexibility needed to deal with the economic and social consequences of the pandemic, provided that medium-term fiscal sustainability is not endangered.

It is important to recall that this is part of a coordinated European strategy, whereby fiscal and monetary policy are fully in sync to steer our economies. In my view, this is the best way to allow our economies to rebound as quickly as possible. Together with the effective implementation of reforms, this will help the sustainability of public debt, which largely hinges on the growth potential of our economies.

The Commission will continue to apply the full flexibility within the EU fiscal rules for as long as necessary. At the same time, Member States will at some point need to gradually move back towards prudent fiscal positions and start reducing their debt levels. I am confident that we will be able to ensure a withdrawal of fiscal support when appropriate, in a gradual manner and taking into account each country's specific position.

The pandemic has delayed the discussion on the effectiveness of the EU fiscal framework, which was kicked-off by the Commission's review published in February but has not made it less relevant. We will resume our reflections once the immediate impact of this crisis is over, factoring in the lessons learned. I believe that we need an inclusive and open debate involving all stakeholders before we move on with concrete proposals. It is important that we arrive at a high degree of consensus, because ownership and trust are crucial for any framework to be effective.

IS ENSURING THE FINANCIAL SOVEREIGNTY/ INDEPENDENCE OF THE EU A RELEVANT OBJECTIVE IN THE CURRENT MACRO-ECONOMIC AND POLITICAL CONTEXT (E.G. BREXIT) AND IF SO WHAT DOES IT IMPLY IN TERMS OF PUBLIC POLICY?

Strengthening the financial sovereignty of the EU is all the more important in the current economic and geopolitical context. We can only achieve that by working on different fronts.

One important asset we have is the euro. The euro is already the second most widely used currency in the world in payments, international debt issuance and foreign exchange reserves. Around 60 countries either use the euro or link their currency to it. But there is further scope for the euro to achieve its full potential.

To make the single currency more attractive for international investors, we need large, liquid and deep domestic financial markets, underpinned by solid monetary, fiscal and regulatory policies. We need to start in Europe, making the euro area a rock-solid home for our currency. The actions we took in the context of the current crisis, which I just mentioned, will undoubtedly help. And we need to make further progress on the Capital Market Union and the Banking Union.

Also, sectoral measures to increase the use of the euro can help, for example by developing truly European digital payments systems, or by fostering the use of the euro in invoicing in the field of energy, commodity markets and the transport sector. The EU's trade policy can also play a relevant role.

Finally, we see that the EU's global leadership in new policies, such as the European Green Deal and sustainable finance, contribute to the global use of the euro. One example is the green bond market in euros. Since 2013, euro-denominated net green bond issuance has increased more than ten-fold, reaching more than EUR 100 billion in 2019. Importantly, the issuance of euro-denominated green bonds is also strong outside of the euro area: in 2019, almost 30% of all euro-denominated green bonds were issued by non-euro area issuers.

WHAT ARE THE KEY PRIORITIES OF THE CMU INITIATIVE GOING FORWARD AND WHAT ARE THE MAIN FACTORS OF SUCCESS?

We launched work on the Capital Markets Union (CMU) well before the current crisis. The pandemic has injected even more urgency for finishing CMU. Bank lending will not be able to cover all financing needs. The strength of the economic recovery and the path towards sustainable and inclusive growth will also depend on access to market financing. There is lots of money ready to be invested in the EU. There are also many companies with massive potential in the EU. We need to get the money to where it can help realize that huge potential. That is the job of CMU.

As the report by the High Level Forum on CMU points out, a fully-fledged CMU will be vital for mobilising much-needed investments in new technologies and infrastructure, as well as to tackle climate change. We have to complete CMU to deliver Europe's Green Deal and Digital Agenda. Public financing simply will not be enough. We need to get private capital from where it is now, to where it will do the most good – building a sustainable economy, creating new future-proof jobs and providing return for investors all the while.

In the new CMU action plan, which we intend to present in the coming months, we will set out the new vision for CMU through three key pillars: SME access to finance, market infrastructure, and measures to help savers in Europe to invest more through capital markets.

We have had successes in our approach to completing the CMU. But we will keep pushing onward until the promise of a truly single market for capital in the EU is realized, and the full potential of the money that EU citizens, businesses and others invest in our markets is unleashed to sustain an EU economy that works for people. ●

Q&A

Klaus Regling

Managing Director,
European Stability Mechanism (ESM)

The response to the Covid-19 crisis and remaining vulnerabilities in EMU

WHAT ARE THE ECONOMIC VULNERABILITIES OF THE EUROPEAN MONETARY UNION THAT HAVE BEEN AMPLIFIED BY THE COVID-19 CRISIS ? WHAT ARE THE PRIORITY POLICIES REQUIRED TO REPAIR THE MONETARY UNION AND THE RELATED KEY SUCCESS FACTORS? TO WHAT EXTENT, SHOULD THE EU'S NEW €750 BN RECOVERY FUND CONTRIBUTE TO ADDRESS THESE VULNERABILITIES?

It is six months since the Covid-19 virus reached Europe in March. Although the economic recovery has been fairly strong since May, 2020 will register the deepest recession in 100 years. Economic activity will not reach pre-crisis levels before 2022.

Europe reacted quickly to the economic consequences of Covid-19 with a strong and concerted response.

Shortly after the viral outbreak, the European Commission activated the General Escape Clause, temporarily suspending the EU fiscal deficit rules of the Stability and Growth Pact, and facilitated the implementation of state aid. The European Central Bank contained euro area fragmentation by significantly expanding its asset purchase programme with the Pandemic Emergency Purchase Programme.

In July, the European leaders took a historic decision by agreeing on an instrument called "Next Generation EU" that will boost the next EU budget. To finance this package, the Commission will borrow money on financial markets on behalf of the EU, through the issuance of bonds. Money will start flowing in 2021.

This Summit decision was preceded by a first support package with three safety nets that are all available now: one for sovereigns provided by the ESM, one for businesses provided by the European Investment Bank and one for workers provided by the EU Commission. These safety nets can immediately provide up to €540 billion and are designed to help the most affected countries.

All these measures at the European level in response to Covid-19 - which come on top of significant national measures in every EU member state - are important to limit the economic and financial damage of Covid-19, to protect the EU Single Market and to maintain a level-playing field.

These measures at the European level are also welcome from the perspective of monetary union as they are designed to prevent economic divergences among euro area countries and can also contribute to a stronger international role of the euro. However, they do not make a further deepening of EMU obsolete. The euro area is where Europe has integrated most economically and financially – and it is the main focus of global investors, analysts and market participants.

The agenda for deepening EMU, which we discussed during the last few years, remains valid: completing banking union, creating a capital markets union, setting-up a fiscal capacity for macroeconomic stabilisation and completing the ESM reform.

One important element of the ESM reform is the backstop to the Single Resolution Fund (SRF). If SRF resources are depleted, the ESM can lend the necessary funds to finance a bank resolution. The backstop - together with some form of common deposit insurance - would complete banking union, leading to more cross-border risk-sharing through the private sector. Progress on capital markets union would facilitate cross-border equity investments and provide new ways of funding for companies. All this would improve the allocation of capital in EMU, thus enhancing its growth potential and making the euro area more attractive to international investors.

In addition, a permanent fiscal stabilisation mechanism for euro area countries will be needed eventually.

A central fiscal capacity to stabilise economies would help to avoid excessive divergences between euro area countries and can avoid small problems from becoming big problems. It would also reinforce investors' confidence in the euro area's capacity to respond to future crises. While the "Next Generation EU" is the right response to the Covid-19 crisis, it is a temporary measure for all EU countries. What is needed for the better functioning of our monetary union is a permanent stabilisation instrument for the euro area. Such a facility would not be an annual budget - there will be many years when it is not needed - but a revolving fund, to be repaid within a cycle. With the revolving fund replenished, money can be used again in the next crises for another country.

A fiscal capacity would be particularly useful because countries that are members of EMU have given up two key macroeconomic policy instruments: monetary policy and exchange rate policy. Only fiscal policy remains available to counteract if necessary. The ESM, which has recently diversified its toolkit with the Pandemic Crisis Support, could add such a shorter-term facility to its range of instruments. This would help countries bolster national buffers, giving them more fiscal space in a crisis. The institution has sufficient firepower left for this task even after using the Pandemic Crisis Support.

For the moment, priority is of course to fully operationalize the recovery instruments and focus on implementation. But we should not lose the longer-term perspective and keep working on a robust euro area structure. Starting to work on a stabilization facility now would allow creating an insurance mechanism for the years to come.

Finally, the important role of a European safe asset is more and more recognised. It would facilitate the transmission of monetary policy throughout EMU, allow Europe's banks to reduce their holdings of national sovereign debt, and strengthen the international role of the euro.

The measures taken in response to Covid-19 can increase the amount of European debt issued by the Commission, the EIB and the ESM from €800 billion to almost €2 trillion. Together with sovereign debt issued by highly rated euro area countries, the amount of safe assets would increase to around 40% of euro area GDP over the coming years, compared to 90% in the United States.

WHAT SHOULD BE THE CHARACTERISTICS OF A RENEWED AND EFFECTIVE STABILITY AND GROWTH PACT ONCE THE CRISIS IS OVER? SHOULD NEW RULES BE ADDED? WHAT MEASURES WOULD FINALLY MAKE IT EFFECTIVE? IS IT A PREREQUISITE TO MOVE TOWARD A FISCAL UNION?

Let me stress that despite its complexity, the Stability and Growth Pact has worked better than most people believe. In 2007, before the Global Financial Crisis, the aggregate fiscal deficit in the euro was 0.6% of GDP. Japan, the United States and the United Kingdom had deficits of 3% to 4% of GDP in the same year, while all countries were in a similar cyclical situation. Just before the pandemic, the euro area was again doing significantly better than the rest of the world, providing more fiscal space when the crisis broke.

However, the Pact needs to be reformed to become more credible again. Simpler and more effective rules and procedures would help stabilise and guide policy-making and market views. Investors have little faith in the current framework with its many exceptions. And one should not blame the European Commission for that, these exceptions were decided by the Member States. Now it has become too complicated.

The other reason why a reform of the Pact is needed, is that one of the key variables used to assess fiscal policy, the "structural" balance, is not observable but must be estimated. That requires estimating the output gap and potential growth rate of every euro area country. Before the Global Financial Crisis, a fairly reliable system existed for making these estimates. Since 2009, this approach does not work any longer.

We should therefore seize today's unique situation – with the EU fiscal deficit rules suspended for 2020 and 2021 - to agree on an improved, simpler and more credible fiscal surveillance framework. This will not be easy but is also a pre-condition for making progress on more fiscal risk-sharing in the euro area.

The Commission presented in February a review of the effectiveness of the economic surveillance framework, launching a public debate on its future, which is a good start. The European Fiscal Board has made very useful recommendations in this context, focusing more on observable variables, including debt sustainability and the growth rate of expenditures.

A more credible fiscal surveillance framework and more fiscal risk sharing would present additional steps towards a fiscal union, on top of the measures taken during the last 10 years in the context of the euro crisis. But we do not need, in my view, a full political union nor a full fiscal union to make the euro area function smoothly. The European Union is unlikely to become the United States of Europe but we should continue to work towards strengthening the EU, and deepening the euro area in a few specific areas, fully respecting the principle of subsidiarity, thus bringing more prosperity to Europeans, making EMU less vulnerable and strengthening the international role of the euro. ●

Q&A

Felix Hufeld

President, Federal Financial Supervisory Authority, Germany (BaFin)

How to face multiple challenges at the same time

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WHAT ARE THE RISKS POSED BY THE SIGNIFICANT INCREASE IN PUBLIC AND PRIVATE DEBT IN SOME EU COUNTRIES TO FINANCIAL STABILITY IN EUROPE?

The situation in the EU paints a heterogeneous picture as far as public and private debt is concerned. In some of the countries severely affected by the pandemic, public and private debt was already high before the crisis. With the precipitous rise in debt over the course of the pandemic, the risks for financial stability are not decreasing and must be monitored continuously. But in most countries, the challenges have been identified and various measures to counter excessive debt are being discussed.

EUROPEAN BANKS HAVE BEEN SHOCK ABSORBERS OF THE HEALTH CRISIS. DO THEY HAVE SUFFICIENT EQUITY TO COPE WITH THE UPCOMING INCREASE OF NON-PERFORMING LOANS (NPLS) AND FINANCE THE RELAUNCH OF ECONOMIC ACTIVITY? WHICH MEASURES WOULD BE APPROPRIATE FOR DEALING WITH THIS DETERIORATING SITUATION (E.G.EQUITY/PARTICIPATING LOAN, EU OR NATIONAL "BAD BANKS", NETWORK OF NATIONAL " BAD BANKS" FINANCED CENTRALLY...)?

The results of the ECB's recent COVID-19 Vulnerability Analysis for the banks it supervises directly indicates that the eurozone's banking sector, taken as a whole, will likely be able to withstand the pandemic-induced stress. This can also be said for the less significant institutions in Germany that are directly supervised by BaFin. They, too, should be able to cope with the COVID-19 crisis as things currently stand.

But let's go back to the ECB's analysis: forecasting whether and how banks will be able to deal with the credit defaults caused by the crisis heavily depends on the underlying scenario. According to the central scenario, in which a sharp recession is assumed, there could be a decrease in the average CET1 ratio of the banks in question from 14.5% to 12.6%. This would mean that the economy would continue to have a sufficient supply of credit. As for the severe scenario, modelling a more drastic decline in economic activity, there could be a drop in the average CET1 ratio from 14.5% to just under 8.8%. On the whole, most of the banks would still be able to comply with the minimum capital requirements. This is in part the result of national and European supervisors repeatedly calling on institutions to keep enough capital in the system.

At this juncture, it is too early to engage in discussions relating to the creation of potential bad banks. What we need to do right now and what we are already doing is closely monitoring and stabilising the solvency and profitability situation of banks with the tools and flexibility available.

WHAT FURTHER PROGRESS IN THE BANKING UNION FRAMEWORK WOULD OVERCOME THE FRAGMENTATION OF THE EU BANKING SECTOR, ADDRESS THE INCREASED SOVEREIGN BANK-LOOP AND THE ROOT CAUSES OF RING-FENCING PRACTICES, REMOVE THE OBSTACLES FOR NON-VIABLE BANKS TO EXIT AND FOSTER CONSOLIDATION IN THE EURO AREA?

Further improving and expanding the EU's resolution and liquidation toolkit is currently very important for the banking union. We need further harmonisation here – and we must broaden this toolkit so that we can use it for medium-sized institutions, too. The Federal Ministry of Finance and BaFin are actively involved in discussions.

We could also consider EDIS in relation to a reform of the resolution and insolvency regime – and less as a stand-alone solution as in recent years. And as we have stressed many times, we also need to place negotiations on EDIS into the context of actually further reducing risk in the European banking sector. Germany's Finance Minister addressed this topic in November 2019 to reignite the debate.

In addition, things haven't really moved forward as regards the regulatory treatment of sovereign exposures. Work in the Basel Committee on Banking Supervision and at EU level – which was practically inconclusive – has been put on the back burner. There are profound differences of opinion internationally, but we should make every effort to break the sovereign-bank nexus.

The ECB has addressed consolidation in its "Guide on the supervisory approach to consolidation in the banking sector", which I very much welcome. The ECB's guide shows that it is not seeking to punish credible and sustainable consolidation projects based on a plausible business model by imposing higher capital requirements. It is key that the ECB sets high standards: e.g. such projects must meet strict requirements in the areas of governance and risk management. Only then can further consolidation help banks achieve economies of scale and make them more efficient and robust. We all know that two ugly ducklings do not automatically turn into a beautiful swan. On the other hand, the ECB's guide makes clear that, in principle, we accept the concept of badwill and will not burden M&A activities with overly strict supervisory requirements. But ultimately – and this should be very clear – it is not supervisors but market participants who need to decide on the benefit of M&As.

WHAT ARE THE KEY PRIORITIES OF THE CMU INITIATIVE GOING FORWARD AND WHAT ARE THE MAIN FACTORS OF SUCCESS?

The stock market capitalisation-to-GDP ratio alone shows how significant the need for action is. It is still much higher in the UK and the US than in the EU. In Germany, it is roughly 50%; in the UK, it is about twice as high. In the US, it is even three times higher. Brexit has put even more pressure on the EU 27 to remain competitive internationally. The pandemic has made this even more necessary – despite extensive state aid.

I expect considerable impetus for the development of the CMU to come from a roadmap that the European Commission intends to release in the autumn. The road map is likely to address parts of the proposals that an expert group commissioned by the European Commission presented in mid-June.

The group has shown what is important now: building a truly integrated CMU, creating a more vibrant and competitive business environment and more efficient market infrastructure and making the capital market accessible for retail investors, too. More transparency and more homogeneity in the area of regulation is needed here – not just for financial supervisory purposes. Germany will promote this approach during its presidency of the Council of the European Union.

Here, I believe it is key that we seek more "U" – i.e. more of a union or – to be more specific – more uniformity for Europe's markets. But we also need more "M" – in other words: larger and deeper markets. We still have a buy-side that is far too weakly developed compared to other capital markets in the world; and we are still lacking a genuinely European investor structure. That applies in particular to the heavyweight EU countries of Germany and France.

I believe that the development of funded pensions is an ideal starting point to counter this. I am therefore pleased that the expert group has dedicated an entire chapter to this aspect. The group has made various proposals, including the establishment of a pan-European dashboard that should help increase transparency. This is a step in the right direction but it still needs to be supplemented with additional European and national initiatives. Some of the proposals to strengthen occupational pension schemes come to mind here; a topic which legislators, for instance in Germany, have already been discussing for a while.

IS AI LIKELY TO BE A "GAME CHANGER" IN THE FINANCIAL SECTOR OR IS IT A SOURCE OF OPTIMISATION AMONG OTHERS? WHAT ARE THE MAIN POLICY PRIORITIES FOR ENSURING AN APPROPRIATE DEVELOPMENT OF AI IN THE FINANCIAL SECTOR AND WHICH CHALLENGES DOES AI RAISE IN TERMS OF SUPERVISION?

Beyond the possibilities of mere automation, AI is definitely a game changer. Ever-growing data volumes and ever-improving analytical possibilities support disruptive developments, whether this be new products, services or entire business models in a self-reinforcing cycle of innovation.

We are undergoing a period of radical change, prompting many new questions for both market participants and supervisors and regulators, too. One question is: who will bear responsibility for business decisions? Humans or machines? Companies will, to the extent that AI is finding its way into the financial industry, be very tempted to outsource entire processes – or even decisions – from humans to machines. But what happens if something goes wrong? How do supervisors respond when managers say: "It wasn't me, it was the algorithm"? This is something we cannot accept! The principle that humans must at least bear ultimate responsibility must be upheld at all times.

Another aspect: how long will supervisory approvals remain valid in times of AI and machine learning? For instance, to what extent can a model used to determine regulatory capital requirements via self-learning systems evolve independently before we are faced with a model change that requires a new approval? Regulators and supervisors need to be prepared for such developments and be able to set standards. AI raises many more questions, e.g. regarding consumer protection or cyber security and the explainability of highly complex solutions.

Whatever the specific issues that need to be addressed, as regulators and supervisors, it would be wise to bear in mind two key ideas: Firstly, international phenomena require international answers. Same business, same risk, same rules – this applies across the EU and ideally worldwide. Secondly, in times of ever-shorter innovation cycles, regulation and supervision should be designed in a forward-looking, technology-neutral and principle-based manner. By not spelling out everything to the last detail, we are promoting both legal certainty and innovation. ●

I. POST-COVID PRIORITIES

Content

What way forward for the EU following the Covid crisis?

Bruno Le Maire

Minister of the Economy, Finance and the Recovery Plan, France

We need a genuine "Savings and Investment Union" to help us out of the crisis and to boost European financial sovereignty

The Economic and Monetary Union (EMU) is a decisive achievement of the European integration that we all cherish. But this political project should be further developed, especially in the current context.

Thanks to the reform momentum that followed the Eurozone crisis, important milestones have been achieved to improve the EMU's resilience to economic shocks. As a response to the Covid crisis, we have made unprecedented steps towards deeper solidarity and integration. We have acted quickly and strongly to face the urgency of a crisis of unprecedented scale. As early as April, the Eurogroup has taken ambitious and innovative decisions. It has notably agreed on three safety nets, relying on the European Commission, the European Investment Bank and the European Stability Mechanism. On the monetary policy side, the European Central Bank has shown its determination and ability to deliver quick and efficient responses, by massively increasing its purchase programs and by considerably easing bank refinancing conditions. Finally, in July, the European Council has agreed on a historic recovery package that includes a common debt to finance the recovery and to face the green and digital transition of our economies. This package is the concrete expression of European solidarity to ensure that no region is left behind from the economic recovery.

While considerable progress has been made to reinforce the financial, fiscal and economic dimensions of the EMU, the Eurozone architecture remains incomplete and must move towards deeper integration. It is all the more important since recent forecasts have underlined that the different recovery prospects between Member States could deepen pre-existing diverging trends. To avoid further divergences between Member States, a centralized fiscal stabilization function could help improve the financing of the European economy by better allocating resources across jurisdictions. In parallel, we also need to advance on the completion of the Banking Union and the construction of a full-fledged savings and investment Union.

Indeed, it is high time we strengthen our financial markets so that they can play their financing role fully and diversify the funding sources for the European economy. Equity funding must be facilitated and financial flows should circulate more easily across the European domestic borders to serve the countries hardest hit by the crisis.

This is why the Capital markets Recovery Package the European Commission unveiled last July is a positive outcome. Still, we need to go further and set up a genuine savings and investment Union which will garner both individual savers and financial actors in the battle to fund the recovery.

To that end, we must take every step we can to channel equity into the real economy. Insurers and banks should be able to play their role of long term funders of the economy on the European market. The upcoming revision of Solvency II, which will contribute alleviating corporate solvency stress, and a transposition of Basel III avoiding any gold plating and adapted to the European reality will be key to further integrate the capital markets across the EU. At the same time, individual savers should be given new investment opportunities, in particular given the negative interest rate environment. We should, for instance, continue our efforts to develop pan-European funding vehicles, especially when it comes to employee share-ownership or private equity. Similarly, it is time to revamp the legal framework of the European long term investment fund (ELTIF) to make it more attractive.

Once we are able to mobilize private investors and retail savings as a complement to fiscal and monetary policies, we must make sure small and medium businesses can benefit from diversified sources of funding to strengthen their net position.

Finally, to build a strong and coherent "Savings and Investment Union", we need a convergent and enhanced supervision at the European level. Strengthening and deepening the Capital Markets Union is not only necessary to weather the current economic crisis, but it also turns out to be a leverage to ensure a genuine European sovereignty at a time when trade tensions are rising and the United Kingdom is leaving the EU. ●

Roberto Gualtieri

Minister of Economy and Finance, Italy

An opportunity Europe must not miss

In challenging times bold policy initiatives become feasible

In recent years, the process of deepening of the Economic and Monetary Union that was charted by the Five Presidents' Report back in 2015 was fraught with difficulties and a general lack of enthusiasm, if not outright disagreement. The European Union at large experienced political divisions and then the exit of a prominent Member State such as the UK. However, as the EU was losing momentum, global challenges mounted: from threats to multilateralism and 'trade wars' to the scourge of climate change and the spread of populism. These growing challenges reminded us of the importance of staying united and of the wisdom of the European 'project'.

Last year's political agreement on the new European Commission marked a long-overdue refocusing on social and environmental sustainability and on an integrated EU approach to climate change and innovation under the 'European Green Deal' banner. More recently, it was the Covid-19 epidemic to focus the minds and the hearts of European leaders on the need to forge a forceful response to an unprecedented and sudden stop in economic activity – a global shock that, given the disparity of initial conditions across EU Member States, might have irreparably compromised their economic and political equilibria. European institutions rose to the challenge: the European Central Bank succeeded at countering deflationary risks, stabilising the financial markets and reducing financial segmentation. Capitalising on prior work on proposals such as the unemployment fund and the reform support mechanism, the European Commission swiftly finalised a package comprising the SURE funding facility to mitigate unemployment risks and, most importantly, Next Generation EU (NGEU), also known as the Recovery Plan. In addition, Euro area countries agreed on a new credit line from the European Stability Mechanism, the Pandemic Crisis Support.

NGEU comprises 750 billion in loans and grants over the 2021-2026 period, for the first time leveraging the EU budget in order to finance reforms and investments in innovation, digitisation, environmental and social sustainability, as well as the quality and resilience of health services of Member States. The allocation keys of the program reflect pre-crisis unemployment and per-capita output levels. As a result, NGEU is not only an instrument to build a stronger and more sustainable European economy, but also a rebalancing mechanism that will make the EU more sustainable also from a social and political point of view.

This ambitious plan must be quickly finalised by EU institutions and leaders, and be ready for use in 2021. We must ensure that bureaucratic and political hurdles do not stifle the timely deployment of growth- and sustainability-enhancing investments and reforms. Disbursements from the EU budget should be made available to Member States as soon as milestones are fulfilled.

Furthermore, it is crucially important to align the whole EU framework with the goals of the Recovery plan. That includes fiscal rules, which not only need to be streamlined but also to be more conducive to growth, investment and rebalancing of the Union. Granted, the fiscal framework must preserve debt sustainability in the face of ageing of the population. Solid budgetary positions in good times are necessary to be able to respond forcefully to unexpected shocks like the current pandemic. At the same time, at this critical juncture we must prioritise the revitalisation of our economies and their convergence towards a more advanced and sustainable model. It would be a serious mistake to blunt the stimulus provided by the Recovery Plan with offsetting fiscal tightening. Furthermore, a growth-friendly fiscal policy stance will facilitate the implementation of a wide range of reforms that are necessary to make our economies more efficient, competitive and sustainable.

We must also complete the banking union and capital markets union. Compromises will be necessary to achieve these goals, but if all parties involved adopt a constructive approach, we will be able to fulfil the vision laid out by the Five Presidents and to move on to even more ambitious goals.

It is in challenging times that long-held red lines are called into question and new and daring policy initiatives become feasible. In Next Generation EU, we now have a program that can genuinely revitalize and deepen our Union and allow us to achieve higher levels of prosperity, innovation and environmental sustainability. It is an opportunity that Europe must not miss, and will have to build on over the coming years to complete the Economic and Monetary Union and to put Europe in a leadership position in global affairs. ●

Werner Hoyer

President, European Investment Bank (EIB)

The way out of the crisis: investing for a new, green, innovative Europe

We are in the midst not only of a global pandemic, but of the worst global economic crisis since the Great Depression. Despite some worrying local upsurges, there is hope that Europe has seen the worst of the pandemic, thanks to tremendous efforts. We cannot yet be so hopeful about the economic recovery. The impact is deep and economic uncertainty remains high. It will take tremendous European efforts to surmount this crisis. The EU bank is ready to play its role.

We should not expect the EU economy just to bounce back any time soon. We still don't know how the spread of the virus will evolve, or when a vaccine may eventually become available. We don't know what economic knock-on effects, like rising non-performing loans, may still prove disruptive. And we don't know whether anything will be quite the same again when it comes to how consumers behave.

Facing such enormous uncertainty, it is not surprising that European businesses have cut back on investment. Calculations by EIB economists suggest that this could be by as much as 30%. We cannot afford weak investment now. We cannot afford an economic lost decade when we face such enormous challenges as climate change, declining productivity growth and the need to digitalise the European economy. With the economic impacts hitting many people in low-paid service sector jobs the hardest, driving social exclusion, we cannot afford to pile even more burdens on European citizens.

European solidarity is now needed more than ever. As the EU bank, the EIB Group has been an integral part of the collective European response to this pandemic.

From the beginning, we have acted to ensure that finance is never the obstacle. We immediately made €6 billion available for investments in the healthcare sector such as medical infrastructure or research into vaccines and treatments. In July alone, we approved € 10.2 billion of new financing for the public health response to COVID-19, to adapt key public services and to help companies survive and invest. This includes €2 billion to Italy to reinforce Italy's healthcare system and € 1.5 billion to help local authorities in France to better respond to the pandemic, as well as support for the public sector response and businesses across Europe.

In just 3 months, we also developed a powerful pan-European instrument – the European Guarantee Fund – to help Europe's economic recovery in the coming period. As part of the overall EU COVID-19 response package, it will enable the EIB Group to provide up to €200 billion of additional financing for mostly SMEs, companies that are the life blood of our economies yet that face devastating, unprecedented challenges. Following guarantees by EU Member States the European Guarantee Fund is now operational.

In addition, we are part of Team Europe response to the challenge posed by the pandemic around the world. We have pledged to provide up to €6.7 billion in the coming months, supported by guarantees from the EU budget. This will both strengthen urgent health investment and accelerate long-standing support for private sector investment, reflecting financing needs in more than 100 countries around the world.

We have responded with the urgency required of the COVID-19 outbreak. But we also haven't – and mustn't – lose sight of the longer-term challenges we face: climate change, digitalisation, inclusion. This is another case where we must, as Europeans, say that we will do "Whatever it takes". Recovery is not enough; we have to invest in an innovative, inclusive and carbon-neutral Europe. What we need is a sustainable recovery.

Given the size of the challenge, public funds can only cover part of the total required! This is why we must structure our support in such a way that it 'crowds-in' as much private capital as possible. As the EU's Climate Bank we are well placed to help catalyse the kind of patient, targeted, risk-absorbing finance that our response to these structural challenges require. And we are ready to do more.

Jörg Kukies

State Secretary, Federal Ministry of Finance, Germany

Enabling the financial sector to contribute to the economic recovery in Europe

The European Council's agreement on a recovery instrument and a new Multiannual Financial Framework (MFF) for the period 2021-2027 have been a major achievement during the first month of the German Presidency of the Council of the European Union. The heads of state and government of the 27 EU Member States have agreed on an overall package worth 1.8 trillion euros. Between 2021 and 2023, 750 billion euros of this sum is to be made available via a recovery instrument to address the adverse economic consequences of the COVID-19 crisis. Thereof, 390 billion euros will take the form of grants and 360 billion euros will be provided as loans.

During the next months, the German presidency of the Council will focus first on facilitating the legislative process for the acts needed to implement the agreement by the European Council. It is important to ensure a green and socially inclusive recovery, the digital transformation, including increasing the EU's competitiveness and strengthening its digital sovereignty.

In addition, we will have to plan beyond crisis management and identify where Europe needs to become more resilient and independent. We must think about ways to tie up some of the loose ends that have faded into the background somewhat while we have been focusing on the Covid-19 epidemic. This includes the work on the completion of the Banking Union and advancing the Capital Markets Union.

While the MFF and the recovery instrument will already provide a significant amount of public money to overcome the pandemic, the German Council presidency will also focus on the mobilisation of further resources via the financial markets. In this regard, it will be key to continue completing the Banking Union, with uniform rules for the European banking sector. A strengthened Banking Union that enables further market integration will facilitate the access to bank financing for consumers and small and medium-sized enterprises, as well as for corporates in Europe.

To enable a swift recovery of the European economy, we will also need to improve the access of companies to financing via the capital markets. Therefore, another key priority of our Presidency will be to ensure access to diversified funding sources and promote competitiveness of the EU financial sector. Short-term focus should be on measures providing direct benefits to investors and enterprises to overcome the economic consequences of the Covid-19 crisis.

We aim for council conclusions on the Commission's action plan on CMU, underlining the commitment of the member states. In the short term, we will take forward proposals for the Capital Markets Recovery Package and BMR tabled end of July, aiming for a political agreement by the end of this year. We are keen in working closely with the European Parliament to achieve quick results in order to assist the recovery of European economies from the Covid-19-crisis.

Our work will also focus on creating a secure environment for using digital technology more widely in the financial sector. This will also facilitate overcoming the crisis. Our key priority is to turn Europe into a modern, secure and innovative financial market union for tokenized financial services, to promote the Retail Payments Strategy as well as increasing cyber security and operational resilience of the European financial market.

> *Beyond the MFF and the recovery fund, the financial sector plays an important role in the economic recovery in Europe.*

We aim at further improving the fight against money laundering and terrorism financing. We will especially focus on those areas which can be best addressed by a regulation. Additionally, we will look into the question how a future supervisory structure at EU level can contribute to ensuring better compliance throughout the common market.

Sustainable finance as a cross-cutting topic is of central importance for our presidency, especially in the fight against climate change. We will therefore promote the EU's leading role for sustainable investment. ●

Priorities for the financial sector in the post-Covid era

Jean Lemierre

Chairman, BNP Paribas

What are the priority measures that would enable the EU financial industry to contribute to a strong and rapid recovery in Europe?

About six months after the beginning of the Covid-19 crisis, which triggered a confinement that stopped the world economy, we can start to reflect on the lessons to be drawn.

As the economy was locked down, banks immediately responded by providing liquidity support to their clients, through moratoria, credit lines drawn, and other supports. It was accompanied by decisive and massive measures at European and national levels, considerable fiscal support, prompt resumption of the ECB asset purchase programs and TLTROs, as well as targeted measures to operationalize the flexibility embedded in the accounting and regulatory framework. The battle against the first phase of the crisis is now over.

This first phase has shown again the central role of banks in the functioning of the economy, from lending to payment and settlement systems, as bank staff worked hard to address the needs of their clients. It also showed the resilience of the European banking system thanks to solid capital and liquidity buffers. In practice, a massive number and amount of credit lines were granted to clients, in record timeline, thanks to the mobilization of European banks.

BNP Paribas has contributed to supporting the French economy, and all the clients, in particular European corporates, wherever they are based, in line with its European integrated strategy. This is « private risk sharing » at work.

We are now entering into a second phase of the crisis, as moratoria will come to expiry and State-guaranteed loans will have to be reimbursed in a time of recovery, mixed with a still negative economic and social impact. The dialogue with every single client will restart on a new base: while in some sectors, cash-flows are back to normal, and further lending support may not be needed, in others the crisis will have lasting and deep consequences. Some companies may default. NPLs will rise. Others will have the potential to continue their business, but their financial structure, loaded with debt, will require equity or quasi-equity injections. Finally, some sectors may be the winners of the crisis, and will contribute most to the recovery, and those companies will need more lending to finance their investments, including, according the Commission's priorities, to speed up the Europe's green and digital transition. At the same time, it is crucial to implement quickly the European Payment Initiative (launched by 16 banks from 5 countries) to ensure the European sovereignty.

> *We count on a continued dialogue with authorities, focused on the need to support the economy and the employment, to win the second battle.*

Again, banks will be at the core of the response. They have a unique client knowledge and risk analysis capability. But banks have, as in the first phase, to rely on authorities to implement the relevant measures in a decisive and agile way to ensure their role is not hampered by counterproductive rules in the current economic situation. We warmly welcome the July EU decision about the landmark Corona virus recovery package, which is a major and decisive step forward.

Full implementation of Banking Union, without any fragmentation, maintaining flexibility of the rules as needed to ensure an efficient funding of the economy, true relaunching of securitization are examples of points where regulation will need swift and pragmatic adaptation.

More subjects will certainly appear as the situation develop.

We count on a continued dialogue with authorities, focused on the need to support the economy and the employment, to win the second battle. ●

Christian Sewing

Chief Executive Officer, Deutsche Bank AG

A partnership for growth: financing recovery and growth in Europe

The German Presidency of the European Council comes at a critical time. In the midst of the unprecedented global health challenge of the COVID-19 pandemic, Europe needs to focus on recovery and averting an economic crisis. The financial sector has a critical role to play in supporting recovery and, in partnership with governments and regulators, can ensure that recovery is aligned with the strategic objectives of a digital and low carbon Europe.

The EU financial system has proved resilient in the face of the extraordinary economic challenge posed by COVID-19. This was the first real test of the regulatory reforms put in place following the financial crisis of 2008 and, for the most part, the new regime worked as intended. Capital and liquidity buffers provided the cushion required to absorb the initial shock and banks have been able to provide significant additional lending to support the economy, whilst markets have continued to function. Prompt action by regulators to provide targeted relief from aspects of the regulatory regime ensured unhelpful pro-cyclical effects have been avoided in the short-term.

However, the economic fallout from the pandemic will continue to be felt for some time and that will put pressure onto a European financial system which was already facing headwinds. Long-term negative interest rates, tensions in international trade (including Brexit), structural challenges arising from digitization of finance and competition from non-financial technology companies, as well as inflation in resolution fund contributions, pre-dated the COVID crisis. Pressure will increase as emergency government support packages are withdrawn and insolvencies of companies and households will inevitably surge.

The European financial sector, particularly the banking sector, wants to support immediate recovery and deliver the investment required to put Europe on to a sustainable growth path. But we cannot do it alone – or under the current regime. Europe needs action with political and regulatory focus on reform in the following key areas:

1. **The Banking Union needs to be completed and its benefits realised.** This is essential to underpin the efficient operation of the banking system and to remove the deadweight cost of trapped liquidity and capital within the Eurozone. It is also critical to facilitate consolidation and rationalization within the EU banking sector necessary to support profitability and growth of capital to support lending.

2. **Changes to the EU capital regime should be paused** until the impacts of COVID-19 are clearer. The existing framework has proved robust and Europe should coordinate with other regions in taking forward implementation of final Basel III rules.

3. **The Capital Markets Union must become a reality.** Deep and liquid capital markets are critical to deliver efficient finance, cost effective risk management and access to international investment for European businesses. In the short-term, developing an active securitization market in the EU could play a critical role in freeing up bank balance sheets to support new lending and allowing them to manage the challenge of increasing NPLs. The package of proposals published by the European Commission on 24 July is an important first step to delivering some of the changes required to enable capital markets to support recovery, but further bold steps will be required to achieve real change.

> *Change will require political ambition, policy vision and a strong partnership.*

4. **The ambition for a true digital single market must be delivered.** To realise the opportunities afforded to European citizens and business of digitalization there needs to be legal and regulatory certainty, but also consistency across Member States. A fragmented legal and regulatory environment will undermine scale efficiencies, disincentivise innovation and open the door to regulatory arbitrage.

5. **The framework for sustainable finance needs to be further enhanced.** The EU has taken a lead in legislating to support the shift to a low carbon economy with the green taxonomy and climate disclosure requirements. The COVID recovery provides an opportunity to accelerate that agenda. Regulatory incentives need to be put in place to encourage the flow of sustainable projects and to support the development of new channels of 'green' finance.

To achieve this change will require political ambition, policy vision and a strong partnership between public and private sectors. ●

Helmut Schleweis

President, Deutscher Sparkassen- und Giroverband (DSGV)

Recognising and ensuring the stabilising effect of smaller banks

The Corona pandemic caused severe economic damage affecting the financial health of many households, businesses and the self-employed. This has made comprehensive recovery necessary and triggered immediate and important policy and supervisory measures on EU and national level. Among them, the various government programmes, the easing and postponement of regulatory measures and of course the EU aid package "Next Generation EU". As for the latter, the Savings Banks Finance Group welcomes the framework and conditions foreseen as they display a clear sign of European solidarity between Member States, leave room for subsidiarity and proportionality, encompass accountability as well as shared control – and they are limited in time and size.

Throughout the exceptional situation in which we find ourselves, the EU banking sector was able to prove that it is part of the solution. The saving banks played an essential role within the German financial infrastructure. They made a major contribution with new financing, extensive advisory services and forbearances, preventing the otherwise inevitable economic collapse of many companies and small businesses by providing them quickly with liquidity.

Once more, this proves the stabilising effect of small- and medium-sized banks to the economy in times of crisis. And it emphasises the need for regulation that recognizes the existence of smaller and locally rooted banks by applying the principle of proportionality. Decision makers should have the importance of the diverse EU banking sector in mind when responding to the current situation, but also when shaping the regulatory framework of tomorrow:

- It is vital now that institutions are able to make optimal use of their equity to finance the real economy. When looking at proportionality within the prudential framework, there were already important steps taken at EU-level during the previous legislative term. Regulators will have the chance to continue that road with the finalisation of the Basel III package allowing to calibrate regulation more stringently to match the size of institutions. At the same time, the effects of Basel III should be under strict scrutiny as they could contradict the efforts to the economic stabilisation of Europe's national economies. Furthermore, the functioning of the existing regulatory framework during the crisis should be evaluated and where necessary, lessons should be drawn.
- Maintaining the diversity of the EU's banking sector has to be a guiding principle for every step taken in further shaping the Banking Union, be it with regard to supervision, crisis management, or deposit protection. The European Deposit Insurance Scheme (EDIS) as proposed by the European Commission would certainly not be helpful in this regard, as it leads to further centralization and transfers, increases contagion risk and moral hazard. Going forward, the debate should rather focus on the stabilising effects of existing schemes, which already are harmonised according to EU rules.
- A diverse European banking sector would also help to progress in another area of vital importance: tackling environmental issues by financing the necessary transition in a sustainable way. Ecological strength needs to be well-balanced with social and entrepreneurial powers. Local banks can considerably contribute to this balance and thus support European resilience.

> *In times of crisis locally active banks showed their strength in supporting businesses and private individuals.*

- Despite all the understandable efforts made to improve access to the capital markets for businesses, credit financing must not face discrimination. Loans are the most important source of finance for European businesses – and this holds particularly true in times of crisis, where the relationship between house banks and borrowers, the possibility of deferrals and payment moratoria prove essential. These flexible and rapid responses are not available in the capital markets, where we often see a high degree of uncertainty among investors leading to increased volatility.

For all the above, we will need to find the proper regulatory environment, by providing the right incentives, enabling innovation, striking the right balance and allowing for a well-functioning financial services sector. Thus, the German savings banks and their partners in the Savings Banks Finance Group can make their full contribution to our joint efforts for an economic recovery.

We thank **the partner institutions**
for their support to the organisation of this event

Is the EU response to the Covid economic crisis fit for purpose

Harald Waiglein

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

Fiscal risk in the monetary union

The main economic weakness of the euro area stems from unsustainable public and private debt in a number of Member States. Before the 2009 crisis, diverging debt developments were not a major concern for investors, but differentiation according to country risk has re-emerged since then. Following the experience of the last crisis, EU economic surveillance was reinforced via the so-called 6pack and 2pack legislation, with a view to reducing vulnerability to shocks. Yet the new toolbox has never been fully exploited, and the drawdown of public and private debt stocks in vulnerable Member States over the past years was not as ambitious as it could have been. As a result, some Member States are now in a particularly weak position to address the economic fallout from the COVID-19 crisis, calling upon the EU level to provide unprecedented support.

The key problem of the monetary Union is that an important constraint to the build-up of unsustainable debt has been eliminated, and none of the EU's surveillance tools has come close to reproducing the same disciplining effect. That constraint was exchange rate risk, which acted as a natural barrier for external flows to domestic economies. Under national currency regimes, differentiation according to country risk might have reappeared earlier in the form of currency risk, reducing inflows and preventing the accumulation of unsustainable debt. In the absence of the disciplining effects of currency risk, fiscal policy bears an even higher responsibility for economic stability. Yet at the same time, the rules of the Stability and Growth Pact have not been enforced to an extent commensurate to that responsibility.

It is often argued that monetary union without fiscal transfers is prone to failure. Yet this does not do justice to the enormous benefits from sharing a strong currency with partner countries. About half of all countries worldwide (and half of the non-euro area countries in the EU) voluntarily peg their currencies to that of another country, without having a say in the monetary policy of that country, let alone benefitting from fiscal transfers. Many of those countries that have subjected themselves to the monetary policy of another country are successful precisely because they have imposed the necessary fiscal, and in some cases macro-prudential, constraints on their governments and financial sectors.

> *In the absence of the disciplining effects of currency risk, fiscal policy bears a higher responsibility for stability.*

How can we address this apparent weakness of the euro area? The Recovery and Resilience Facility will soon make available unprecedented financial support from the EU budget to Member States' economies. Support under the Facility shall be used as a carrot for ambitious structural reform with a view to increasing growth potential, resilience and adjustment capacity in vulnerable Member States. Full compliance with the rules of the Stability and Growth Pact post-2021 shall be made an explicit requirement for grants from the Facility. The tools are there for the success of the monetary union, we just need to exploit their full potential. ●

Irene Tinagli

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

The Recovery Package and the new priorities for the European Union

The COVID-19 pandemic is not just a dramatic health emergency. It also has significant impacts on our economies and our daily life. Since March, all EU Member States have taken relevant steps to support their national economy and to safeguard as much as possible the well-being of their households and firms. This effort was accompanied by important initiatives taken immediately by the Commission, the ECB, the EIB, the SSM and the ESAs.

The presentation of the Recovery Package was undoubtedly a fundamental step in this regard. Unlike what happened right after the 2008 crisis, this time the EU relaunch package had to be more than the mere sum of national plans. What was decided by Member States with the Recovery Package was - in a certain sense - an unavoidable choice.

The activation of the escape clause of the Stability and Growth Pact has facilitated the actions of national governments, which unquestionably helped avoiding the immediate collapse of the economy. However, as already described by the latest Commission's forecasts, these measures will likely lead to a sizeable, but uneven, increase of debt/GDP ratios across the different countries, adding on to the already existing disadvantages and discrepancies due to different spreads of the virus, and to different structures of the economies in the various countries. As a matter of fact, Member States will not be able to face the economic consequences of COVID-19 pandemic with the same instruments and with the same firepower, and this could lead to unavoidable and permanent divergent dynamics within the Euro area and the European Union as a whole.

The Recovery Package addresses this challenge building up on two clear priorities for the Union: the sustainable and the digital transformation. The Commission's proposal was ambitious not only in terms of size of the overall package, but also in terms of the range of legislative proposals that were put forward. In this sense, although the July European Council's agreement has to be welcomed, one cannot hide some disappointment for the heavy cuts in the financial envelopes or even with the deletion of certain programs that would have been key to support a harmonious and sustainable recovery of the Union.

In fact, despite the usefulness of the measures allowed by the temporary framework on State aid, one has to consider that not all Member States are able to afford them and provide a robust economic and financial support to their industrial sector. This obviously creates an unlevelled playing field that, along with entry barriers and further fragmentation, might undermine the functioning of the single market, driving further divergences between Member States. The Commission's proposal for the establishment of a European solvency support facility addressed precisely this problem by ensuring support for equity capital in those countries and sectors where more action would be needed. The European Council's decision to cancel this program is short-sighted and the European Parliament, while being perfectly aware of the difficulties of the negotiation on Next Generation EU and on the next Multiannual Financial Framework, has nevertheless decided to move forward because it considers this instrument as essential.

> *Unlike what happened right after the 2008 crisis, this time the EU relaunch package had to be more than the mere sum of national plans.*

In the final agreement of the European Council, a fully decentralized approach in the use resources has prevailed, and therefore it will be up to the Member States to define their national plans. However, I believe it is important that it remains clear to all what the objectives of the Recovery Plan are, namely to fill the gaps that emerged due to the COVID pandemic and, simultaneously, to address the structural weaknesses of the various economies, in order to foster integration and convergence while encouraging the sustainable and digital transformation of the European economy. The Recovery Package must be an opportunity to rebuild our economies on more solid grounds, capable of producing long-term growth that is both socially and environmentally sustainable through quality job-creation, which would allow the European Union to maintain and strengthen its position of global leader.

The role of the Commission will be crucial in this regard. Nevertheless, I believe that an enhanced role of the European Parliament would indeed be a natural and necessary complement to these important steps. I hope that the interinstitutional negotiations will take this into account.

Odile Renaud-Basso

Director General of the Treasury, Ministry of the Economy, Finance and the Recovery Plan, France

The European recovery plan to pave the way to a stronger, more sovereign and independent Europe

The EU economy is facing an unprecedented crisis, still surrounded by a lot of uncertainty. We are hit by a symmetrical shock, but with asymmetrical consequences among Member States, as they are not exposed to the same risks and vulnerabilities and because of different sequencings of the containment measures. Since the gradual lifting of these measures, our key challenge has been to reduce the sanitary risks to a minimum, in order to prevent or limit the second wave of the pandemic, restore confidence and thus maximize the effects of our economic support. Many other challenges remain ahead. The high degree of uncertainty we are facing is likely to delay the investment decisions of firms, which are also facing liquidity constraints as a result of lower revenues and a greater debt burden.

The increase in public debt will be substantial in the Member States, as they cover a large part of the losses related to the crisis. We also need to prevent further widening divergences, especially in the euro area. In our policy response, we need to ensure a proper transition between short-term support measures and accompanying measures, to sustain recovery without impeding economic adjustment to structural changes, and to ensure that the measures we take are properly designed to support longer-term objectives. These challenges are also an opportunity to further support public and private investments needs and incentivize reforms, especially in our priorities: green and digital transitions.

The agreement on a European recovery plan reached by the European Council in July (€750bn – or around 5 points of EU GDP) is an historic milestone towards more solidarity and a deeper integration of European economy, offering a visible signal to all citizens of the added value of the European Union. For the first time in the history of the European Union, this plan will be financed through common debt issuance, thereby maximising its counter-cyclical effect. It will provide for real budgetary solidarity towards the regions and sectors most affected by the crisis. Considering the interdependence of the EU economies and the dynamics within the Single Market, no country should be left behind the recovery support: the recovery in each Member State will affect positively the strength of the recovery of other Member States.

Beyond its ambition to stimulate and stabilise the economy, the Next Generation EU instrument aims to durably transform our economies and pave the way to a stronger, more sovereign and independent Europe. The funds disbursed under its Recovery and Resilience Facility (RRF) – amounting to €672.5bn, of which €312.5bn grants – will support investment and reform projects that enhance the growth potential, job creation and economic and social resilience from the next year onwards. They are also expected to contribute effectively and sustainably to the green and digital transitions, in line with the EU climate-neutral objective for 2050 and through the introduction of a 30% green spending target in the recovery package. From now on, we will have to deliver quickly on the implementation of our national recovery plans, that need to be consistent with the objectives mentioned above, so that the RRF could be disbursed swiftly, to fully play its countercyclical role.

> *The agreement reached by the European Council in July is an historic milestone towards more solidarity and a deeper integration of European economy.*

In the meantime, the agreement of the European Council allows us to relaunch public investment as of today - following the large-scale national recovery plans Germany and France already announced - as recovery expenditure committed by member states since 1 February 2020 will be retroactively eligible for funding under the RRF. Next Generation EU also includes other programmes, including InvestEU - €8.4bn of which €5.6bn via the recovery plan - specifically dedicated to supporting private investment in the European Union, which should generate, after leverage, investments around €300bn. Finally, the Covid19 crisis has exacerbated our companies' need for equity capital and the need to diversify sources of financing beyond traditional bank lending. In the wake of the recent report of the High Level forum, we are committed to strengthen the Capital Market Union to forge a true Savings and Investment Union as one of the pillars of our European Recovery Plan. We are also committed to support the turning of our financial industry towards a more sustainable and technologically advanced future. ●

Axel Weber

Chairman of the Board of Directors, UBS Group AG

Creating a stronger, greener, and more integrated Europe

According to the World Bank, the COVID-19 global recession will be the fourth deepest since 1870 and the most severe since the end of World War II. While posing serious challenges, the pandemic at the same time offers a great opportunity for EU leaders to address major outstanding issues which we have not been able to address so far, among them the deepening and strengthening of the Single Market and the transformation of the EU economy towards a more sustainable growth model.

Unlocking the Single Market's full potential and the full range of its benefits, especially in financial services, will provide the much-needed funding to support economic recovery and finance a sustainable transformation.

A key challenge to overcome in the deepening of the Single Market for financial services has been regulatory fragmentation. While important progress has been made, hundreds of millions of EU consumers, businesses, and the bloc's overall economy are still not reaping the full benefits of the single market.

In a first step, national "options and discretions" in the prudential framework should be further harmonized in order to avoid unwarranted ring-fencing practices and let banking groups allocate capital and liquidity across multiple legal entities as needed and economically sensible. Although a lot of progress has been made already, there are still more than 30 provisions which require further harmonization.

Second, further efforts should be made to harmonize regulation and establishing a level playing field around innovative technologies in financial services. This would span across areas such as digital identity, which is a key technology of the future, including the fight against financial crime, as well as the usage of data to harness the full potential presented by new technologies.

Thirdly, further steps to complete the Banking Union are needed. In particular, a single EU crisis management framework is the conditio *sine qua* non for further risk reduction measures and a common deposit guarantee scheme, thus strengthening the credibility of deposit insurance and reducing the bank-sovereign vicious circle.

Furthermore, EU depositors should be able to move and use funds across and in different countries seamlessly and without additional charges. IBAN discrimination and the fragmentation of card schemes along borders need to be overcome to establish a truly integrated single European payment platform, which is the backbone infrastructure of the financial system.

When it comes to financing the transition towards a more sustainable European growth model, the Capital Market Union (CMU) is the key complementary project to the Banking Union. Strong and well-functioning economies need capital market funding to complement bank lending. As recently highlighted by the ECB, this is particularly relevant when it comes to financing the greening of our economy, given the high capital intensity, high risks, and long-term horizon of most projects. The EU urgently needs to make faster progress towards creating a true CMU, also to support a sustainable transition.

> *Deepening and strengthening of the Single Market and transforming the EU economy towards a more sustainable growth model as key opportunities.*

To further drive a sustainable transition of our economy, the EU should accelerate carbon pricing. The EU's emission trading system (ETS) is the world's largest carbon market, but currently it only covers economic sectors that together account for less than 50% of total carbon emissions in the EU, whereas the remaining sectors are subject to a patchwork of non-harmonized measures across the EU. Greater harmonization would facilitate the transition towards a low-carbon economy.

By creating the "Next Generation EU" fund, one of the most important milestones since the introduction of the single currency, EU leaders recently have shown that a common response can be achieved in a timely fashion. EU leaders should use this momentum and shape the recovery further, delivering on the pending issues mentioned above. This will allow Europe to emerge stronger from the current crisis and create a greener and more integrated Europe. ●

Pierre Heilbronn

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

We are all in this together

In the face of the COVID 19 pandemic, Member States, under extreme time pressure, adopted various national emergency measures to confront the immediate impacts of the crisis. The EU stepped up in its coordination role and mobilisation of resources through EU institutions followed soon after, with ECB, the ESM, EIB, EBRD and European Development Finance Institutions putting together ambitious economic crisis response measures. Now, the EU must ensure that funding the European recovery, is supported by practical steps on the ground.

IFIs, including the EBRD, and the EU financial industry are a key conduit to translate European solidarity principles into practice. It is for this kind of crises that multilateral institutions were established. To invest where others will not. To be counter-cyclical. To provide a bulwark against economic – and possibly even political – maelstrom. As the economic and social impacts of the pandemic magnified, IFIs introduced immediate crisis response programmes focussing on a) strengthening health infrastructure; b) supporting viable businesses; c) assisting financially vulnerable households; d) offering working capital support to existing clients including banks. Lending and technical cooperation projects in 2020 and 2021 have been redirected toward the crisis and, importantly, to build the foundations of the eventual recovery.

EBRD has already delivered an evolving and dynamic 4 billion Euro "Solidarity Package", providing the operational framework and leverage for the Bank to invest an ambitious 21 billion Euro over 2020 and 2021. Given the magnitude and severity of the crisis, the key to its successful resolution is coordinated responses targeting the more efficient mobilisation of investment funds at both the aggregate level and toward specific financially stressed actors such as SMEs. Resilience of the financial sector is crucial to resolution of this emergency and capital market reform must continue with added haste to facilitate this. Governments will need to fund their expenditures through increased bond issuance and long-term fund investment will be needed to meet heightened and altered infrastructure needs.

Policy work within the EU addressing access to finance for SME such as the European Secured Note initiative and equity finance solutions are actively supported by the EBRD and the final investment products will augment our existing suite of financial and risk sharing products including our bond investments, commercial loans, Trade Facilitation Programme, and credit lines to local banks. With the support of various financial sector partners, we are also targeting the development of new financial products to address short-term emergency finance needs and aid in NPL resolution. Although the COVID 19 response is currently taking centre stage, an essential part of any rebuilding must address the long-term fundamentals of building a sustainable market economy.

EBRD already reflects this through the "tilt to Green" in our Solidarity Package, our new Green Economy Transition approach for the period 2021 to 2025 and our work on Greening the Financial Sector in the Baltics, Greece, Hungary and Poland to create a more flexible capital market and encourage greater issuance of green and social instruments.

> *IFIs and EU financial sector are a key conduit in translating European solidarity from principle to practice.*

The COVID-19 crisis will have significant short and long-term consequences for our region comprising some of the EU smaller states. EBRD commits to step up and play a systemic role in maintaining well-functioning markets, helping governments shape their policy responses to minimize distortions to well-functioning markets, and protecting transition. This means ensuring the resilience of the private sector to prevent value destruction; retaining our focus on inclusion through gender mainstreaming, workforce restructuring/employment retention; tilting the recovery towards green and promoting good governance given the increased role of the state. ●

Frédéric Oudéa

Chief Executive Officer, Société Générale

Europe can no longer afford a muddle through approach to its financial system

Europe's single currency continues to surprise its sceptics, showing resilience in crises and delivering a safe store of value to its citizens. It is fair to say, however, that the euro has fallen short of its potential, and not least due to its fragmented financial system. Completing Banking Union and building out Capital Markets Union (CMU) are commonly agreed goals, but paths have divided on how to achieve this, at no small cost to jobs and growth, and overburdening the ECB in the process.

The Covid19 crisis has dramatically compressed the timeframe to deliver, not only due to the unprecedented growth shock but also by accentuating several pre-existing trends. In a world where protectionism and the willingness to use finance as a diplomatic weapon is only increasing, the absence of a strong financial system threatens both Europe's ability to recover and its economic sovereignty.

European banks entered the current crisis well capitalised and this, combined with the swift action by governments and the ECB, has helped protect the supply side of the economy from the initial liquidity shock, and not least at a time when foreign banks have tended to pull back.

Ensuring sufficient European bank capital to finance recovery will require that the finalisation of Basel III does not result in an excessive capital burden and that banks can continue to access a diverse pool of private investors. Near-term, visibility on temporary measures including dividends would help ease investor concerns, but the key metric ultimately is profitability.

The prospect of losses due to Covid19 is something that banks share globally, but Europe's fragmented and cumbersome approach, be it tackling NPLs, bank resolution, the regulatory framework or future integration adds significant pressure. The detrimental effects were already all too visible pre-crisis, holding back the transformation of financial system even as Brexit loomed.

Consolidation of the European banking industry is central to securing economies of scale and freeing up resources for the much-needed digital transformation. Early July saw the ECB launch a public consultation on its supervisory approach to consolidation and this marks a positive step, but far more work is required to secure the single jurisdiction key to any Banking Union.

Equally critical is delivering CMU. It is evident from the current crisis that non-financial corporations need more equity capital. Excessive reliance on debt not only leaves non-financial corporates more vulnerable to refinancing risks but may arguably also be holding back more productive investments, thus weighing on trend growth. Accessing a diverse pool of equity financing requires deep capital markets and consideration should also be given to the securitisation framework, the coordination of supervision, and the relative tax and regulatory treatment of debt and equity.

A single safe asset is often seen as a bellwether to finalising Banking Union and delivering CMU. The landmark Council agreement on Next Generation EU, will pending parliamentary approval, allow the Commission to raise €750bn of debt on capital markets and marks important progress; but this is not the genuine single safe asset that the euro area needs and overcoming the political hurdles will take time. Even absent a single safe asset, there is room for considerable progress on CMU and the recent conclusions of High Level Forum offered a welcome tangible roadmap.

> *The absence of a strong financial system threatens both Europe's ability to recover and its economic sovereignty.*

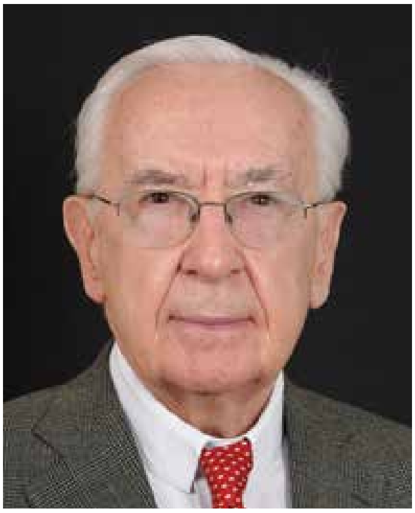
The time to act is now. The ECB has already taken its rates to exceptionally low levels and the existence of a reversal rate, where the effects of further monetary easing turn contractionary, is well accepted. While its level is yet unknown in practice, finding out could trigger a new major crisis that Europe cannot afford. It's no wonder that the ECB continuously calls for greater financial integration and a stronger international role for the euro.

It's no exaggeration to say that the euro's future today depends on its financial system; absent a strong and unified system, Europe will struggle to finance recovery and not least one that prioritises its goals of a greener and fairer society. The option to continue to muddle through and rely excessively on foreign banks, third-country financial centres and the dollar is simply no longer viable. ●

II. CHALLENGES AND CONDITIONS FOR RELAUNCHING GROWTH

Content

Is current monetary policy doing more harm than good and are there alternatives?



Jacques de Larosière

Former President, EUROFI

Negative interest rates cannot save indebted economies

Can interest rates be eliminated to avoid servicing monumental debts? The Covid-19 crisis, exacerbated by the consequences of having hyper-accommodative monetary policy for too long, has led to entire economies becoming over-indebted.

To deal with this situation where public leverage has broken all peacetime records, some advocate monetising the debt through central bank purchases of new bond issues and negative interest rates. This is despite the historical record which shows that debt restructurings have proven to be the most effective way to address unsustainable debts.

In the context of economic depression, low inflation and interest rates already at zero, central banks of course cannot achieve negative real interest rates. So, instead, they may want to retrieve some margin by deliberately setting negative rates. Monetary policy would then regain its traditional driving role, as it would be able to recreate negative real rates, despite a lack of inflation.

Proponents of this approach have anticipated some of the objections.

First, the liquidity trap. When rates are negative, investors tend to shun bonds to avoid the "tax" caused by negative rates. One result of this is an accumulation of savings, held in liquid assets such as banknotes or cash accounts. But these barely help foster productive investment.

Proponents of negative interest rates argue that the response to this problem is to eliminate large denomination banknotes and ensure that banks pass on the full cost of negative rates to their depositors. But should depositors be taxed and made to pay most of the cost of emerging from this crisis? That would create major economic and political problems in a country like France, where household savings historically finance about 85 per cent of national investment.

Then there is the risk of inflation. In the long run, any anti-recessionary monetary policy must eliminate the difference between potential growth and currently depressed growth rates through money creation. The risk of inflation is nonetheless considered unlikely given the scale of the Covid-19 crisis, the slow recovery, and structural forces such as ageing, unemployment and technological progress. Even if inflation does return, there will still be time to turn the tide and return to more traditional monetary policy.

Surprisingly, such proposals — which are designed to eliminate an economic fundamental, namely the price or cost of saving — fail to consider an essential question: the value of money. Money is based solely on trust. But the risk of losing that trust will loom if those responsible for it resign themselves to a role that leaves them as suppliers of an unlimited commodity rather than as vigilant guardians of its stability.

Moreover, the moral hazard of a system where indebtedness can be permanent and infinite, regardless of debtors' credit quality, poses serious moral and political problems as it nationalises risk and responsibility.

Negative rates also damage productive investment. They encourage companies to take on cheap debt to pay for share buybacks instead of investment; allow zombie companies to survive, lowering overall productivity; encourage asset bubbles; obliterate the distinction between profitable and unprofitable activities; and make little or no distinction between good or poor-quality debtors.

An economy where interest rates remain negative for decades will not inspire confidence in entrepreneurs. Paradoxically, it will create more precautionary savings. The monetisation of government debt — most of which will end up on central bank balance sheets — will also lead to creeping economic nationalisation and crowd out profitable economic activity.

Everyone knows how excessive debt can lead to crisis. We have paid the price of this causality for decades. And yet negative interest rates open the credit floodgates to both governments and the private sector. They are a source of financial instability and help to create asset bubbles.

A more reasoned policy response to over-indebtedness is clear. Undertake, where necessary, debt restructurings with a co-operative spirit and a sense of market priorities. Scrutinise public budgets and prioritise certain future expenditures, such as education, health and research.

Last, undertake the structural reforms that have been postponed for too long but are the only measures that can deliver a sound, sustainable and better future.

Boris Vujčić

Governor, Croatian National Bank

Hand that rocks the cradle: limits of unconventional monetary policy

A debate on side effects of unconventional monetary policies has gained a lot of traction over the past decade. Issues like governance of central banks or interaction of monetary policy with income and wealth inequality made their way into the mainstream. And then central banks reacted to the Covid-19 crisis with unprecedented speed, scale and scope. As recovery gradually advances, there will be ample time to contemplate potential effects and possible adjustments to the monetary policy. With no ambition to exhaust the topic, I will raise only a few points on overreliance on unconventional monetary policy.

First of all, we should not forget that monetary policy alone is far from sufficient to lift growth and inflation. Low interest rates are a real phenomenon rather than simply a reflection of monetary conditions. The "natural interest rate" has been on a declining trend for at least a few decades due to the combination of secular and cyclical factors. This trend has coincided with a slowdown in productivity and with falling investment levels. Adjusting dials on monetary policy instruments to reflect this underlying economic reality will not resolve the dearth of investment opportunities. Fostering perception that unconventional monetary policies will simply take away the savings glut is risking inaction on more relevant policy-front.

The real issues for economic policy are how to improve business environment, remove structural impediments for investments, foster competition, boost investments in R&D and encourage new businesses to start and grow. Long period of exceptionally loose monetary policy may provide a headwind as it softens the debt sustainability constraints and can reduce both government and corporate dynamism, capturing economic resources in inefficient uses. In communism something like that was called soft budget constraint, and the central bank was in charge of enabling it.

Excessive reliance on unconventional monetary policies may divert attention from needed policies.

The impact of unconventional policies on financial system is another popular topic. We rely on a healthy financial system in order to pass-on our monetary policy actions to the wider economy, and the financial system relies on maturity transformation with upward sloping yield curve to function properly. Sure, loose monetary policy is supporting banks' loan books and banks can improve on their cost effectiveness in order to dampen the effects of low interest rates. However, as we push our unconventional policies further, we may be nearing the "reversal rate" where damaging effect of persistently low interest rates and flattened yield curve overwhelms their positive effects.

Finally, one way in which unconventional monetary policy operates is the risk-taking channel. Encouraging "search for yield" type of behaviour should support investments. But it is also fuelling asset price rally and a boom in real estate markets. In theory, macroprudential policy should deal with growing imbalances and excesses in the financial markets. In practice, our macroprudential toolkit still lacks instruments to cover non-bank intermediaries in a comprehensive manner and cross-border activities may circumvent even the best policies. Also, significantly stepping-up macroprudential policies may exacerbate legitimacy issues. Monetary policy should not shun the financial stability concerns.

Monetary policy is like most medicines – it can speed-up recovery, but it is up to the immune system to restore health to its normal state. Undesired side effects expand if the medicine is administered for longer periods and if the dosage is increased. The primary goal for our economic policies should be to foster creation of profitable business opportunities, inject more dynamism and increase long-term growth potential. Excessive reliance on unconventional monetary policies may divert attention from needed policies and even work in the opposite direction – reduce government and corporate dynamism by creating the soft budget constraint and permeate our financial systems with risks.

Klaas Knot

President, De Nederlandsche Bank

New sails for new waters: towards a Covid-19 recovery policy mix

The Covid-19 crisis that has hit the economy poses unprecedented policy challenges for both economic policy authorities. The euro area economy is experiencing the worst recession since its inception. In response monetary, prudential and fiscal policy authorities have stepped in rapidly to help the economy establish a foothold as it went into lockdown. The ECB responded forcefully by employing a multitude of instruments including the new Pandemic Emergency Purchasing Program, while prudential authorities released capital buffers. Fiscal authorities responded swiftly with major stimulus packages by supporting workers and companies facing a sudden stop of economic activity.

Now that we have moved past the impact phase of the shock, we can shift our attention toward the recovery phase. Recently, forward-looking confidence indicators look robust, while high frequency data suggest that mobility is recovering. These developments solidify the confidence in our baseline projection with a more favorable balance-of-risks. However, even if no further setbacks materialize economic activity will only approach pre-corona levels at the end of 2022. It is therefore clear that ample policy support to the economy will remain important also during the recovery phase.

At the same time, we will only learn more about the underlying state of our economy as the recovery unfolds. What we do know is that the observed increase in private sector savings as a consequence of crisis-induced uncertainty provides a strong rationale and leeway for the public sector to increase spending to lean-against the increased propensity to save. Over the medium to longer-term horizon, dissipating uncertainty will invoke a resumption of private sector activity which will allow fiscal support to be gradually withdrawn. At the same time, we have learnt that there are significant benefits to ensuring that fiscal policy moves consistently with monetary policy. Looking ahead, the extent to which the impact on the economy will materialize as a demand versus a supply shock is still unknown. While we are fairly confident that in the near-term increased uncertainty implies a strong withdrawal of aggregate demand, in the medium to longer-run negative supply effects may very well gain relevance as businesses adjust their production processes to the new environment. Since the latter would be associated with upward price pressures, this impacts on the intensity with which monetary policy can continue to support the economy.

Relying too heavily on monetary policy to get the job done might have contributed to perceptions of a "central bank put" in the recovery from the euro area debt crisis, where the ECB bore all of the downside risk to the economy. More generally, an important element was missing in the policy mix. Monetary policy can be successful in eliminating slack in an economy, and, indeed, euro area labor markets saw a strong recovery. But without sufficient sustainable (public and private) productive investment to put the economy onto a permanently higher growth path, it is difficult for sustainable growth to take hold.

These observations imply that the policy mix will continuously have to be adjusted in terms of composition, based on our evolving assessment of the economic outlook. A broad and encompassing policy response is important to ensure that we don't rely overly on individual measures or policy areas that could be subject to unintended side effects if they are kept in place for too long.

It is in this light that I particularly welcome the establishment of the European Recovery Fund that has been agreed upon by the European Council. It is vital that, contrary to previous crisis episodes, in the wake of this crisis productive investment does not get crowded out by the immediate need for countercyclical stabilization policies. Furthermore, the recovery fund provides an important political signal that we do not stop short at only stabilizing our economies, but also take the opportunity to address common longer-term structural challenges that enable us to sail through future storms smoother.

Madis Müller

Governor, National Bank of Estonia (Eesti Pank)

Evergreen temporary policy measures may pose hidden risks

History has shown that the next crisis may hit us before policy makers have exited from the stimulus measures applied during the previous emergency. The limits of monetary policy have been significantly extended in recent years both by introducing new policy tools, as well as by going beyond what has previously been the norm with traditional instruments, such as lowering the interest rates.

Most of the non-standard measures applied during the last decade have been initially proposed as temporary measures to address a very rapid fall in activity. As the economic outlook and the conditions in the financial markets have not improved significantly, the extensive policy support has become long lasting. By introducing temporary policy measures, we understandably focus on their expected short-term positive impact. Given their intended short-lived use, there is less of a need to worry about their long-term effects, which in any case are also more difficult to foresee. Decisive action by central banks has worked well by easing the financing conditions at times where markets where freezing up or by supporting the gradual recovery. Nevertheless, we should refrain from viewing the very accommodative policy stance as the new standard just because it has been around for long.

An important innovation during the last crisis was the ability to utilize the extra policy space provided by negative rates. Following the conventional logic of banking, negative rates might trigger dramatic changes in business models. The fact that negative rates would be introduced only for a limited time was expected to mitigate this risk. Now that ultra-low rates have been around for longer than initially expected, we need to study the impact this might have on the term structure of interest rates, business models in the financial sector, or changes in the real economy.

When temporary measures last longer, they may bring about structural changes that are not the expected outcome of the policy. Structural shifts in the financial sector caused by the prolonged accommodative policy stance can be viewed as unintended side effects of monetary policy. While change is natural and there might be nothing wrong with the financial sector adjusting to new policies, there may also be changes that weaken policy transmission.

A timely exit from temporary emergency measures is just as important as decisive policy action during the acute phase of a crisis.

Asset purchases by central banks have led to flatter yield curves and lessened the turbulence in financial markets. But there is also the risk that central bank interventions may weaken the role of markets in adequately pricing the credit risk. This in turn may hold back favourable structural changes in the private sector and necessary reforms in the public sector, both leading to lower productivity. "You cannot fix the roof when the house is on fire" and similar considerations are valid during the days of an acute crisis.

However, one should be careful not to plant the seeds for the next crisis by allowing short-term relief provided by policy measures to continue for too long. We know that debt levels and asset prices tend to become elevated, as interest rates remain low for a long period. High levels of debt in turn can limit the upper bound of policy rates, since financial and political stability concerns may emerge.

A timely exit from temporary emergency measures as the economic outlook gradually improves is just as important as decisive policy action during the acute phase of a crisis. This will minimize the risk of undesirable side effects of accommodative monetary policy kept in place for longer than strictly necessary. Other factors can facilitate a timely exit from non-standard policy measures. For example, a fully functional Capital Markets Union can contribute to a more efficient transmission of the monetary policy. In addition, a regulatory environment that encourages the creation and use of financial buffers in the real, financial and the public sector may improve the resilience of the economy and reduce the need for policy support.

Jordi Gual

Chairman, CaixaBank

The specter of fiscal dominance

The struggle to contain the epidemic has immersed the global economy in a recession of unprecedented scale. The response needs to be bold, everywhere and by everyone. Everywhere because there is a need for a synchronized recovery –otherwise, weak external demand will lead to a slower and incomplete rebound. And by everyone because all policymakers, both monetary and fiscal, need to act forcefully.

There is little doubt that they have risen to the challenge. Monetary policy has done what was necessary thus far. In the eurozone, the ECB has not only supported the economy but also –and crucially– preserved an effective policy transmission and swiftly placated any signs of financial fragmentation. On the fiscal front, the response has also been commensurate to the crisis. In the European Union, not only at a national level but also at the Union level with the agreement on the Next Generation European Union (NGEU) package. A consequence of this necessary fiscal boldness, however, will be a staggering increase in public debt levels. This is not without risks.

An easy monetary policy and a fiscal expansion will reinforce each other and make the overall response more effective and efficient. Policy coordination, however, must be the result of independent institutions acting within their respective mandates. This is a fundamental cornerstone of every prosperous economy and cannot be taken for granted. It could easily be compromised by the simple fact that every monetary policy action has fiscal consequences, more so in the age of quantitative easing.

High budget deficits and public debt levels raise the specter of fiscal dominance, especially if the central bank holds a significant portion of domestic public debt on its balance sheet. Under these conditions, there is a serious risk that the decisions of a central bank end up geared toward guaranteeing the sustainability of public debt rather than achieving a certain level of inflation. Fiscal authorities may also take advantage of this bias and delay the necessary fiscal adjustments when economic conditions improve.

The coordination problem is even more complex in the case of several sovereigns sharing a central bank, such as in the euro area. A robust institutional architecture is absolutely key to surmount these challenges anywhere but even more in a monetary union that remains incomplete and where fiscal rules do not have a successful implementation track record.

This is why NGEU –funded by common debt issuance and including grants– is a very welcome step. With its €750bn firepower, it will meaningfully add to macroeconomic stabilization efforts, easing an excessive reliance on monetary policy, and can spur reforms and investments that increase potential economic growth. The issuance of EU debt in large quantities will also enable the creation of a European safe asset that increases the effectiveness of monetary policy, improves financial integration and mitigates the bank-sovereign doom loop.

But more will need to be done. For instance, European fiscal rules need to be reviewed with a view to simplifying them, moving away from the use of imprecise estimates of unobservables like the output gap. Instead, simple spending rules may be easier to monitor and implement. The Banking and Capital Market Unions also need to be finalized.

Robust institutions are key to allow fiscal and monetary policies to work hand in hand when their joint action is needed. But also, to allow them to part ways when the time comes to do so.

Xavier Larnaudie-Eiffel

Deputy Chief Executive, CNP Assurances

Low interest rates: What should policymakers do?

Interest rates have been at historically low levels for many years and are widely expected to stay low for some time. Low interest rates drive down returns on new and re-investments and this can have some major negative impacts on insurers and also on their customers.

For customers, low rates mean higher non-life insurance prices, lower guarantees, fewer long-term savings and — potentially most damagingly — lower pensions when they retire. For insurers, in addition to lower returns on investments, low interest rates can significantly increase the valuation of liabilities and capital requirements and make it more difficult to offer long-term products and guarantees, particularly in respect of long-term business and investments, which tend to exaggerate liabilities and capital requirements. Very low and especially negative interest rates amplify these measurement problems.

Insurers have been taking actions and adapting for many years in response to low rates and this has helped them to remain strong and profitable. Actions taken include looking hard for investments (such as infrastructure) that can provide a reasonable trade-off between risks and returns, even under current market conditions. On the liability side, companies have adjusted prices and lowered guarantees on new business in line with the lower returns available. In some cases, products have been redesigned, costs cut and there has been a shift towards unit-linked business. And, of course, asset/liability matching and hedging remain key tools that are used to manage interest rate risk.

So, what should policymakers do? Firstly, in setting monetary policy, they need to consider, along with the potential benefits, the wider and negative impacts of low interest rates on long-term consumer savings and pensions. While, the need for low interest rates following the global financial crisis and now the COVID-19 pandemic is well understood, the monetary policy behind the low rates should be continually reviewed and planned with an exit strategy in mind.

Secondly, policymakers should make use of the current review of the Solvency II insurance regulatory framework to address measurement flaws that can create important barriers to long-term business and investment. Some of these flaws are amplified by the low interest rate environment. Addressing these is especially important, given the need to encourage insurers to contribute to supporting the recovery from COVID-19, to supporting sustainable long-term growth and financing transformation to net zero carbon and to tackling the pension savings gap — rather than preventing them from doing so.

There are two main improvements needed related to the valuation of liabilities. One is the Volatility Adjustment which is intended to reflect the additional return above the risk-free rate insurers can earn on the assets backing liabilities in order to avoid artificial volatility in the balance sheet. This is currently designed and calibrated unnecessarily low and also results in too much artificial volatility in insurers' balance sheets. The other is the Risk Margin which is a notional amount above the amount actually needed to pay all costs and claims and is added to make liabilities transferable in a market context. However, in 2019 it reduced European insurers' total capital by over €180bn and is another source of artificial volatility. These two issues unnecessarily reduce the industry's capacity for and interest in long-term products and investments.

> *Policymakers should make use of the current review of the Solvency II insurance regulatory framework to address measurement flaws.*

Changes in interest rates, including if they go negative, are already immediately reflected in the valuation of insurers' assets and liabilities. The interest rate methodology used in Solvency II as part of liability valuations is already conservative enough and should not be changed. For example, the euro risk-free rates in Q1 2020 were -0.12%, 0.12% and 1.49% for years 10, 20 and 40 respectively. The current solvency capital requirement (SCR) to cover the risk that interest rates go even lower needs some change because it does not currently allow for negative rates. However, care must be taken in setting an appropriate and plausible "floor" on how negative interest rates can go.

Low interest rates are already a challenge for insurers and customers. Policymakers should use the Solvency II review to fix measurement flaws and so help insurers play their role in protecting and investing.

Alexandra Dimitrijevic

Global Head of Research, S&P Global Ratings

Post-Covid-19 productivity growth is paramount to cope with higher debt

The extraordinary monetary policy response to the Covid-19 crisis has bought time. It averted a liquidity crunch by sustaining the supply of credit and keeping debt markets open. Combined with a massive fiscal response, monetary policy helped preserve economic capital and social cohesion. Illustrating this, investment-grade bond issuance in Europe increased about 180% since the ECB created PEPP, the region's unemployment rate barely increased, and the 12-month speculative-grade corporate default rate rose only slightly to 3.2% in July. Even so, this is nothing like a normal recession. No central bank nor government can fully control the virus's evolution nor when a vaccine will become available. The necessary opening of monetary and fiscal spigots has elevated global leverage to new highs.

This follows a decade of steady increases, weighing further on corporate and government creditworthiness. Global debt reached a record high of 331% of GDP at end-March, up from 320% in 2019 and 200% in 2011 according to the IIF, driven largely by governments and corporates. The GDP-weighted median rating of EU countries weakened from 'AA+' to 'AA-' as the financial crisis snowballed into the Great Recession and sovereign debt crisis.

As for corporates, low interest rates in the past decade have enabled those with weaker credit profiles to access capital markets. As a result, we entered today's crisis with 11% of European non-financial corporate ratings at 'B-' and below, indicating high vulnerability to economic and financial cycles. Most additional COVID-19-related public debt globally has been incurred by countries with wealthy economies, monetary and fiscal flexibility and reserve currency status (G7 countries account for about two-thirds of global direct and indirect fiscal support). At the EU level, S&P Global Ratings estimates the median sovereign debt will peak close to 64% of GDP by year-end, up from 58% at end-2019, but low interest rates will ease the burden. Taking Italy as an example, while general government debt is set to rise by 20 percentage points to 147% of GDP at the end of 2020, the interest burden should remain below its 2018 level (close to 7% of revenues).

The situation is more difficult for lower-rated countries, particularly in emerging markets, more vulnerable to fluctuating capital flows and with less flexibility to cope with the economic consequences of the pandemic. Ultimately, containing the build-up in credit risk across the EU will hinge on the strength of the recovery and the resilience of non-financial corporate, which were hit first and hardest by the recession. Though the effects have been uneven across sectors, it may take well into 2022 or later for certain industries to return to pre-COVID-19 credit metrics, and some like retail face an accelerating secular shift toward digital.

As a result, we forecast the speculative-grade corporate default rate in Europe to rise to 8% in the next 12 months. Although banks entered the crisis with solid balance sheets, they are not immune. We estimate credit losses for banks in Western Europe will more than double this year and next. While preprovision earnings should cover most of those, some banks will unavoidably report net losses. Durably low rates and flat yield curves will exert further pressure for many to undertake a further round of structural reforms.

> *The monetary response averted a liquidity crisis, but solvency challenges will hinge on higher growth.*

The pace of withdrawal of extraordinary fiscal support will be critical to the unfolding of the crisis. Policymakers will have to manage the delicate balance between the risk of rising bankruptcies with the long-term costs of greater government intervention. While preserving employment is beneficial in the short term, the survival of companies with unsustainable capital structures or obsolete business models might hinder long-term productivity.

The accommodative monetary policy will buy time, but prolonged, very low interest rates tend to fuel asset bubbles and push investors in search for yield take on greater credit risks. More positively, there is momentum to implement structural reforms and build greater potential growth by funding infrastructure and human capital development to support the digital and green transitions. While government has its role to play, we believe the shape of recovery will depend on how the corporate sector emerges from this crisis.

Conditions for relaunching growth in the EU

Rolf Strauch

Chief Economist,
European Stability Mechanism (ESM)

Addressing post-Covid invesment needs

Euro area investment never fully recovered from the collapse during the European financial and sovereign debt crisis. Even today, Europe has not caught up with the upward investment trend which existed prior to the 2008-12 crisis. While it is true that the euro area investment to GDP ratio increased by four percentage points between 2014 and 2019 and reached levels recorded prior to the previous crisis, this did not compensate for the damage done by the significant decline in investment and loss of capital which the euro area suffered during the previous crisis.

At the same time, the euro area exported savings abroad by running most recently a current account surplus for a number of years. By comparison, the investment gap compared to trends prior to the global financial crisis is much smaller for the US, less than half. As a result, Europe was not on track to meet its R&D investment targets and failed to generate new market leaders in technologically strategic sectors. Relative to the United States, particularly the service sector lags behind in its digitalisation.

There are different drivers of this investment gap in the public and private sector. First, public investment displays a downward trend from 2009 to 2018. This means the recovery of the investment rate during the period 2014 to 2019 had to be driven by private investment. Second, private investment did not accelerate in the post-crisis environment because the corporate sector needed to deleverage, in some countries coping with an overhang in residential investment.

Investment was generated once the liabilities decreased sufficiently. Second, investment is highly sensitive to uncertainty in the medium-term outlook. Effectively, growth prospects were rather subdued and uncertain in aftermath of the crisis and it took some time until expectations had fully consolidated on a growth scenario. Third, Europe has a much smaller market for risk capital. While Europe's stock market capitalisation is half its gross domestic product, US stock market capitalisation is nearly double the country's GDP. Enlarging Europe's capital market could provide necessary growth financing.

The pandemic crisis further increases investment needs, while the indebtedness of firms and governments has already started to increase. The pandemic causes a liquidity squeeze for companies and households. The European Commission estimates that the loss of equity in the European corporate sector may amount between EUR 720 billion and EUR 1.2 trillion depending on the length and severity of the crisis. These investment needs differ substantively across countries, depending on the degree to which the crisis affected each country.

Similar to the past crisis experience, it can be expected that households and companies will again engage in precautionary savings as the uncertainty regarding economic prospects persists. As a result of this situation, investment may remain suppressed, despite the substantial stimulus provided by both fiscal and monetary authorities. The fiscal measures taken now will also leave less space for manoeuvre to promote capital accumulation through budgetary spending later on. Differences in fiscal space across countries reinforce economic divergence.

Europe needs to engage in a strategy of structural reform and targeted fiscal support at the national and European level. During the recovery phase, public investment should support R&D and human capital, digitalisation and the greening of our economies. Policies addressing climate change imply substantive investment needs to cover transition risks and contain carbon levels. Targeted public support to companies is needed to overcome market failures and balance sheet constraints.

> *Regulatory reform should aim to improve the single market for both services and capital.*

Support to be effective during the recovery needs to be directed to productive and growth-enhancing sectors, rather than shielding companies from necessary adjustments when facing oversupply. The bulk of policy initiatives will have to be based on structural and regulatory reforms. Investment support and regulatory reform have both a national and European dimension. European efforts complement national measures in providing support to ensure a level playing field.

The New Generation EU and the Recovery and Resilience Fund will be instrumental. Regulatory reform should aim to improve the single market for both services and capital. Advancing Banking Union and Capital Market Union should facilitate the necessary private sector funding and risk-sharing across countries.

Mario Nava

Director General, DG REFORM,
European Commission

Technical Support, DG REFORM and the recovery and resilience of EU Member States

On 27 May 2020, the European Commission put forward a very wide-ranging package combining the future Multiannual Financial Framework (MFF) and a specific Recovery effort under Next Generation EU (NGEU)[1] in order to respond to the impact of the coronavirus pandemic. A key element of the proposed Recovery effort is the Recovery and Resilience Facility (RRF). The special European Council of 21 July 2020 agreed on a comprehensive package, which includes the proposed RRF. Of course, this Council Agreement is a very important step opening but not the end of the road as the European Parliament still has to vote on the whole package of the MFF and the Recovery Instrument.

The proposed RRF will provide large-scale financial support to reforms and investments undertaken by Member States, with the aim of mitigating the economic and social impact of the coronavirus pandemic and of making the EU economies more sustainable, resilient and better prepared for the challenges posed by the green and digital transitions.

The support will take the form of up to EUR 360 billion in grants and up to EUR 312.5 billion in loans and will be demand-driven. To access the proposed RRF, Member States should prepare recovery and resilience plans setting out their reform and investment agendas for the subsequent four years, until 2024. These plans should comprise both reforms and public investment projects through a coherent package.

Following the 21 July agreement in the European Council on a powerful, modern and revamped 2021-2027 long-term EU budget with NextGenerationEU at its heart, a Recovery and Resilience Task Force was created within the European Commission's Secretariat-General. Under President von der Leyen's authority, the Task Force supports Member States with the elaboration of their recovery and resilience plans, ensures that plans comply with the regulatory requirements and deliver on the objectives of the green and digital transitions and monitors the implementation of financial support and coordinates the European Semester in this period of time.

However, as we know all too well, money alone will not ensure recovery. Investment and reforms are both essential components of the economic recovery and of the strengthening of the economic resilience. Member States will require support in designing and implementing such investments and reforms. The Commission created in January 2020 the Directorate-General for Structural Reform Support (DG REFORM), which took over the mandate previously carried out by the Structural Reform Support Service.

DG REFORM supports EU Member States carry out reforms to stimulate job creation and sustainable growth. EU Member States can ask DG REFORM for tailor-made support and expertise in a wide range of policy areas covering EU priorities and EU law or areas of national interests and initiatives. The support offered covers the whole reform cycle, from identifying needs to implementation, monitoring and evaluating outcomes. Today, DG REFORM is engaged in over 1 000 projects in all 27 EU Member States.

To deliver the support to Member States, DG REFORM has been managing a dedicated programme – the Structural Reform Support Programme (SRSP) – with a budget of EUR 222.8 million for 2017 to 2020. The Commission proposed to replace the SRSP as of 2021 by a new proposed Technical Support Instrument (TSI). The proposed TSI puts particular emphasis on support to the recovery and resilience of Member States, including support to the green and digital transitions. It also provides, as a matter of priority, for the support to the preparation and implementation of recovery and resilience plans.

The European Parliament will soon vote on the EU Council of 21 July affirming that the Technical Support Instrument (TSI) will improve Member States' administrative capacity to design, develop and implement reforms, and that TSI will be available for all Member States with a financial envelope, for the period 2021-2027, of EUR 767 million. ●

1. COM(2020) 456 final.

Thomas Westphal

Director General European Policy,
Federal Ministry of Finance, Germany

Beyond the crisis – Conditions for the relaunch

The Covid crisis has put a heavy strain on the European economies. The slump in GDP in the first half of 2020 is of historic proportion. While current economic indicators point to activity moving towards pre-crisis levels in many sectors, uncertainty about the further course of the pandemic and thus the economic recovery remains.

The EU and its Member States have responded to the challenges with unprecedented determination and speed. In the area of financial and economic policy, we have activated the general escape clause in the Stability and Growth Pact so that Member States can take timely, temporary and targeted action to deal with the ▶

social and economic consequence of the pandemic. At the same time, the EU Commission adopted a Temporary Framework for State Aid Measures. With the pandemic crisis support of the ESM, liquidity support from the EIB and SURE as a temporary support instrument to mitigate unemployment risks in an emergency, we have adopted first building blocks of a Covid shield for Europe. In July, we achieved another major breakthrough with the European Council's agreement on the recovery programme Next Generation EU with its main spending tool, the Recovery and Resilience Facility (RRF), which goes beyond emergency measures, balancing the need for immediate economic support with the need to provide sustainable and inclusive growth. A key project of the German Council Presidency will be to finalise the RRF and make it operational.

Governments of individual member states, EU institutions and the EU as a whole have assumed a special and extensive role in this specific situation. In the acute phase of this crisis, governments stepped in to provide companies with liquidity, to keep people in employment and, overall, secure the confidence of people and companies. With these measures, governments help to build a bridge over the deep crisis, avoiding long-term damages to the economy and laying the fundaments for sustainable and inclusive growth. To enable a swift recovery, we will also need to improve the access of companies to financing via more integrated financial markets. This will also be a key priority of our Presidency.

It is now important to take the right decisions to strengthen the resilience of our economies and the EU and more specifically to increase Europe's growth potential. I am convinced that there is higher acceptance for change in the current crisis. We have to make use of the momentum and make the European economies fit for the future.

Challenges that already existed before the crisis are still relevant today: in particular, the need to address climate change in the context of a broader sustainability agenda as well as digitalisation. Demographic change and its effects on, among other things, the sustainability of public finances will also continue to concern us in the coming decades. We have started to address the question of strengthening investment and future orientated spending already before the crisis. This is about high quality public investment, but also about the right institutional setup for private investment. The crisis has highlighted weaknesses in our economies and structural framework. Nevertheless, it has also accelerated transformation processes; just think of the increase in cashless payments, smart working and video conferencing.

How can we get there? With the significant funds of the Recovery and Resilience Facility, we should address country-specific challenges identified for each country in the context of the European Semester. If we strengthen the forces of sustainable growth, a major step towards recovery and greater resilience will be possible.

The combination of national and European measures now gives us an opportunity that we have to seize. For all the suffering that this virus has brought upon us, it has also clearly shown that we stand and are stronger: Together. For Europe's recovery.

Dorothee Blessing

Co-Head EMEA Investment Banking & Chief Executive Officer, J.P. Morgan AG, Frankfurt, J.P. Morgan

Relaunching productive investment in Europe

The impact of COVID-19 as an extraordinary health and economic shock will likely be felt for months and years to come, with the long-term socioeconomic repercussions still unknown. As Europe pivots to a recovery phase, a strengthened banking sector, a continued drive towards Capital Markets Union (CMU) and preparing workforces with skills for the future will serve as the foundations for relaunching investment, and reigniting growth and job creation.

Throughout the crisis, banks such as ours have stood ready to help governments, our employees and our communities across Europe. In the first half of 2020, we prudently raised $1.2 trillion of extensive credit and capital globally for consumers and businesses of all sizes aimed at working capital and general corporate purposes, and provided governments with business expertise to help the recovery. In short, this demonstrates how banks, including those with headquarters outside the EU, fulfill a vital role in supporting the economy.

Yet concerns remain around the impact of non-performing loans (NPLs) on banks' balance sheets. Experience tells us that dealing with NPLs and ensuring banks' financial strength is critical to economic recovery. An improved EU securitisation framework, as recommended by the European Commission's High Level Forum (HLF), could help. When developed in such a way as to be responsible, prudentially sound and transparent, securitisation can act as an important vehicle to increase the capacity of bank lending and investors' access to European credit products. This is no less the case for NPLs, and could help banks de-risk their balance sheets.

We appreciate there remains a degree of scepticism surrounding securitisation as a consequence of the global financial crisis over a decade ago. However, the HLF, of which my colleague Vittorio Grilli was a member, outlines how the securitisation framework can be improved through better credit underwriting standards and NPL reduction, providing an increased scope for synthetic securitisation and a clearer role for Competent Authorities in Significant Risk Transfer assessments, as well as increasing clarity around disclosure and due diligence requirements, including in relation to third-country securitisation issuance. There is also the opportunity for the EU, alongside other global prudential regulators at the Basel Committee for Banking Supervision, to revisit the capital and liquidity treatment of securitisation issuance.

Critically, as well as encouraging cross-border investments, a better securitisation framework could specifically support the financial needs of SMEs, the growth engines of Europe, as well as acting as the bridge between the Banking Union and CMU.

We are also supportive of the HLF's broader CMU recommendations, in particular the need for a review of disclosure rules to improve retail investors' decision-making, strong infrastructure to ensure that financial markets maximise their role in funding the real economy, increasing Europe's role in developing a coordinated and consistent global regulatory framework, and improving financial health and literacy across Member States to increase retail participation.

It is worth bearing in mind that productive investment and growth are not just enabled by the traditional financial services domain of banking, lending and markets activity. They are also driven by a competent and diverse workforce equipped with the relevant skillsets for a changing world of work, which is also essential for rebuilding economies and supporting communities most affected by COVID-19.

At J.P. Morgan, part of our philanthropic efforts in Europe focus on helping adults adapt to the future of work through reskilling and upskilling for the digital transformation, supporting young people with skillsets for career readiness and providing upskilling pathways for vulnerable workers. We welcome the launch of the European Skills Agenda to upskill and reskill young people and adults for a digital and green world of work and to unlock public and private investment in educational and vocational training.

As the crisis recovery continues to evolve, the financial industry must continue to work in partnership with local organisations, governments and civic society to lend our resources and expertise toward solutions for recovery and help relaunch investment across Europe.

Jonás Fernández Álvarez

MEP, Committee on Economic and Monetary Affairs, European Parliament

Paving the final way for a historic EU response to the COVID-19 crisis

In July, the European Council reached a political agreement to make feasible the issuance of European debt of €750bn. This decision marks a monumental step in the project of (re)building Europe. The common fiscal response is a historically unprecedented move and addresses demands made in the resolutions adopted by the European Parliament (April and May 2020) which preceded the formal proposal of the European Commission. The additional resources of the Next Generation EU will be vital in order to relaunch the economy following months of confinement due to covid-19. The EU has supported member states both with fiscal (SURE, EIB, ESM, etc.) and monetary, through the new debt purchasing program of the European Central Bank, measures. However, this political agreement must now be confirmed through a legislative procedure in which the European Parliament will make efforts to review at least three fundamental aspects.

Firstly, the European Council agreement substantially raised the amount of national rebates for some member states at the expense of lowering expectations for the Multiannual Financial Framework (MFF) 2021-2027 and key programs for the Parliament, such as Horizon 2020 or Erasmus+. In addition, this agreement increased the amount of money available for member states through the Recovery and Resilience Facility, reducing the finance available in the Next Generation EU for Community programs. This translates into a dramatic reduction in the funding proposed by the Commission for InvestEU, Solvency Support, Just Transition, EU healthcare or foreign policy. In doing so, the European Council has cemented its position regarding the reduction of funding available for specifically European-based programs.

Secondly, the European Council has increased its key decision-making powers in terms of governance of the Recovery and Resilience Facility, which will now channel €672.5bn of the total debt issuance for the Next Generation EU. While the initial legislative proposal of the Commission left the Parliament with a minimized role, the agreement of the European Council has left the Parliament in a residual position. However, MEPs cannot allow one-third of the European budget (MFF and Next Generation EU) to be managed without democratic control. Therefore, I presume that the Parliament will have a clear, contrasting position regarding this point that must be negotiated before the end of the year with the Germany Presidency of the Council of the EU.

Thirdly, the Parliament is expecting to clarify the framework of European own resources in order to service the debt. The European Council has signed a lax and insufficient agreement which does not clarify the resources available for this purpose. The Parliament aims to eliminate any uncertainty regarding the resources available for European-based policies for the period 2028-34. This requires a strong position concerning the development of new European taxes that cannot increase the tax burden but must address current levels of fraud and tax avoidance. In addition, this requires the ability to tax more mobile tax bases at the European level in order to guarantee the efficiency of general tax systems.

In view of these circumstances, the Parliament welcomed the political agreement reached by the European Council. However, its formal approval faces new challenges. The Parliament has the power of veto on the MFF and full legislative competence on the Recovery and Resilience Facility. Thus, negotiations with the Council are pending, in order to consolidate all of these details and to pave the way for a true and significant European response to this crisis.

Laurent Zylberberg

Chair, European Long-Term Investors Association (ELTI)

Let's preserve Long-Term Investment!

In times of such incertitude, the role of National Promotional Banks and Institutions (NPBIs) and more globally of Public finance seems more obvious than ever.

Sustainable development, demographic changes and now health crisis are, in a way, the best incentives we could have for investment, especially for public long-term investment. This environment reinforces the diagnosis and considerably amplify the investment needs in social infrastructure, digital technology, health, innovation or sustainable transport. Since 2008, when constraints were put in place, the context have dramatically changed. We are now experiencing low interest rates, availability of liquidity, national downturns and the gigantic threat of global warming.

There is an imperative need to continue investing for the long-term. Our economic vehicle does not need a repair but a profound transformation for preventing any further breakdown. Our economies need strong public financial actors. They are enablers for investment as they trigger high leverage effect. Priority must be given to the functioning of the economy by favoring both debt and capital financing. This requires an easing of prudential measures which, in the current situation, risk leading to the financial embolism that we experienced in 2008. Then, it is necessary to take incentive measures, for example by financing the deferral of repayment of debt in favor of riskier investments, either because they are long term, or because they contribute to the general interest without necessarily having immediate financial returns, like social infrastructure (hospitals, affordable housing, educational establishments…).

In Europe, banking system is the main source for financing the economy, therefore the role of public finance is key for earmarking funds in the direction of the general interest needs. We need to think again, in this new environment, the meaning and the enforcement of prudential rules for the different actors and the different assets. This will be the price for having a tailor-made financing system. As countercyclical actors, NPBIs have to play an active role. If the EU wish so, they are prepared and ready. In Europe, their size (a total consolidated balance sheet of €1,700 bn for the 30 member institutions of the European Association of Long-Term Investors) and their prudent management give them the means to act.

Very responsive in the deployment of the Juncker Plan, they make a crucial contribution to relaunching investment. In this context, it is essential that they benefit from the active support of European actors and European tools. The Council of the EU agreement in July 2020 send contradictory signals with more solidarity between States and less means for European instruments managed by the European Commission. Among expected clarifications, restrictive measures on public funding should be alleviated by generalizing and simplifying the possibility of mixing European subsidies and investment with public capital.

More than ever, it is crucial today to give long-term investors the means to invest for tomorrow!

Carsten Brzeski

Global Head of Macro Research and Chief Eurozone Economist, ING

Fiscal policy to the rescue

Since the financial crisis in 2008/9, investment in Europe has remained low in comparison with pre-crisis levels. There are several explanations for this underperformance. Let's focus on two main themes: the lack of funding and too much uncertainty, ie weak growth prospects. An often-heard explanation for weak investments it the complicated access to risk capital and start-up funding. In this regards, fragmented financial markets, the unfinished banking union and high dependence on bank lending could be the reason why low interest rates and accommodative monetary policies have not kick-started investments. Despite so many measures by the ECB, the transmission of low interest rates to the real economy looks still hampered.

Indeed, even though external funding has been available excessively, it was mainly available to companies with direct access to capital markets and focused on few sectors like technology. Here, low interest rates and high-risk appetite have indeed reduced the cost of capital market funding. However, very accommodative monetary policies and low (to negative) interest rates have not at the same extent translated to lower costs and availability of bank credit. As a result, smaller sized companies face tighter financing conditions than large firms. Still, while small firms are typically most finance-constrained, their contribution to aggregate investment is generally relatively small. In addition, if only small firms had good investment opportunities but only large firms had access to funding, then some form of financing cascade could be expected to develop. Consequently, the

(lack of) access to funding cannot be the only explanation for weak investment.

A second explanation is uncertainty and low investor confidence as a reason why companies do not invest even though they do have the financial means. It is uncertainty about future economic conditions and whether the possible return on investment will actually justify its cost. In this regards, structural factors like ageing societies, fragmentation of growth and financial markets, euro break-up risks and the lack of a common fiscal policy seem to weigh on future returns on investment. With economic prospects often higher in other parts of the world, Europe has become less attractive for both domestic and foreign investors. As so often, there is no single explanation for such a complex phenomenon as weak investments in Europe. In reality, it is a combination of factors, which have kept investments weak. In addition to the above-mentioned factors, do also think of the lack of outstanding and symbolic future and high-tech oriented sectors in Europe like Silicon Valley in the US.

Looking ahead, given the complexity of weak investment, there also is no one single solution to finally unleash investments in Europe. Instead, Europe needs a multi-layered strategy. A strategy which does not only provide ambitious words like the old Lisbon strategy but a strategy which actually delivers and increases Europe's competitiveness in the global economy. Such a strategy needs to define a few sectors of excellence. The transition towards a carbon-neutral European economy as well as boosting digitalisation could be the unique-selling-point for Europe and trigger for investments, both from the public and private sector. The initiatives started by the new European Commission since late-2019 point already into the right direction. It is now up to national governments to take over the baton and implement measures and initiatives, in a coordinated matter.

In general, to unleash investments in Europe, governments and fiscal policy are currently key. Particularly as monetary policy has reached the limits of the lower bound. Making cheap money even cheaper will not kick-start investments. It needs fiscal policy, be it by creating (financial) incentives, be it by implementing structural reforms to increase European growth prospects or be it by defragmenting financial markets by finalizing the capital market union. The Covid-19 crisis has shown what governments and fiscal policy are able to achieve and deliver in an unprecedented crisis. Europe needs more of this if it wants to survive global competition.

Jean-Jacques Bonnaud

EUROFI

Europe must take charge of its strategic interests

Long term and productive investment is essential for economic growth. However, corporate, infrastructure, energy investments and R&D are higher in large economies than in Europe and real GDP growth and productivity gains in the euro area have failed to catch up with US, China and Japan over the past two decades.

In 2018, the EU invested EUR158 billion in climate change mitigation. At 1,2% of GDP this figure is marginally less than the United States (1,3%) and little over a third of China's performance (3,3% of GDP). Moreover, the Investment Report of the EIB (2019/2020) shows that the European Union is risking a gradual loss of global competitiveness with slow innovation, adoption of digital technologies and productivity growth. As of the end of 2019, Europe was not home to any of the world's 10 largest internet companies and only one European company were in the worldwide digital top 20. Europe is adding an Artificial intelligence (AI) gap to its digital gap. In June 2020, Europe had only 5% of the world's 483 unicorns – private companies with a value of at least $1 billion – compared with 47% for the US. China had 25% of unicorns (CBInsight, 2020).

The Covid -19 pandemic and the induced global lockdown have caused a sharp slump in the global and EU economies. This crisis also worsens economic disparities across the EU. In such a context, the big fiscal deal agreed at the European Council in July 2020 is a welcome and significant step forward which should strengthen the European Union. This move towards fiscal cohesion and solidarity is real and reassuring. For the first time, the EU will collectively borrow the plan's full amount from the financial markets and repay it from the EU budget over almost 40 years. The shock absorbing role for the EU is a real novelty and this EU fiscal deal may set a precedent for future crises to be met with collective debt.

But Europe also needs much more to fill its infrastructure gap, the goals of climate change, the rise of senior generations and other sustainable goals. Given its size and its duration, the Next Generation EU plan will only partly cover these needs. More will be needed for Europe to escape the current trap of low trend growth. The EU plan is not designed to cover all investment needs but to help low-income countries narrow their gap.

Among other key policies that must be delivered are European Banking Union and Capital Market Union (CMU) without which the EUs' key political priorities will not be able to be implemented. Faced with the "technological war" between the United States and China, Europe must lay the foundations of its sovereignty for the next 20 years. In the field of security and defence, reinforcing technological autonomy is essential. Sovereignty must also be exercised in the field of green technologies, and Europe must become the leader in this area. Technological challenges require a European industrial policy and strategy for technology funding. A holistic industrial policy marrying finance, research, industry, competition, trade, existing local eco systems and education is vital and urgent. The choice is simple: unite our forces to give Europe its economic independence or allow our industrial base and capacity to disappear. In this way, we need to rethink the EU competition policy in order to better protect our critical companies.

Such an EU approach also requires that Member States accelerate their homework and implement strong and credible domestic reforms in order to improve the business environment, the potential growth and the competitiveness of SMEs, facilitate the shift to renewable energies, promote digital services, education and skills and attract private investors whose savings are frozen or misallocated due to uncertainty and lack of confidence.

Should we be concerned about post-Covid financial stability?

Elke König

Chair, Single Resolution Board (SRB)

A sound framework to safeguard financial stability

The COVID-19 pandemic constitutes an unprecedented global shock. The latest economic forecasts point at the deepest recession since World War II and, at this stage, we do not yet know its full and final impact on the economy: it remains a very large 'known-unknown'.

In mid-March, stress metrics reached historical high levels, and strong market reactions led to major re-pricing in the financial markets, including sharp declines in bank equity prices. The large uncertainty surrounding the scale and duration of the pandemic's economic impact provoked acute stress in key funding markets (including US dollar liquidity markets), unleashing concerning destabilising dynamics and jeopardising financial stability.

Fortunately, during the last few months we have seen some easing of financial conditions and a substantial (although asymmetric) asset price recovery. This is the result of two main factors. First, we have much firmer foundations in place across Europe today than a decade ago. It is often said that one should never let a crisis go to waste. In Europe, we acted on the lessons of the financial crisis, and are now harvesting the benefits of that work.

The banking system is today more resilient as a result of the regulatory reforms adopted in the aftermath of the previous crisis. Banks have higher capital and liquidity buffers and lower NPL ratios, proving that the system on average is fit for purpose and can absorb shocks. Without the existing institutional and regulatory framework, a recession of this magnitude would have had immediate devastating effects on our banks and therefore on financial stability.

The ECB's most recent vulnerability assessment by contrast showed that, overall, banks in principle can withstand pandemic-induced stress, although there is still large uncertainty regarding the final magnitude of the crisis.

Second, swift and bold policy actions adopted by the authorities have substantially contributed to cushioning the global hit and thus safeguarding financial stability, including unprecedented ambitious monetary and fiscal measures.

At the SRB, in line with other European authorities, we have focused on giving banks operational relief but simultaneously moving forward with our resolution planning. Coordinated policy action by public authorities is supporting the banks' capacity to absorb losses and to channel funds to the real economy, which is especially relevant in times of large revenue shortfalls.

We have adopted a transparent and pragmatic approach, using the existing flexibility in our legal framework while ensuring that we do not undermine its credibility. Disorderly bank failures have proven their devastating effects in the past. Avoiding them is precisely our *raison d'être*. We cannot roll back recent reforms that have made our banking system more robust. Focus on making banks resolvable is key to protecting financial stability.

To conclude, the financial and economic outlook is still largely uncertain. The second quarter data point to an unprecedented and severe recession and an uneven recovery, as the economic toll of the lockdown is proving more severe than initially expected. Second-round effects like increased unemployment or precautionary savings could put further strain on the economy. High levels of debt may prove challenging for some borrowers, especially in case of a second wave of infections or hysteresis. Until now, banks have proven their resilience. Recent regulatory reforms have put our banks in a better shape to cope with the crisis, but they are not bulletproof. Banks are under severe profitability pressure, and asset quality deterioration would imply an additional burden at least for those institutions that are still recovering from the financial crisis. If the situation worsens, depletion of bank capital would be material.

The banking system is today more resilient as a result of the regulatory reforms adopted in the aftermath of the previous crisis.

Looking forward, we must continue our work on the completion of the Banking Union, building on the progress achieved thus far. We will continue to support the recovery and strive to ensure that banks keep on acting as a countercyclical force, and not as an amplifier of financial instability.

If, and when needed, we have the appropriate tools to manage bank failures effectively and avoid financial instability. We also firmly believe they will be up to the task. Solid resolution planning and resolvable banks are the best safeguard of financial stability. ●

Denis Beau

First Deputy Governor,
Banque de France

After the Covid shock, treading carefully and drawing the necessary lessons

Several months into the pandemic, we are still grappling with its consequences: speaking of a "post-Covid" world is premature. The public health dimension is and will remain front and center in the near term. As for the economic outlook, the worst may be over but the speed and extent of the recovery remain uncertain and the economic and social consequences of the pandemic will remain with us for quite some time (when they have already surfaced yet).

So far, potential threats to global and European financial stability remain under control. Two factors proved decisive so far for navigating this stormy sea. First, the banking sector held up, providing a clear vindication of the reforms introduced in response to the global financial crisis, and allowing it to contribute to the support of the real economy. Second, swift, simultaneous and massive measures taken by economic and financial policy makers have helped dampen the shock to the real economy and maintain the stability of the financial system as a whole.

Yet, we are not out of rough waters. The current circumstances call for remaining cautious in the near term, executing a balanced exit strategy over the medium term and addressing longer term challenges.

In the near term, the strong improvement in sentiment and associated markets rally call for caution. While a positive development in itself, it raises the probability of a disconnection between asset prices and underlying economic conditions. Managing market sentiment is elusive, especially in such uncertain times. But reining in excessive risk-taking and being prepared for the possibility of a market correction will be key to ensure financial stability.

Current geopolitical risks only compound these concerns. Now that uncertainty around the Brexit timeline has been lifted, all stakeholders must finalize their preparation to smoothly get past the end of the transition period or collectively face a renewed risk of market stress in an environment already weakened by the Covid.

Massive public support has provided essential protection to households and firms. A decisive and most welcome step forward has also been taken at the EU level with the European Commission's Next Generation EU proposal, which should strengthen the EU's economic stability by introducing a mechanism for fiscal solidarity between State members critically lacking until now. Both –public support and fiscal solidarity- were and are still necessary but should not give way to complacency vis à vis the need to tame –in due time- fiscal spending to ensure fiscal sustainability.

Public support needs indeed to be carefully managed and eventually phased out in order to avoid backfiring to the real economy through worsening financial conditions. At a later stage (but sooner rather than later), refilling the buffers that helped cushion the shock in the banking sector will be necessary to ensure that the banking system remains part of the solution to ensure the recovery of our economies.

Finally, "pre-Covid" longer term developments and associated risks need more than ever to be addressed.

At the top of the list lies high levels of debt, and leverage, which exacerbate risks. Despite public support, an upturn in corporate insolvency risk and bankruptcies could weaken banks' balance sheets and weigh on the credit supply the recovery depends upon. Accordingly, negative shocks to households' income would increase the weight of debt service, resulting in slacker consumption and, in more extreme scenarios, greater credit risk. The "post-Covid" recovery will have to avoid overreliance on debt fueled growth and the associated build up in vulnerabilities.

> *"Pre-Covid" longer term developments and associated risks need more than ever to be addressed.*

In addition, the stress in a number of core markets in March laid bare the vulnerabilities of market based financial intermediation. It only receded thanks to massive central banks' interventions and highlighted tensions between individually legitimate actions (e.g. MMF seeking to strengthen their own liquidity position) and their destabilizing consequences (exacerbated liquidity stress for other stakeholders, including banks and corporates). A much more comprehensive macroprudential framework is long overdue to effectively underpin financial stability.

Finally, the massive scaling up of remote working brought about by the pandemic heralds an acceleration in the digital transformation of the overall economy. For the financial sector, it entails major challenges to business models' , exacerbates cyber-risks and requires major investments going forward. Similarly, the pandemic shock is a foretaste of what is just around the corner if climate change is left unchecked.

Not only banks and other financial institutions should proactively adjust to the low carbon transition and brace for adverse physical risks likely to materialize even in a 2°C world but, just as they did in this crisis, they should aim for being a decisive part of the solution. ●

Francesco Mazzaferro

Head of the ESRB Secretariat,
European Systemic Risk Board (ESRB)

COVID-19 pandemic: financial stability implications for the EU financial sector

Following the onset of the COVID-19 pandemic, EU bodies, national governments, central banks, and supervisory and resolution authorities took unprecedented action to support the economy. Responding to the initial shock in financial markets, the ESRB General Board identified and took measures in five priority areas: (i) the implications for the financial system of guarantee schemes and other fiscal measures to protect the real economy; (ii) market illiquidity and its implications for asset managers and insurers; (iii) the impact of procyclical downgrades of bonds on markets and entities across the financial system; (iv) system-wide restraints on dividend payments, share buybacks and other payouts; and (v) liquidity risks arising from margin calls. Beyond the immediate financial market volatility in March and April 2020, significant challenges remain. In June 2020 the ESRB reviewed its systemic risk assessment to account for recent developments. A key systemic risk stems from the widespread defaults in the real economy which are expected in light of a deep global recession. This is likely to result in a challenging macroeconomic environment for both banks and non-banks.

The European Central Bank (ECB) completed its vulnerability analysis of banks to assess the sector's resilience to stress caused by the Covid-19 pandemic. As the planned EU-wide stress test exercise was cancelled due to the pandemic, the ECB's top down analysis provides a best estimate of the sector's resilience. The assessment includes a severe stress scenario where real GDP falls by 12.6% in 2020 which would deplete banks' average CET1 from 14.5% to 8.8%. Key drivers for the modelled fall in capital are impaired credit exposures, market risk losses and lower profitability. Several banks would need to take action to maintain compliance with their minimum capital requirements, but the overall shortfall would remain contained. The high level of resilience in banks is a reflection of the regulatory reforms since the 2008 global financial crisis as banks are facing the current crisis with significantly higher capital levels. With bank profitability strained in recent years, those banks that have previously strengthened their profitability through efficiency-enhancing measures tend to be better positioned to withstand a severe stress. When entering the next phase of the crisis, it will remain important for banks to deploy their capital effectively. With its recommendation, the ESRB is supportive of financial institutions (banks, insurance corporations and CCPs) choosing to preserve their capital resources through dividend restrictions in these critical times, until end January 2021. This can help to enhance the resilience of the financial sector, strengthen its capacity to lend to the real economy as the crisis unfolds and reduce the risk of failure of financial institutions.

Risks also remain elevated for the non-bank sector where a deterioration of liquidity in financial markets can pose significant challenges. The ESRB took several measures at the onset of the crisis to help address risks faced by investment funds and insurers stemming from market illiquidity. This included a statement highlighting the importance of the timely use of liquidity management tools by investment funds, a Recommendation to ESMA to undertake a focused supervisory exercise to assess vulnerabilities in some segments of the investment fund sector, and a communication to EIOPA supporting increased monitoring of liquidity risk in insurers. Given the expected rise of defaults in the real economy, the mechanistic reliance on credit ratings by some institutions could pose a risk to financial stability. The ESRB therefore conducted a system-wide scenario analysis to help assess future possible fire sales which could be triggered by widespread simultaneous bond downgrades.

While the current focus particularly remains on responding to the immediate crisis, the ESRB also highlights three additional systemic risks which require continued monitoring. These include operational risks such as a system-wide cyber incident, finance-driven disruptions in critical financial infrastructure, and risks linked to climate change. Given the large potential impact of some of these risks, continued progress to tackle them will remain important while navigating the current crisis. ●

Jose Manuel Campa

Chairperson, European Banking
Authority (EBA)

The Corona crisis: a chance to build a stronger and more viable banking sector

The outbreak of the Coronavirus has brought huge social disruptions and unprecedented economic challenges. Banks have entered the crisis on a sound footing thanks to the post Great Financial Crisis' (GFC) reforms. Capital ratios are relatively high, with a CET1 ratio of 14.4% in Q1 2020, which compares with 9% in 2009. Management buffers of capital above supervisory requirements, and the release of macroprudential- and other supervisory buffers have provided room for banks. However, expectations for banks to manage this crisis well are high. Banks are also maintaining stable liquidity positions, with LCR at 148.9% in Q1 2020 (149.9% in Q4 2019). Banks' funding compositions are moreover healthier nowadays than at the outbreak of the GFC, not least thanks to higher shares of deposits from households and non-financial corporations in the overall funding mix. Banks are also making strong use of favourable conditions on wholesale funding markets, and quickly resumed issuance activity of debt instruments across the capital structure after funding markets were temporarily closed following the outbreak of the crisis.

While solvency and liquidity ratios are providing certain comfort, concerns are significant when it comes to the outlook for profitability and asset quality. Average ▶

return on equity (RoE) contracted to just 1.3% in Q1 2020, mostly driven by declining net interest and trading income as well as rising cost of risk. Persisting underlying weaknesses, such as low interest- and lending margins, are expected to exacerbate in the even longer for lower interest rate environment. The expected asset quality deterioration in the evolving economic downturn will likely result in markedly rising impairments. Cost of risk already sharply increased to 81bps in Q1 2020, after it had mostly been around 50bps in the past two years. Intense competition and overcapacities in many banking markets, coupled with sticky operating costs, pose further profitability challenges. Online banking and technological solutions are thriving in the crisis, and many banks will face additional needs to embark on ambitious but costly digitalisation strategies.

It is paramount that banks keep on supporting the economy. The EBA encouraged supervisors and banks to make use of the flexibility embedded in the regulatory framework. Several competent authorities released buffers accordingly and allowed flexibility for banks to operate below their Pillar 2 Guidance (P2G). The EBA has emphasised that capital relief should be used to finance the corporate and household sectors and urged banks to refrain from dividend distribution and share buybacks.

Banks legitimately request more clarity about the timing of reintroduction of buffers, as well as a potential lifting of the dividend restrictions. More certainty on these aspects is key but needs to go hand in hand with more certainty on the path of the crisis and its economic impact.

Notwithstanding unparalleled fiscal, monetary and supervisory measures deployed by EU and national authorities, the economic crisis will hit the sector hard, particularly in terms of deterioration of credit quality and profitability. Our analyses show that the sector is overall resilient, but banks that entered the crisis with lower capital levels, poor business models and riskier exposures may face challenges. In addition, second waves of contagion and a delayed economic recovery could further weaken the banking sector.

Pre-existing elements of weakness in the banking sector must not exacerbate the crisis. The need to address overcapacities and advance with banking sector consolidation will become ever more important and supervisors are supporting measures to facilitate such process. Addressing overcapacities includes mergers and enabling non-viable banks to exit the markets in a sound and orderly fashion. A coherent and consistent application of the European resolution framework will be important where banks may become non-viable in the crisis. Although the challenges ahead are huge, the crisis might as such offer the chance for the banking sector to leave it behind stronger and more advanced.

Nausicaa Delfas

Executive Director of International, Financial Conduct Authority (FCA)

How can regulators and the financial sector address vulnerabilities raised by the pandemic?

The global health crisis caused by the Covid-19 pandemic and the unprecedented economic disruption that has followed continue to be sources of concern for all. The effects will be felt across the world for some time yet and the broader impact will likely only be fully understood with hindsight.

The global financial system has so far proved to be more resilient than during the last financial crisis, at least in part due to the swift and decisive action taken by financial regulators.

As we look to the challenges ahead and consider the medium to longer-term crisis response, we will need to develop a complete picture of how all elements of the system - including banks, market infrastructure, and the non-bank sector - are interconnected, what the impact of market stress has been and what risks have materialised to date. This should act as the foundation for any future regulatory action.

In the immediate phase of the crisis, at the UK FCA we implemented support measures to keep markets functioning, ease operational pressures on firms where appropriate, and ensure that adequate protection for consumers was provided. For example:

- We modified our rules to facilitate equity and debt capital raising, so firms could provide the necessary finance to businesses as quickly and efficiently as possible;
- We provided flexibility over regulatory requirements where appropriate, such as giving firms additional time to publish annual financial reports;
- We introduced a range of temporary measures to support consumer credit and mortgage arrangements in areas where consumers are in financial difficulty.

In doing so, we have worked intensively with our counterparts in the UK, the EU and globally to address common challenges, share insights on respective market developments, and coordinate responses where appropriate. A number of these actions have been coordinated with the Financial Stability Board, IOSCO, and ESMA; the latter within the parameters of the EU-UK Withdrawal Agreement. Pragmatic and swift cooperation with our international counterparts was vital when responding to the immediate pressures of the crisis. It is now critical that we continue to work collaboratively on common challenges, towards common objectives.

Recognising the significant uncertainty that remains over the health situation and its economic consequences, focus areas will be:

- Recapitalisation - Market participants will face rising funding challenges as the economic implications of the crisis continue to unfold. To address these, we have started working on proposals to ensure capital markets continue to be a vibrant source of funding for businesses;
- Operational resilience – Sustaining the agility with which firms have adjusted to the unfolding crisis will be important. Alongside the Bank of England, we continue to focus on operational risks, strengthening resilience and business continuity, and minimising consumer harm;
- Systemic vulnerabilities – The FCA is actively contributing to new workstreams in global standard setting bodies to come to a detailed understanding of market stress seen in Spring 2020, and to assess potential vulnerabilities in Non-Bank Financial Institutions (NBFI). Early evidence points to significant diversity in the experience of the non-bank sector, meaning it is too early to draw conclusions without first considering how different elements of the broader system have interacted. We must ensure this work and any future regulatory change considers the benefits of vibrant capital markets alongside the potential risks, not least in the context of a sound economic recovery. Domestically, we are currently consulting on proposals to increase the resilience of property funds during periods of market stress;
- Consumer protection – It will be essential to build on the measures we have taken to date, to ensure the support we offer consumers is sustainable and reflects the needs of the most vulnerable in our society.

Overall, the financial system has proved to be broadly resilient to this crisis to date, without some of the severe market dislocations observed during the previous financial crisis. As then, this crisis has again demonstrated the value of close and pragmatic cross-border coordination between regulators. Nonetheless, it is clear that the crisis is far from over. Both regulators and the industry will need to continue to work hard to ensure the stability of and confidence in our markets, that consumers are given adequate protections, and that the financial sector can play its part in supporting the economic recovery.

Dan Sørensen

Managing Director, Nykredit Bank

Basel III finalisation might reduce European financial stability

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 future crises. However, in recent years, the profitability of banks has been a major challenge. The length and depth of the recession in the wake of the COVID-19 pandemic crisis is yet to be seen, but it is already evident that this crisis affects all aspects of micro- and macroprudential regulation. Nevertheless, so far the updated framework has passed the test and proven that banks are now part of the solution and not part of the problems of a global recession. In combination with the swift response from global and European regulators clarifying or fixing regulatory inconsistencies, this has made banks capable of supporting the real economy through the recession.

Looking forward, the final part of new global standards in the form of Basel III finalisation is yet to be implemented in Europe. It is positive that the European Commission has decided to review its impact assessment in light of the COVID-19 crisis. However, given the current 'live stress test' scenario with increasing credit risk in both a broad and a sector-specific perspective, assessing the extent to which the already implemented Basel III 'pre-finalisation' framework would prove sufficient to deal with severe crisis situations should be strongly considered.

In the current situation for all European banks, any increase in capital requirements will reduce their capacity to support the real economy throughout the COVID-19 recession – and, not forgetting, to accommodate the already pre-COVID-19 urgent need for households and businesses to make sustainable investments. It is difficult to see how banks could improve their profitability although operating cost reductions are on the agenda in many banks. Thus in case of increasing capital requirements, banks will find themselves caught between a rock and a hard place – either cutting the lending book to improve capital ratios or using all retained earnings only to build up capital – in both cases not capable of maintaining their lending capacity to the creditworthy part of the real economy.

> *Any increase in capital requirements will reduce the capacity to support the real economy.*

From a broader perspective, the Basel III finalisation standards have not been calibrated taking European specificities into account. For instance, European specialised, 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. One example is Danish mortgage lending, characterised by especially low risk and therefore even more susceptible to this. Danish credit institutions will need another EUR 10bn of 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 their low-risk business activities and instead include far riskier exposures in their lending book. This will be a problem for financial stability when the next crises hit the real economy.

The reforms implemented immediately after the financial crisis were well founded and addressed a fundamental lack of risk management in certain parts of the financial system. With Basel III finalisation, this fundamental motivation for risk management will be undermined, and the ability of banks to make quick and flexible adjustments and support the real economy in a crisis will be reduced. Based on the current shock to the global economy, it is time to reconsider the implementation of the Basel III finalisation framework.

Stefan Simon

Member of the Management Board – Chief Administrative Officer, Deutsche Bank AG

Banking on recovery: balancing stability and growth in the wake of the pandemic

The COVID-19 crisis has demonstrated the resilience of the European financial system in the face of extraordinary challenges. With aggregate total capital ratio in Q1 2020 standing at 18.1%, and liquidity well above 100% of the LCR, Euro area banks have shown their capacity to absorb losses, maintain market liquidity and extend credit where needed.

In general, the regulatory and supervisory architecture put in place post the 2008 financial crisis has worked as intended. Banking in 2020 has been part of the solution, with a critical role in supporting economic recovery. However, there have been some unintended effects and examples of regulation not working as intended.

Examples of regulatory headwinds for banks looking to support the European economy include:

- *Capital conservation buffers* – These additional capital cushions have not been as flexible as hoped. For many banks the calculation of running through capital buffers in the short term, knowing that they are likely to have to rebuilt them in a stressed economic environment, where capital will be more expensive, has not proved attractive.
- *Non-risk sensitive constraints* – As bank balance sheets have expanded to accommodate credit drawdowns and support government mandated loan support, so non-risk sensitive constraints such as the leverage ratio have risked becoming binding. Monetary policy interventions have also led to a growth of deposits across Eurozone banks, triggering increased contributions to the Single Resolution Fund (SRF).
- *Treatment of non-performing exposures* – New accounting rules under IFRS 9 risk magnifying the impact of the extraordinary challenge of the COVID-19 lockdown across Europe, whilst the capital treatment of securitisations (particularly of NPEs) means that easing the constraints on bank balance sheets remains challenging.

All of these aspects of the current prudential regime in Europe create incentives for banks to de-leverage, in line with a sharp economic contraction. This is the result of a design informed by the 2008 financial crisis and the need to discourage leverage, especially ahead of a recession. That design had not envisaged a situation like that of the COVID-19 pandemic. A fire sale of assets and lending freeze now could result in impairments for banks, harming the economy and undermining the resilience of the sector as a whole.

As the Financial Stability Board (FSB) noted in its July report, "policymakers should enable the financial system to continue to provide financing to the real economy under different recovery scenarios". The ECB expects the financing needs of the economy until 2025 to reach EUR 1.2 trn. For Europe, with only ca. 20% of new finance coming from capital markets, this credit will have to be provided by banks.

Fortunately the European authorities moved quickly to provide targeted and temporary relief from some of these pro-cyclical effects through the adoption of regulatory 'Quick Fix'. As the focus turns to recovery, however, a more sustainable solution will be required to ensure EU banks remain able to play an active part in financing a return to growth.

Additional action will be required. A small number of targeted changes should be sufficient to reflect the lessons of the crisis and ensure the regulatory framework remains fit for purpose – striking a balance between resilience and support for the economy:

- **Support for high-quality securitisation,** especially for NPEs, because it allows banks to monetise loan portfolios and share the risk with investors with the right appetite and recovery expertise, thus freeing up lending capacity. The EBA has already identified areas where this can be done safely without undermining the resilience of the banking sector.
- **Recalibration of capital buffers** to focus on counter-cyclical buffers (which have worked well) as opposed to capital conservation buffers where the sequencing of recharging the buffers is much less clear.
- **Tailored implementation of Final Basel III reforms,** to ensure European banks are not faced with the significant capital increase calculated by the EBA, especially as their internal models have proven resilient in this crisis.

Targeted changes can future-proof the European prudential framework so that European banks can provide the necessary financing for the economic recovery. That will be beneficial both for financial stability and sovereign finances.

Way forward to address unsustainable sovereign debt in the EU

Mário Centeno

Governor, Banco de Portugal

The pandemic crisis: sustainability, role of monetary policy and the need for long-term growth

The COVID-19 pandemic induced a severe downturn in the economic activity that has been unbalanced across sectors, with harsher consequences in some Member States. The downturn triggered a coordinated and swift response from policy makers. The general escape clause was activated, within the rules of the Stability and Growth Pact. In ten days, the Eurogroup agreed upon three key safety nets for workers, businesses and sovereigns. And last June an extraordinary meeting of the Heads of State or Government agreed upon a recovery package and an European budget.

The speed and scale of the response were unprecedented. The strength of this response goes beyond the financial support. It reinforces solidarity and policy coordination. Some concrete elements will facilitate further steps towards financial integration. The financing of the Recovery Fund is one of them. The Commission is expected to issue debt worth 750 billion euros over the next years; that's an issuer twice as large as the traditional European supranational peers. The EU bonds are not a substitute for a European safe asset, but they will provide a preview which impact on the financial markets should not be underestimated.

The role of the ECB has been critical in the policy response to the pandemic in the euro area. Monetary policy response was strong, stabilizing the financial markets and providing abundant liquidity to economic agents, in a timely manner. The highly accommodative stance of monetary policy – in a regime of low interest rates – will certainly not be reverted for some time. In general, a central bank can assist the government's policy effort not only by reinforcing its lending to the financial system and by lending directly to firms, but also by strengthening its role as a backstop for government funding. As a backstop, the central bank can avoid expectations-driven debt crises without further budgetary implications.

However, if a policy of debt purchases by the central bank reduces interest rate spreads that are due to fundamentals, then it has budgetary implications, eventually translating into inflation and into currency devaluation. Monetary and fiscal policy responses to the pandemic crisis have been decisive and complementary. Central banks ensured ample liquidity provision with favourable conditions, decreased interest rates when policy space was available and reinforced asset purchase programs. As referred, the fiscal response was extensive, leading to soaring public debt in the euro area and elsewhere that may still be impacted by implicit guarantees. Even if public debt is sustainable, the uncertainty and the existent risks on the sovereign debt of the euro area countries should be monitored as to prevent an abrupt increase in spreads over a longer horizon.

Monetary dominance has to be preserved. Otherwise, inflation would likely increase, leading to a depletion of the value of debt. Inflation that is not rooted in the reputation of an independent central bank may be uncontrollable. Furthermore, once the reputation of a central bank is lost, it may be hard to regain it. The euro is an international reserve currency and this status depends crucially on the independence of the central bank.

> *Monetary and fiscal policy responses to the pandemic crisis have been decisive and complementary.*

Against this, it is necessary to guarantee credible fiscal discipline at the country and at the European Union level, which may benefit from a reflection of the existent fiscal rules and improved quality of public expenditures. This is critical as it has to be made compatible with the existent and future investment needs. It is also important to strength the resilience and stability of our financial system putting in place the missing pieces of the Banking Union and, also, of the Capital Markets Union.

Finally, I recall that in a context of low inflation, even with the support of very low interest rates, strong GDP growth also emerges as a necessary condition for fiscal sustainability and for the improvement of social conditions. It is important that the allocation of funds of the recovery plan promote converge in the European Union and, in particular, the ones allocated to the Euro Area member states are used in a way consistent with the monetary union, helping to prevent the build-up of imbalances. ●

Vitas Vasiliauskas

Chairman of the Board, Bank of Lithuania

European-level response can guard against risks to debt sustainability

In light of the Covid-19 pandemic, we – policy makers – seem to have learned our lesson following the previous crisis episodes: this time, fiscal and monetary policies have been carefully coordinated to deliver a consistent economic response to the ongoing crisis. To help the European economy survive the severe disruption and to support the rebound afterwards, the European Central Bank (ECB) has strengthened already highly accommodative monetary policy, while national governments have implemented a large number of wide-ranging fiscal measures, reinforced by pan-European efforts.

On the flip side, economic contraction and the unprecedented fiscal policy response will inevitably cause public deficits and debt ratios to rise sharply in 2020. However, the current low interest rate environment helps alleviate the sovereign debt burden as necessary fiscal measures are being implemented. It is estimated that even with rising debt-to-GDP ratios the debt position should remain sustainable over the medium-term across the EU.

Fiscal and monetary support will remain vital in the foreseeable future, especially in view of high uncertainty regarding the course of the pandemic, as well as the partial and rather fragile recovery expected for 2021. Fiscal support at the national level throughout the next year should be continued, as withdrawing fiscal accommodation prematurely could weigh on the recovery and increase the risk of long-term scarring effects. Of course, considering a longer time horizon, delivering an appropriate fiscal stance remains a balancing act. Once countries return to a path of sustainable growth, fiscal policies should aim to achieve prudent medium-term fiscal positions.

Focusing on the euro area, due to a number of factors the policy response among euro area countries has differed in terms of size and composition – despite the overall strength of the fiscal action on the aggregate level. This has raised the risk of fragmentation within the single currency union. Asymmetric growth outcomes could increase economic divergence among countries and impair the transmission of the ECB monetary policy, while, at the same time, render it more difficult to calibrate an appropriate euro area-wide policy stance.

In this vein, I would like to recall a phrase that was popular in the central banking community prior to the current crisis: monetary policy cannot be the only game in town. Or, rather, it cannot once again become the only game in town. In a currency union, this is all the more true when the economy-wide shock – which affects all jurisdictions – is not overcome to the same level of success in all countries. We cannot rule out the possibility that diverging fundamentals – which would also induce financial fragmentation – may ultimately pose new challenges to long-term debt sustainability in certain Member States. At the end of the day, the solution to this issue lies not in euro area-wide monetary accommodation but in fiscal policy and structural reforms, combined with proactive use of the macroprudential tools.

To propel the European recovery and increase convergence, sizeable fiscal support – at least in some parts of Europe – will be required beyond that already provided at the national level. In fact, the recent initiative on the temporary recovery instrument Next Generation EU is a step in a right direction. Complementing national efforts to support structural reforms and public investment, Next Generation EU will provide sizeable fiscal transfers to the most affected European countries.

Nonetheless, moving forward a permanent solution must be developed: the Next Generation EU could serve as basis for a centralized fiscal instrument with a substantial common borrowing capacity. If appropriately designed, a permanent fiscal capacity would provide macroeconomic stabilisation and help counteract asymmetric shocks, thereby contributing to the overall resilience of the Economic and Monetary Union and supporting the single euro area-wide monetary policy. ●

Andreas Dombret

Global Senior Advisor, Oliver Wyman
& Member of the Board, Bundesbank
from 2010 to 2018

ECB and EU have acted swiftly and with determination

The global Covid-19 crisis has prompted governments to roll out unprecedented initiatives to protect economies and societies. EU member states took fiscal measures of nearly five percent of the EU GDP, partially as guarantees, but mostly through direct fiscal outlays, supporting, inter alia, labor markets and health care.

Unfortunately, the crisis hits at a time when several Eurozone countries are still facing a significant public debt burden and so markets questioned the debt sustainability of those economies. The European Central Bank acted swiftly by establishing the Pandemic Emergency Purchase Program with an envelope of €750 billion to backstop debt markets. In doing so, ▶

the ECB has acted swiftly and with great determination.

Of course, the recently agreed EU rescue package is clearly welcome – the question is whether it will be sustainable. Is it truly "Hamiltonian"?

First and foremost, the package is supposed to be a one-off, extraordinary initiative aimed at kickstarting economies, as well as funds to compensate for the economic contraction, for example via short-term worker benefits and health spending. But the issues that weaker Eurozone economies are facing are not just Covid-19 related, they are deeply structural.

Many member states have embarked on a painful path of fiscal consolidation over recent years, most of them with respectable success. Selected economic indicators such as productivity trends do not look promising. For example, Italy is burdened by youth employment of 27.6 percent which means that a substantial share of the Italian workforce is not only underemployed but may not be able to catch up anytime soon, therefore dragging down growth in Italy for years to come.

As always, it is questionable whether the package will need to be expanded in volume and time to be truly "Hamiltonian". But the conflicts that erupted at the Council summit show that several net contributors to the Eurozone budget are not open to a transfer or a debt union. Others regard the recent decisions as long overdue toward further European integration. While this would require extensive political debate and even a change of the EU Treaty, much will depend on the effectiveness of the package that has just been agreed.

Should it become evident that the committed €750 billion is not being spent wisely and does not support tangible convergence of Eurozone economies, preparedness to support such transfers in the future or to provide the EU with additional fiscal and debt capacity, will decline further. The concerns of the "frugals" should therefore be taken seriously, also keeping in mind that similar disagreements have just prompted the second largest European economy to leave the Union.

Conditionality and governance are key now. The EU must ensure that the economic stimulus is spent wisely and supports both targets: Immediate economic turnaround and sustainable investment into the economic and political future of the EU. The challenge will be ensuring efficient outreach of national measures to those in the respective member states having suffered from the Covid-19 crisis. And the challenge will come with national interpretation of what the EU Commission has given out as strategic targets: digitization, in other words, fundamental technological renewal and management of climate and environmental risks, for example, by Co2 emission reduction and avoidance of plastics. All of this should not, however, divert attention from the crucial need to increase productivity in all Eurozone countries, and from efforts to fully utilize and train the workforce in an increasingly complex world.

All of this said, one also needs to keep in mind that political leaders are not the only decision makers. The concerns that have prominently been voiced by the "frugals" are widely shared among EU citizens. Any further integration must come at a speed that allows countries and citizens to follow, in other words, the integration needs to be step by step. Being transparent about consequences, drawbacks and risks is important for any future buy-in, as an integration through the back door could eventually undermine the entire European project.

The greatest danger therefore lies in the disappointment of EU citizens who are meant to benefit from all the above. Grants will need to be implemented against clear and verifiable criteria mapped back to the EU strategic targets. But successfully executed, the EU will prosper.

Alastair Wilson

Managing Director and Head of Sovereign Risk Group, Moody's Investors Service

Debt, growth and policymaking – the EU's trilemma

Moody's is often asked why the current crisis has had limited ratings implications in the EU despite its dramatic impact on growth and debt. The simple answer is that we assume that policymakers will contain and ultimately reverse the impact. But we also recognise the enormous challenges in achieving that outcome and the clear risks. Since 2007, overall public debt of the then-EU members has risen from 66% to 80% of total GDP. While that is down from a peak of 92%, the decline mainly occurred in countries with the strongest credit profiles and in those worst hit by the crisis a decade ago. In some of the largest EU economies, debt has proven sticky or has even continued to rise.

Debt burdens will get worse. This crisis will lower the level and growth of GDP in the EU and worsen the fiscus. Temporary fiscal support may well prove long-lasting. EU governments will likely emerge from the crisis more indebted and more exposed to shifts in financing conditions. Moody's forecasts that the EU debt burden will rise by a further 18 percentage points over 2020 and 2021 on average, with some countries' debt burdens rising by more than 20 pp.

For now, that debt burden is manageable. Debt affordability has improved in recent years as interest rates have fallen. The ECB's response to the current crisis has left policy and market rates very low and we expect them to remain so for a long time. Even the most indebted countries can still refinance expensive global financial crisis debt at lower rates.

But is it sustainable over the longer term? Each crisis leaves the EU more highly indebted. Each increase in debt leaves it more exposed to the next crisis. And it has already faced two in a decade.

Large, advanced economies with strong institutions can sustain large debt burdens. The last crisis showed however that there are limits, which rest ultimately on investors' willingness to continue to refinance enormous sums falling due each year. And investors are mercurial. As we saw during the last crisis, that willingness is not guaranteed.

It rests, ultimately, on confidence in growth and policymaking – two factors at the heart of Moody's own analysis. Investors will step up as long as they believe that governments will be able to sustain the nominal growth needed to cover interest payments, and more broadly as long as they believe policymakers will achieve the fiscal and economic outcomes needed to contain the rise in debt, and in most cases ultimately to reverse it.

There lie the roots of the EU's debt problem. Even by advanced economy standards, growth has been low for many years. Demographic pressures, low productivity growth and perhaps the legacy of the current crisis suggest it will remain so for years to come given.

The EU debt burden will rise by a further 18 percentage points over 2020 and 2021 on average.

Meanwhile, policymakers have had mixed success in implementing the fiscal and economic reforms needed to revitalise growth and reduce debt burdens. After some significant progress early in the decade, momentum has slowed and, in some respects, reversed. Austerity fatigue has emerged long before austerity policies have achieved their goals. The actions needed to deal with the coronavirus pandemic will only add weight to the expansive political narrative.

That leaves the EU, or at least important parts of it, vulnerable to a shift in sentiment, with high debt burdens revealed to be unsustainable. This risk will rise as the environment normalises and interest rates rise. But the risk is not so much a general rise in interest rates as a rise in spreads, and a corresponding fall in debt affordability, for the countries perceived to pose the greatest risk – those with the highest debt, the slowest growth and the weakest institutions.

It may prove difficult for the EU's governing institutions to see off such a threat. The last crisis illustrated the lack of common ground on mutual support initiatives. The ECB continues to play its crucial 'buyer of last resort' role.

But recent negotiations around the Recovery and Resilience Facility show that starkly different visions persist for the EU, and little progress has been made on the closer fiscal and economic integration needed to bolster the euro area's resilience to shocks. ●

Christian Noyer

Honorary Governor, Banque de France

Public debts held by central banks: what are the consequences?

Today, central banks hold huge amounts of public debt. This is geared at legitimate monetary policy objectives, but the situation may change more rapidly than usually thought.

The origin of this massive intervention of central banks on public debts markets is the quantitative easing (QE) that has been used by central banks after the financial crisis. The reason was simple: in the pursuit of their statutory objective of price stability, central banks were confronted with an extraordinary and persistent disinflationary context. The use of traditional tools, i.e. interest rates, met with a limit, the zero-lower bound: attempts to move below zero, although conceivable in theory, and achieved in practice by a few central banks, in particular the ECB, has proven to be little effective, simply because the transmission is very limited. It also generates many counter-productive consequences.

Therefore, the main tool used to increase the accomodation of monetary policy has been the pressure on long term interest rates and the flattening of the yield curve, via the purchase of bonds. And because Government bonds are usually the safest, the most liquid pool and the benchmark of any currency's market, they have been the main instrument used by central banks.

These extraordinary purchases by central bank will have an end, maybe sooner than often thought...

Whereas central banks were progressively trying to normalize their policies, and at least stop increasing their bond portfolios, the pandemic crisis forced them to start new purchase programs. Indeed, with a huge recession triggered by the freeze of many activities, with durable effects on several key sectors, new deflationary pressures were threatening to push inflation significantly below the objective

of price stability. What Central banks have done is therefore clearly linked to their remit, i.e. maintaining price stability. And so far, they are still confronted with a weakness of price developments, which vindicates their monetary policy action.

But of course, this happens in a very specific context, where Governments have tried to counter the unprecedented recession by a temporary but huge increase of public expenditures, in particular massive support to corporates and entrepreneurs ▶

with a view to limit to the lowest possible extent layoffs and bankruptcies, and avoid a spiraling move into depression. Governments are bound to accumulate enormous amounts of public debt during the year 2020, that will need to be kept and rolled over for a long period of time, and their amortization is likely to take decades.

From the point of view of central banks, there does not seem to be a real danger per se. It is not unlikely that inflationary pressures start to rise again in the coming years, under the combined effect of huge liquidity and possibly less deflationary pressures from globalization. But if needed, provided that central banks stop buying bonds, increase as necessary their interest rates, and withdraw the excess liquidity they have poured into the market, they should be able to strictly adapt monetary and financial conditions so as to maintain price stability. And to withdraw liquidity, no need to sell bonds massively on the market: they can easily achieve the same objective by using reverse repos for instance.

For Governments, it means that they might not be put under pressure for this extraordinary debt issuance linked to the pandemic crisis. All this debt kept in the books of central bank is in fact of no cost, whatever the interest rate paid in the future (when this debt is eventually rolled over), since the amounts paid by a Government to its central bank increases its profits which are distributed to the former. This is true in particular for the governments of the euro area, the bulk of QE purchases decided by the ECB being done by the National central banks of the Eurosystem, each on its own national government debt.

At the same time, thanks to the flexibility it gave itself within the PEPP, the ECB has provided effectively the necessary degree of accomodation throughout the euro area, ensuring the resilience of the entire currency zone.

But Governments should clearly see the following: these extraordinary purchases by central bank will have an end, maybe sooner than often thought; and interest rates will eventually increase, and with them the cost of newly issued debts that will have to be kept by the private sector. Therefore, ensuring sound public finance for the years to come is of the essence.

Christian Keller

Chief Economist, Barclays

Dealing with Europe's high debt: complicated but not impossible

Europe's debt will soar to new highs in the aftermath of the COVID-19 pandemic, but its aggregate level is not higher than elsewhere: we estimate public debt to GDP in 2020 to reach 108% for the euro area versus 136% in the US, 104% in the UK and 276% in Japan. However, these forecasted debt levels within the euro area vary widely, from 198% in Greece to 20% in Estonia. Crucially, euro area sovereigns issue debt in euro, their common currency, independently controlled by the ECB. Thus unlike sovereigns who issue in their own (fiat) currency, euro area sovereigns would not be able to, as a last resort, print their own money to avoid default.

Otherwise, governments can reduce their debt as a share of GDP in only these basic ways: 1) generate primary surpluses (ie. a fiscal surplus after interest rate payments on the existing debt); 2) achieve GDP growth rates higher than the average interest rates paid on their debt; 3) restructure their debt. However, debt restructurings are realistically only an option for smaller, non-systemic economies, and most governments will need to pull on all other levers to keep their debt dynamic sustainable.

Fiscal consolidation makes sense only after economies have recovered from the current crisis. At such a time, we would expect it to be pursued more through the revenue rather than the expenditure side: because of the unpopularity of 'austerity'; the bigger role of government as consequence of the COVID-19 crisis, and the fact that tax rates have generally fallen over the past decades.

As for increasing GDP growth, structural reform efforts and increased public investment could help. But demographic trends in Europe make large increases in real growth rates unlikely. Similarly, Europe is unlikely to be able to 'inflate' debt away. Not only because this depends on how inflation affects fiscal balances and how rapidly creditors can react to higher inflation, but because Japan has also shown how difficult it is for ageing economies to break out of low inflation, regardless of easy monetary policy.

However, an environment of inflation and low real interest rates can also help to sustain much higher public debt ratios than in the past. Central banks already play a crucial role. By setting very low - even negative - short-term policy rates while also buying longer term government debt, they keep the entire yield curve very low and flat. This allows governments to lengthen the maturity of their debt profiles, locking in extremely low and often negative interest rates - which will become even more negative in real terms, if central banks do successfully raise inflation rates over time.

At the same time, central banks and regulators can effectively force private agents to hold such low-yielding government debt, eg. through statutory liquidity coverage ratios. Such 'financial repression' keeps governments' debt service burden low.

An optimistic scenario thus looks as follows: the combined effort of structural fiscal reforms and accommodative monetary policy help boost real growth and inflation (temporarily even above target); as this translates into a higher real interest rate burden only with a long lag, governments have enough time to consolidate their fiscal positions in the meantime. Debt-to-GDP ratios would be high but not become unsustainable.

However, moral hazard and political economy dynamics pose significant risks. As central banks continue to absorb government debt with seemingly no harmful consequences, politicians may feel less pressure to make reform efforts. This moral hazard is particularly relevant in the euro area, where in spite of a common monetary policy, fiscal policy remains largely in the hands of national governments. The EU's recent generous crisis package seems based on the hope that this gesture of solidarity will also create a sense of responsibility for the common European project.

Ultimately, a proper European fiscal union, where member states would largely relinquish fiscal sovereignty in return for a mutualisation of debt on the European level would in theory solve the issue. But such a 'United States of Europe' seems very far away, if at all desirable. At the other extreme, a sovereign default of a larger systemic euro area member would seriously challenge the survival of the currency union.

Pedro Marques

MEP, Committee on Economic and Monetary Affairs, European Parliament

Helicopter money to land in Europe?

These days, every new economic forecast is worse than the previous one. Most of the countries face severe crisis and the fears of massive unemployment arise, following the end of lay-offs or equivalent measures which were able to sustain jobs. The pace at which those measures are phased-out is now critical, since smoothening the growth of unemployment can result in the smoothening of the crisis itself.

Although the crisis is inevitable, its size and duration depend on a large scale on the measures that are put in place by national and European authorities – and the speed in which they are put in place. The analogy with healthcare is clear: the faster we initiate the healing the higher are the patient odds of getting better. So, at the beginning of the deconfinement phase of this crisis, short-term measures are still essential, both on fiscal and monetary policy.

The Recovery Plan is very important, of course, but its money will never reach the real economy before the end of 2021 or even the beginning of 2022. Meanwhile, millions of jobs might be destroyed.

The response to this crisis needs to be effective starting now, and not in a year from now.

To increase demand and stimulate the economy, Member States have to dramatically increase public investment, support private investment and money transfers to households. This will lead to a substantial growth of public debts.

But not to increase (or even decrease) public expenditure could, in the end, result in even higher levels of public debt, as a result of a more profound crisis, with the consequent reduction of Government revenues and increase of social expenditures (e.g., unemployment benefits). That was the (bad) experience from the last financial crisis and we should not forget the lessons learned and make the same mistakes.

In such a demanding situation, monetary policy must be used at its full potential. The starting point must be to assure that the low-interest rates environment that resulted from ECB's interventions in the recent past are maintained for a large number of years, as a way to incentivize private and public investment. But the ECB can do much more.

Within its mandate, it is clear that ECB can assume a more assertive position. Through this crisis, the rhythm of expansion of the ECB's balance sheet has to continue and even speed-up significantly.

If an effective response to the crisis and its consequences demands legal intervention, we should face that reality and not be bounded to old solutions that might not work for the new problems. The unprecedented challenges we face must give us the strength to challenge taboos.

Helicopter money is one of the taboos. If we consider the current limitations of the transmission of monetary policy, transferring money directly to households could be the most efficient way to raise the persistently low inflation up to the 2% target. At the same time, stimulating demand with this unconventional and effective policy would increase rapidly investors' confidence, and therefore investment, growth, and job creation could become a reality again in the short-term.

> *The unprecedented challenges we face must give us the strength to challenge taboos.*

Other taboo, the monetization of public deficits, relies on the same fear: inflation. But the real danger at the moment is deflation and massive unemployment.

We all saw what happened in Japan, where persistent deflation forced Governments to implement fiscal policies that resulted in public debt that, at first glance, seemed to create an impossible economic situation. But Japan's answer was a *de facto* monetization of public debt, which was very positive for the economy: Bank of Japan (BoJ) bought Government bonds that represent around 100% of the GDP. What was the result? i) it did not create uncontrolled inflation; ii) it was not necessary to raise taxes to pay the debt; iii) and, anyway, the profits that BoJ gets from that debt are Government revenues.

Monetization of public deficits and helicopter money, as well as other unconventional tools, can generate strong reactions in many economists and policy-makers, but they deserve a second thought.

If the biggest downside of those measures – inflation – is not a real concern now, not to analyse it may not be a rational option.

We can study the amounts involved, the consequences, the institutional framework, the operational issues, and the safeguards that would be necessary to make it acceptable for those who are more reluctant. It could, perhaps, be necessary to reinforce the economic governance and the creation of a Finance Minister for the Eurozone. A lot would have to be studied and discussed. But it is a discussion we certainly should have.

Jerome Haegeli

Group Chief Economist, Swiss Re

Europe – now is the time to invest

Vast fiscal stimulus may keep Europe afloat this year, but the long-term solution is investment.

Governments have unleashed unprecedented fiscal stimulus to keep economies afloat through the COVID-19 pandemic. The crisis has so impacted public finances and output simultaneously that the Euro area aggregate debt-to-GDP ratio is set to surpass 100% for the first time in history. Debt in a few member states is particularly high, notably Italy and Greece, where the ratio will likely rise above 150% and close to 200% respectively. Even Germany's debt to GDP is expected to climb to about 75% from 60% at end-2019 following one of the largest stimulus packages in the EU. While the immediate urgency is focused on the rebound from the economic crisis, eventually the question will arise: how to reduce these exorbitant debt levels?

The good news for debt sustainability is the record-low cost of borrowing. There is no guarantee, however, that interest rates will remain low forever and even if they do, we will have less capacity in future to absorb new shocks with higher spending. From all angles it is clear that we have to address today's record debts.

Inflating away debt is unlikely to be an option. The European Central Bank has tried for more than seven years to increase inflation sustainably to its close to 2% target. We expect the focus will shift back to fiscal restraint, with the EU likely to try to keep government spending in check after the crisis subsides. However, austerity introduced after the global financial crisis has been widely criticised for impeding growth. An increase in taxes to finance spending is more likely but may prove both contentious and not a good policy, especially in countries that already have high tax burdens.

The most desirable and indeed only viable long-term route is to boost GDP growth by enhancing productivity. To address our record debt levels, we must spend wisely to lift economic growth. The recently agreed EUR 750 billion EU recovery fund, and the European Green Deal launched in 2019, are welcome steps towards enhancing GDP growth. Yet they are not enough: more decisive policy decisions are needed to secure Europe's future and preserve its single market. Investments should focus on productivity enhancing areas such as infrastructure, technology in a way that advances climate goals. Building new sustainable infrastructure and upgrading the old has a significant multiplier effect on GDP growth.

Throughout Europe's history, transformative decisions have emerged from crises. Today we face the most acute economic and health crisis of modern times and the time to act is now. Europe needs to invest and is stronger with private capital at work. A single currency alone is insufficient to attract long-term investment capital from institutional investors such as insurance companies – we must accelerate the capital markets union. Well-functioning, dynamic capital markets are key for the competitiveness of European companies, particularly as competition will intensify as China opens its financial markets further and attracts a much larger slice of global capital.

To expand Europe's capital markets, we ultimately need a risk-free euro rate and a form of burden-sharing for governments. The EU could use the newly created borrowing power of the recovery fund for joint debt issuance, for example in the form of perpetual bonds, as the UK and US have issued in centuries past. With no maturity date, perpetual bonds allow for cheap long-term financing, with the advantage that the mutual obligation would stop at paying annual interest.

> *Raising Europe's competitiveness is the only viable strategy to deal with the debt ...*

Second, Europe needs to address the problem of so-called zombie companies – highly leveraged and unproductive firms. A European bad bank and clear principles would enable orderly corporate restructuring and unwinding of government credit. An EU-wide recapitalisation fund would support otherwise-viable private companies that lack access to capital markets. Third, a harmonized EU-wide insolvency regime would constitute a tool to deal with non-performing loans created by the debt bazooka. To sum up, raising Europe's competitiveness is the only viable strategy to deal with the debt and for this completing the capital markets union is key It is time for Europe to invest capital and in deep capital market reforms.

Dino Kos

Chief Regulatory Officer, CLS

Free money will not last – planning for the shift

The fiscal and monetary response to COVID-19 has been quick and massive. The ECB and other central banks have reduced interest rates and purchased assets, including large amounts of government bonds that have been issued by sovereigns to finance the fiscal response. As a result, sovereigns in Europe and other developed markets can borrow at near-zero or even negative interest rates, easily financing deficits that have exploded. Those deficits, which add to the already existing level of debt, further add to the future burden that taxpayers will ultimately bear.

Given the cheap financing costs, is this expansion of fiscal policy really a problem? After all, if governments do not use spending flexibility in a time of pandemics and economic shutdown, then when would such flexibility be used? Indeed, providing necessary stimulus so that the economy minimizes social dislocation and lost production seems justified. That argument has merit.

Alas, the justified short-term response has, so far, not been coupled with a medium-term plan to return to a more normalized fiscal situation. While increased debt levels are frequently criticized for pushing repayment onto future generations, that does not account for risks that could be confronted much sooner. Even if the current cost of issuing new debt is low, or negative, it would be foolish to presume this period of "free money" is permanent. While numerous risks could disrupt this happy situation, I want to highlight three in particular.

Refinancing risk: The debt issued in 2020 will almost certainly not be repaid at maturity. Instead it will be rolled over into new debt. The cost of that new issuance could increase for any number of reasons, vastly adding to interest costs and forcing a higher level of borrowing.

Rollover risk: When today's bonds mature in the future, the sovereign may not be able to rollover that debt. A liquidity and potentially solvency crisis may result that could lead to a rescheduling of debts, forced fiscal consolidation, slower growth, and reduced living standards.

Inflation risk: COVID-19 has had a deflationary impact on the global economy. In the medium-term, the impact of reduced trade, de-globalization, interrupted supply chains, and "re-onshoring" are all trends that will push prices higher. If globalization had a depressing impact on prices, then shouldn't the reversal of that trend nudge prices higher? If that scenario plays out, central banks will take two actions. First, they will increase interest rates. Second, they will stop buying government bonds (and other assets) and, in extremis, sell those bonds. Such a scenario would be the catalyst for both refinancing risk and later rollover risk.

The current period of zero interest rates will not last forever. Central banks will pivot not because they have failed but because they have succeeded! Buying enough time for economies to recover is probably the right decision. But just as central banks stimulated economies during the pandemic, they will reverse course when the recovery is self-sustaining and the output gap has closed.

> *Governments need to show they can both confront the immediate crisis and plan for the future as well.*

Governments need to plan for this "positive" scenario. Without a plan to "bend the (fiscal) curve", debt issuance will be on an unsustainable course and ultimately lead to crisis. Europe has experienced that within the past decade and could again. Who would pay the cost of long-term fiscal profligacy? The average citizen will pay in the form of higher taxes, higher inflation eating into purchasing power, and lower living standards. Governments need to show they can both confront the immediate crisis and plan for the future as well.

Finally, it should be noted that Europe is not alone in this situation. The US budget deficit is forecast to top $3.7 trillion this year – almost 20 percent of GDP. That international backdrop raises the stakes for Europe (and others) to be prepared when the monetary and fiscal tide starts its inevitable reversal. Nobody can know when that will be, but the stakes are too high not to be prepared.

Should financial sovereignty be a key objective for the EU?

Harald Waiglein

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

Integration is the key for achieving a higher degree of sovereignty

Sovereignty in a strictly legal sense means the power and authority to rule. In an economic sense, sovereignty may be more adequately described as the ability to control outcomes and respond to fundamental challenges. In today's globalised economy, domestic policy autonomy may be more constrained compared to earlier decades, but at the same time, the ability to trade, work and invest internationally has increased economic opportunities for all. Sovereignty arises from working together rather than policy independence.

In the financial sphere, sovereignty is necessarily incomplete due to spill-overs from other jurisdictions. As regards exchange rates, there are even political commitments not to target them for domestic purposes. The free flow of capital is among the basic principles of EU integration and the global market, and no other sector is more integrated worldwide than finance. Thus, the quest for more sovereignty in the financial sphere has to strike a balance between maintaining open markets and protecting legitimate interests. Rather than making an increase in financial sovereignty an explicit political objective, policy makers should work towards improving the conditions for economic and financial stability and strength to maximise global influence.

The EU and the euro area have progressed on many fronts since the 2009 crisis. The Banking Union has supported financial stability through harmonising supervisory standards and cutting feedback loops between banks and their sovereigns. The ESM was established as a lender of last resort to distressed euro area Member States. The ECB has expanded its toolbox to address the fragmentation of financial markets and support the transmission of monetary policy. Economic and financial surveillance was strengthened with a view to detecting and addressing risks early on.

Still, there remains untapped potential for the EU to further develop its financial and capital market, and thus to strengthen financial sovereignty. Euro area exporters would benefit from an extension of Euro-based payment infrastructure outside the euro area, which would bolster the euro's role in global payments and exchange market transactions. Further developing equity and venture capital markets would help mobilise private capital for investment and release pressure from banks to provide financing to the real economy.

Yet there are limits to the EU's financial sovereignty, due to the EU being a union of nation states rather than a single nation. Financial interests cannot be traded against geopolitical interests, as practiced by other global powers. There is not a single EU President other nations could talk to, but there are several EU Presidents + 27 Heads of State or Government. This certainly complicates decision making and international economic relations and influence. Therefore, the EU's influence in the international arena should not be measured by comparison to other global powers, but by comparison to the influence EU Member States would be able to exercise individually. Against this measure, the achievements of the EU over the past decades are unprecedented. Internal integration, ultimately also including political integration, rather than restraining market forces, is the key for reaching a higher degree of sovereignty.

Sylvie Goulard

Second Deputy Governor, Banque de France

Finance, sovereignty and a pangolin

Sovereignty is a concept that refers to states. It usually designates an exclusive power on a territory and a population, limited only by its own international commitments. The European Union (EU) has a genuine character, it is not a state. From an institutional point of view, the EU combines elements of a federal state such as a federal Central Bank and a common legal order under control of the Court of Justice, and elements of international cooperation, such as unanimity of member states.

In the financial field, the EU has nevertheless already achieved a lot. The creation of the "banking union" in 2012, with a single rule book and a common supervisor, was a major step forward, even if it is still a work in progress. Large cross border investments are now needed to finance greener infrastructure, digitalization and costs linked to ageing. In times of crisis, it is also critical not to be dependent from banks located outside the common legal framework. Banks have played a crucial role throughout Europe by channelling state guaranteed loans to business and industry. The joint supervisor

(SSM) and the European Systemic Risk board (ESRB) have contributed to a more coordinated response in terms of pay backs and dividends. Persistent fragmentation partly explains the lack of cross border mergers. It is also damaging for the economy, as pan European banks would be a powerful catalyst for growth and development, scale effects boosting intermediation, specialization and productivity. Profitability of European banks remains lower than those in the U.S. The European Commission intends to facilitate further the integration of capital markets. This initiative could help to better mobilize European savings for investments. Hundreds of billions of Euros could be made available for European projects, with positive side effects such as increasing private risk sharing and facilitating the transmission of monetary policy.

> *Europeans share an incredible savoir-faire in transnational governance, at a time where it is needed more than ever.*

The decision taken by the last European Council to create a recovery fund constitutes a quantum leap. The cross-border recovery fund renews the promise of stability already enshrined in the treaties, which means a lot for investors: the EU, the euro are here to stay and the Union is indeed becoming "ever closer", providing grants and loans. Until now, the EU had a single currency but no treasury, no significant common budget, very few bonds issued in common. Though exceptional, the recovery fund linked to the EU budget, partly financed by jointly issued debt, as well as the creation of EU own resources, confirm that the euro is irreversible. It does not only provide help for countries severely hit by the COVID-19, it provides insurance for a common future. The evolution of spreads even before the money is distributed, shows that the message was well received by markets. Disputes between the "frugal" and the "southern countries" are minor in comparison with the political shift this decision represents. It is perfectly normal that the countries with strong ratings ask for conditionality. It is also legitimate that, in an Union based on cooperation, wounded peoples receive help from the partners.

The cumbersome decision-making process of the EU could certainly be improved. However, it would be a mistake to continue to oppose an uncompleted EU with fully fledge sovereign states. Europeans share an incredible savoir-faire in transnational governance, at a time where it is needed more than ever. In 2020, few states, if any, are entirely sovereign. Interdependence is the new reality. When markets are interconnected, financial crises ignore borders. Global value chains, as well as global phenomena like climate change or pandemics put the state-based world order into a new perspective. Everywhere national rhetoric insists on taking back or keeping control. Let's be pragmatic and remember that a pangolin may suffice to block the world economy.

Stéphane Boujnah

Chief Executive Officer and Chairman of the Managing Board, Euronext

Europe must be a continent of finance makers, not finance takers

Europe must be a continent of finance makers, not finance takers. This should translate into policies that encourage European solutions, recognising the immense challenges facing the Union. The current crisis raises the prospect of greater nationalistic tendencies, particularly as its socio-economic impact is increasingly felt. July's agreement of a European Recovery Package by EU leaders was therefore a major step in providing support to the recovery and resilience of Member States' economies.

A reformed CMU will be a critical factor. Covid-19 has underlined how important public capital markets, equity investment, and accordingly an effective CMU, will be for the recovery of the EU's economies. But this will need to be a fundamentally different CMU.

As anticipated for months, it will have to factor in the consequences of Brexit. But it will also have to adapt to the lasting impacts on markets of the recent massive central bank interventions and fiscal stimulus measures, as well as to the very real risks of fragmentation of European capital markets. In order to mitigate these risks CMU should be built on a European competitiveness ambition.

If Europe wants to provide citizens, businesses and society at large with the tools to turn current challenges into opportunities, it needs a vibrant single market for financial services. In this respect, Europe must be a continent of strong and competitive finance makers,

not an open territory of finance takers. For many global players in the finance industry, the European Union is often part of a "Europe, Middle-East and Africa" division. For Euronext, as for many European financial institutions and market infrastructures, the European

Union is home. And the European Union cannot build a strong united capital market without strong European financial institutions and market infrastructures. This is not to suggest the promotion of a protectionist approach, as innovation and competition are key to building any strong industry. But we must stop the unilateral disarmament of the European financial system. This is how we should understand European financial sovereignty. There are three core building blocks for this ambition.

First, every measure contemplated in designing the new CMU should be assessed by a systematic "competitiveness test", which would be more specific than the usual Commission overall impact assessments. This test should be used to analyse, before new rules are introduced, whether they will make the EU's capital markets, financial institutions and infrastructures, stronger or weaker on a global level. If we want to unite European capital markets, we need capital markets in Europe to be united. What the EU must avoid is causing unwanted damaging consequences for Europe which would be experienced a few years down the road, when it is often too late to recover lost competitive positions.

The financial sovereignty of the EU is key to overcoming the challenges ahead.

Second, countries representing 85% of the EU GDP use the Euro currency. The new CMU will have to create the conditions to establish the Euro as a strong reference asset currency, in particular through a revitalized securitization market of Euro denominated assets, and measures to establish sovereign green bonds as a flagship product for the EU's capital markets. The EU's competitiveness and financial sovereignty requires accelerated progress in the use of Euro. This is simply because there is no lasting strong financial centre without a strong international currency.

Third, years ago, the EU decided to shape the telecom industry with the GSM standard, and the aerospace industry with Airbus. The EU is today a legitimate player to build an ambitious Digital Finance Action Plan.

In the global competition where non-European digital players build dominant positions, the new CMU must foster the emergence of global players in the fields of cyber security, pan-European digital payments, innovative digital markets, cloud data management and artificial intelligence.

The financial sovereignty of the EU is key to overcoming the challenges ahead. If the EU were to live up to its ambition to bolster Europe's competitiveness through a stronger CMU, it could pave the way for a real single market for financial services, enabling the emergence of European global players and strengthening both the role of the Euro and the resilience and sovereignty of Europe in the future.

Jacques Beyssade

Secretary General, Groupe BPCE

Financial sovereignty - a pre-condition for real EU decision-making

Geopolitics and economics are closely intertwined. The current health and economic crisis proves yet again that our world is uncertain, disruptive and often divided. For European citizens and corporates, the EU is a safeguard and a stabilizing force. For this to remain so, Europe has to ensure its financial sovereignty. What does that mean for financial services?

First, EU companies need diversified and competitive sources of financing. Reliable financing is a condition for long–term and sustainable growth – to a large part it needs to be available within the EU if we do not want to become the dominion of a larger Empire. During the earlier days of the current pandemic, third-country banks have pulled back from lending to European companies. Conversely, European banks, including BPCE, have mobilized forces for the interests of their European clients.

Second, our sector needs fair regulation and a level playing field adapted to EU economic specificities. A competitive financial sector rewards efficient business models, fosters growth and is distinguished by strong actors. This implies applying the principle of "same activities, same rules", to non-banks undertaking bank-like activities.

The original Basel Accord of 1988 sought to harmonise capital regulation across jurisdictions, i.e. to create a level playing field. However, the Basel rules are turning into a one-size-fits-all approach, and there is increasing concern on whether they are still compatible with the realities of financing the EU economy.

We need a regulatory level playing field and practicality of rules in their daily application.

Looking forward, the clear goal of the Banking Union and the Capital Markets Union has to be a better future for everyone. The EU has the largest pool of savings in the world, this potential should not be wasted by failing to efficiently allocate these savings, invest in Europe and therefore finance European growth.

For the Banking Union, concrete ambitious and pragmatic decisions are needed to ensure a suitable transposition of the Basel agreement, notably: a) to boost specialized lending - crucial because of its link to sustainable finance,

b) to support unrated corporates – crucial providers of activity and jobs in Europe, and c) to avoid increasing fragmentation and address the output floor issue. IFRS and especially IFRS 17 should be geared toward a more long-term and sustainable design.

Third, we live in an increasingly technological world. Yet there are no EU companies amongst the large digital corporations. This has implications for our sector, as banks have become trusted Fintechs, technological actors and third parties, where they ensure the security of their customers' funds and data. If EU regulation succeeds in remaining neutral vis-à-vis technology, the principle of "same activity, same rules" can help avoid hurdles to digitalising the EU financial sector. More specifically, the EU is rightly stepping up on critical infrastructure, cybersecurity, and cloud services.

We especially welcome that the EU is launching an own Digital Strategy and private initiatives such as the European Payment Initiative. GDPR is another cornerstone of the European digital transition. The recent judgement of the ECJ on the EU-US privacy shield further underpins the moral and economic imperative to ensure an autonomy in digital matters.

Fourth, Europe is a leader in developing a sustainable economy and in channelling private investment to climate neutral activities as promoted by the European Green Deal. For this to succeed the EU needs to remain autonomous in its decision-making, i.e. a sovereign in its financing and definitions of standards.

EU banks like ours have shown that EU clients can count on their banks, asset managers and insurers to be key partners in adverse times that are marked by both the challenges of a pandemic and the necessary ambition of sustainable transition. For us the way forward is to grow as trusted partners alongside the European real economy. For this to be realistic, EU decision-makers need to ensure a level playing field in terms of regulation and the practicality of rules in their daily application.

Christian Edelmann

Co-Head EMEA Financial Services, Oliver Wyman

Strengthening European financial sovereignty

Europe's banks are set to take a large financial hit from the COVID-19 crisis, both in terms of credit losses and in several years' worth of weaker earnings that are expected to follow. After a decade of strengthening balance sheets, however, the industry looks sufficiently robust to sustain the economic shock and expected credit losses. Banks have worked hard to maintain their operations and to support their customers during the lockdowns thus far, and they are partnering with governments to protect the economy. Some goodwill, in short supply for years, is now being replenished.

However, ultra-low interest rates and massive liquidity programs challenge the core role and business model of commercial banks. Liquidity transformation is simply of less value in a world where central banks provide a wash of liquidity and money is free.

Hence, a bold vision for Europe's financial system needs to be imagined: robust, providing great services for customers, built on modernized infrastructure, and governed in Europe's best interests in the vanguard of social challenges. However, on their own banks will not deliver the banking system Europe needs. This will take collective endeavour: from management and shareholders, but also employee groups, regulators, and policymakers. Individual bank transformation programs will not be successful without broad stakeholder support, and broader reforms are also necessary outside of individual institutions.

The remedies have been clear for some time: complete the banking union; create a true capital markets union; eliminate unnecessary obstacles to banking consolidation and tackle the fragmented and costly regulatory system. Adding on competing regulations for data protection or digital is only going to make things worse and should now receive much more coordination.

Furthermore, a mutual understanding should be built on the future of banking. Banks would fast-track transformation plans to drive greater efficiency and consolidation and set out an ambitious role in the social and environmental challenges of the next 20 to 30 years, even if this is not always directly aligned with shareholder value.

> *Banks on their own will not deliver the banking system Europe needs - this will take collective endeavor.*

Doing so will substantially increase Europe's financial sovereignty, by giving EU-based financial institutions and markets the ability to provide for Europe's needs. It will also reduce dependency on outside financial firms which can create some risk in times of crisis, as there is a home bias that can cause firms to pull back to their home bases, just as many European banks reduced their overseas operations during the global financial crisis. The analogy that comes to mind is supply chains and the issues the EU faced with medication and masks at the peak of the Covid outbreak. The answer – also for banking – lies not in national efforts but a European response.

Alban Schmutz

Senior Vice-President, Business Development & Public Affairs, OVH

GAIA-X : reinforcing sovereignty of financial institutions using cloud services

Sovereignty of our financial infrastructures are essential for Europe's success. Who controls IT infrastructure is a central question towards sovereignty, and the European financial industry needs to ensure that all its cloud suppliers endorse European values.

Therefore, the European financial institutions not only have to rely on the European regulatory framework (data protection, free flow of data, financial services regulations), but have to take a major stake in the vehicle that will bring the Cloud ecosystem at the next level: GAIA-X.

Gaia-X will ensure that European values will be at the heart of all cloud offerings across Europe in the interest of all European industries' data sovereignty. Avoiding vendor lock-in, transparency of suppliers regarding non European extra-territorial regulations, data protection, security... These questions are at the center of any IT policy. Therefore GaiaX developed a unique set of "Policy Rules" that maps all these principles in points of controls which values will be transparently attached to every single cloud service declared within GaiaX. This set of rules covers both a) infrastructure and b) software and data, in order to be adapted to the market needs.

All industries, including financial institutions, will be able to map automatically which services and which suppliers are able to comply with their internal compliance matrix, based on technical capabilities, quality of services and these very key policy rules. This means that for each workload, a different set of services and / or suppliers will be exposed by GaiaX with machine readable formats and help ensure scalability and reversibility of services.

All these policy rules are not specific to GaiaX and do not seek to reinvent the wheel, but take the best of bread of existing frameworks, already helping to comply with some of the European regulatory obligations. This includes for example the Cispe Data Protection code of conduct (Cispe.cloud) to ensure cloud infrastructure services meet GDPR requirements, the future Enisa European cyber security scheme (Cybersecurity Act), or the Swipo codes of conduct regarding data portability of non personal data (Free Flow of non personal data regulation).

This work has been performed based on the work done for years through already existing non profit organizations like the International Data Spaces Association (IDSA) and Cloud Infrastructure Services Providers in Europe (CISPE). A dedicated code of conduct or framework ad hoc for financial institutions could be envisaged to fully fulfill regulatory and supervisory requirements ensuring the highest standards of a European cloud and preserving a level playing field with other industries.

Presented by German and French Ministers of Economic Affairs Atmaier and Le Maire, GAIA-X gathers 22 founding members (with a balanced representation of providers and cloud users: BMW, EDF, Safran, Bosch, Siemens, Orange, Telekom, OVHcloud, Cispe...) and close to 300 organisations. The GaiaX foundation, a non profit organization based in Belgium, will start its operation in September 2020 as announced by the ministers and founding members the 4th of June.

> *A dedicated code of conduct or framework ad hoc for financial institutions could be envisaged to fully fulfill regulatory and supervisory requirements ensuring the highest standards of a European cloud.*

Some financial institutions are already taking part in some of the GaiaX working streams. But more needs to be on board to ensure that further developments will perfectly fit to European financial institutions needs. GaiaX is also a very unique opportunity to support the evolution of some financial services business models becoming cloud providers on their own, and GaiaX and its framework could enable acceleration of the taking off of such services.

Joining the GaiaX foundation is a major opportunity for financial institutions to push forward their expectations and meet other stakeholders working already together to give Europe some data sovereignty back.

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III. BANKING AND INSURANCE REGULATION

Content

How should the banking framework evolve in the context of the economic crisis?

Yves Mersch

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

Supervisory action in crisis times and limits of the ECB's prudential mandate

Faced with the unprecedented challenge of the coronavirus (COVID-19) pandemic, ECB Banking Supervision has deployed a range of measures to counteract pro-cyclical developments. By recommending that banks restrict their dividend distributions, we are supporting their capacity to absorb losses during the crisis and to lend to the real economy. More recently, we have extended our recommendation to restrict dividend distributions by another three months, until the end of 2020. This was not an easy decision. Banks that are profitable and healthy should – under normal conditions – not be prevented from remunerating their shareholders. Restricting dividends can increase banks' funding costs, have an impact on their access to capital markets and make them less competitive than their international peers.

Furthermore, our recommendation may disproportionately penalise well-capitalised lenders and those organised as non-joint stock companies. We nevertheless consider such a "one-size-fits-all" approach warranted in the current situation, but it must be exceptional and temporary. There is an ongoing need for prudent capital planning and, when we decided to extend the recommendation, the situation continued to be marked by elevated economic uncertainty, which hindered banks' ability to forecast their medium-term capital needs accurately. Similarly, while our vulnerability assessment resulted in best estimates of capital depletion on a sector-wide basis under different scenarios, its top-down nature did not allow an accurate breakdown of projections on a bank-by-bank basis.

We will review our recommendation in December and, unless we conclude that the uncertainty clouding banks' capital projections remains elevated, we will go back to assessing planned distributions on a bank-by-bank basis. We prefer being prudent today to having regrets tomorrow should overall economic conditions deteriorate further.

Other institutions have joined the effort to keep the financial taps open for the real economy during this exceptional period. After the "quick fix" to the Capital Requirements Regulation, the European Commission has recently adopted a Capital Markets Recovery Package to make it easier for capital markets to support the economic recovery. The proposal to amend the Securitisation Regulation includes a recital whereby the European Central Bank (ECB) is to ensure compliance with requirements on direct risk retention, transparency and the re-securitisation ban. In our view, this is problematic.

> *Extraordinary supervisory action is warranted in times of crisis. The ECB cannot, however, assume tasks beyond its prudential supervision mandate.*

The ECB has recognised its competence to supervise banks' adherence to some securitisation obligations that are prudential in nature, e.g. proper credit granting criteria for exposures to be securitised. However, the additional tasks should be viewed as primarily relating to supervision of product markets, as these rules ensure alignment of interests between investors and originators, and sponsors and original lenders, and allow investors to understand, assess and compare securitisation transactions. The ECB cannot assume tasks which go beyond its prudential supervision mandate as stipulated in Article 127(6) of the Treaty on the Functioning of the European Union and the SSM Regulation. A recital cannot change these limitations by simply re-labelling financial product supervision tasks as prudential tasks.

Assigning these functions to the ECB could result in conflicting responsibilities. In its role as prudential supervisor, the ECB generally wants as little of the risk as possible to remain with a bank acting as originator, so as to minimise arbitrage opportunities with the corresponding reduction of capital requirements. At the same time, the competent authority needs to ensure that the bank retains a material net economic interest under the obligation of risk retention. This might be linked to the need to preserve proper credit granting standards but might also create possible conflicts with the ECB's objective as prudential supervisor.

To conclude, the proposed conferral of tasks is neither a viable allocation of labour nor is it legally tenable.

Pablo Hernández de Cos

Governor, Banco de España

Europe should commit to global financial cooperation for its own recovery

History has shown that collective measures to tackle global problems reinforce individual countries' efforts. In fact, the need for timely and proactive global collaboration is even more important in times of stress. Combatting infectious diseases and safeguarding financial stability are both global public goods which know no borders and require collaboration among countries. We must avoid fragmented and disjointed measures. What implications does this have for European financial policies to foster a fast, sound and complete economic recovery across all EU countries?

First, Europe should champion full adherence of its financial policies to global standards and strengthen its contribution to international cooperation so as to mitigate the risks of costly global financial fragmentation. A decade ago, the Basel Committee on Banking Supervision agreed to a comprehensive overhaul of its regulatory standards in response to the global financial crisis. We are now seeing the full benefits of this, and our commitment should hold fast given the current urgency of combating the crisis. The banking system entered this crisis on a more resilient footing than twelve years ago, reminding us of the importance of a strong banking system, underpinned by global and prudent standards whose implementation, if so required, can be swiftly adapted in coordination. This proved particularly helpful in this crisis regarding capital and liquidity buffers. It will thus be critical to ensure the EU implements the outstanding elements of Basel III in a full, timely and consistent manner.

Second, all national and EU authorities should embrace a general equilibrium approach and consider all financial sector/real economy interactions. Under this approach, it becomes apparent how the robustness of the banking sector is key to the resilience of the economy as a whole. In this regard, banks have helped cushion the temporary supply and demand shocks triggered by the pandemic, supported by swift monetary, regulatory, supervisory and fiscal policies; and credit supply should help spur and fuel the recovery phase. But, undoubtedly, the crisis will significantly impact the quality of banks' credit portfolios, on a scale that will depend on its ultimate severity. And we know that an economic crisis, combined with a financial crisis, tends to be deeper and longer. Banks and authorities must thus closely monitor and mitigate risks and vulnerabilities and stand ready to reinforce banks' resilience if needed.

Third, cooperation can also be decisively enhanced within Europe. In the wake of what some have even called a Hamiltonian moment for the EU, with the approval of a common recovery fund, there are still striking gaps in the euro area financial architecture preventing the full eradication of fragmentation risk among European countries. Plugging such gaps by finalising the Banking Union with the creation of a mutualised European Deposit Insurance Scheme, by pushing ahead with the initiatives under the Capital Markets Union and by taking full advantage of the forthcoming issuance of sizeable amounts of European safe assets should also be at the fore of EU financial policy priorities. That may help create the appropriate institutional and regulatory conditions for banks, investors and other stakeholders to adapt to the profound challenges the financial sector is and will be facing in the future.

The pandemic has made some pre-existing challenges more pressing, e.g. low bank profitability, the opportunities and disruptions of financial technology, the impact of the continued rise in both government and private-sector debt, and the increasingly important need to mitigate climate-related financial risks. And new challenges might emerge due to structural changes in the post-pandemic economy. Let us give savers, investors, financial clients and all European citizens the best chances to adapt and succeed in the resulting landscape.

Robert Holzmann

Governor, Oesterreichische Nationalbank

How should the EU banking framework evolve in the context of the economic crisis

The EU banking sector was already facing several challenges before the COVID-19 pandemic wreaked havoc on the real economy. Over the last years, European banks have been struggling to adjust their business models to overcome low profitability. They had to cope with new challenges such as the digital revolution and the increasing importance of environmental, social and governance (ESG) factors. Moreover, they have been faced with new risks like cybercrime or money laundering. In addition, some banks have yet to reduce elevated levels of nonperforming loans (NPLs) – a legacy from the last financial crisis. In the near future, the COVID-19-related impact on the real economy will pose additional threats to the banking industry.

Given the challenges ahead, the European banking sector and the EU banking framework will continue to evolve over the next years. Among EU banks, the current economic environment could trigger a certain degree of consolidation in the medium term, as banks scramble to achieve economies of scale, to become more cost efficient and to diversify their sources of income to boost their currently low profitability. With a view to consolidation, banking regulation must ensure that there are no unjustified barriers and that new entities resulting from mergers and acquisitions have sustainable business models, comply with prudential requirements, have sound governance and risk management practices in place and can be resolved in crisis situations.

The coronavirus pandemic also acts as an accelerator for digitalization in the banking sector, with digital distribution channels gaining in importance. Here, supervisors need to ensure that banks manage the associated risks in an adequate manner. In the same vein, supervisors will have to further explore using new technologies themselves, e.g. by applying machine learning to analyze big data. It is also vital that banks and supervisors keep an eye on the emerging landscape of fintechs as well as on Big Tech's activities in the financial sector, as these developments might have a huge impact on the structure of the EU financial system and its stability.

Becoming ever more important, ESG risks will likewise impact on banks' business models in multiple ways. Banks need to incorporate climate risks into their risk management systems; they will have to adjust their investment strategies and change the pricing mechanism for their loan portfolios. To ensure that banks implement such changes in a uniform way, ESG risks are being included in the regulatory banking framework.

On the bright side, banks have entered the current economic downturn in a far stronger position than was the case during the previous financial crisis. In the wake of that crisis, a new regulatory framework (Basel III) had been introduced that has required banks to build up capital and liquidity buffers far beyond previous levels. Thanks to this new regulation, banks are now better able to support the real economy in the current crisis by granting new loans. Besides, financial institutions are more resilient, with their capacity to absorb losses having increased substantially. Nevertheless, it is of the uttermost importance that the – currently postponed – final part of the Basel III framework agreed on in December 2017 will be implemented in the EU in a timely manner. This is meant to further strengthen the regulatory framework, e.g. by reducing excessive variability of risk-weighted assets and by improving the comparability of capital ratios, and to contribute to the resilience of the EU banking sector.

In response to the COVID-19 pandemic, regulators and supervisors used the flexibility already embedded in current banking regulation, acting swiftly to provide further temporary capital, liquidity and operational relief to institutions. Specifically, banks were encouraged to use macroprudential capital buffers built up over the last years to support the financing of the economy. These measures should, however, not be interpreted as a sign of a general policy shift toward softer regulation. Importantly, what should be avoided is a permanent reduction of capital and liquidity levels. Capital regulation should remain flexible, i.e. capital buffers may be depleted in a crisis like the current COVID-19 pandemic but will have to be restored to pre-crisis levels once the crisis has subsided. Naturally, banks should also heed the lessons from the last financial crisis, which showed the need for both enhanced transparency concerning asset quality and a comprehensive accounting and regulatory reporting framework to ensure market discipline. To grasp the overall picture and analyze the latest developments in a timely manner, supervisors and market participants alike need sufficiently detailed regulatory reporting and transparent accounting systems.

Criticism of banking regulation has been rising; not only has the regulatory framework become stricter and more comprehensive over the last decade, but also much too extensive, and, in some areas, overly complex. From my perspective, this criticism is broadly justified. Both the financial industry and supervisory authorities would benefit from a more transparent and, hence, easier-to-apply regulatory framework. In a next step, we should therefore aim at simplifying the regulatory framework, yet without diluting the underlying prudential intention, to ensure that the banking system is resilient in the face of crises – this will make everyone's life much easier.

Luigi Signorini

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

Banks are key to hastening the recovery from the COVID-19 shock

Banks were much stronger at the start of the COVID crisis than they had been when the global financial crisis struck. This was due to a large extent to the reforms that culminated in the Basel III accord. During the 2008 crisis, banks were part of the problem; this time they have been counted on as being part of the solution. Decisive monetary and regulatory interventions were also essential. No sudden liquidity stops have occurred so far; no credit crunch has threatened to compound the effects of the real shock. Stronger banks have therefore supported a crisis-hit economy.

However, the crisis is not over. The authorities must remain vigilant and ready to act, to avoid financial disturbances. The challenge for banks is to provide credit to the economy while maintaining the soundness of their balance sheets. Immediately after the shock, European banks accommodated the surge in firms' demand for liquidity, helped by public relief measures (especially in the form of guarantees) and a very accommodative monetary policy.

The deteriorating macroeconomic scenario led to a sharp increase in loan-loss provisions in the first half of the year; further losses will probably be recorded in the next few quarters, as the phasing-out of support measures, coupled with higher private sector leverage, continue to affect asset quality. The economic contraction is likely to erode operating income, thereby slowing down the demand for loans and other banking services. Lastly, notwithstanding the ECB monetary policy measures and the decision to set up an EU Recovery Fund, in some Member States banks remain vulnerable to a reassessment of sovereign risks, which may increase their funding costs.

However, while profitability will remain under pressure for some time, the resilience of the euro-area banking system has not been called into question. The recent ECB vulnerability analysis has shown that the reforms and supervisory actions have effectively increased their strength. The challenges are serious but can and must be managed.

As banks hold much of the EU corporate debt, their financial and advisory support will be crucial in keeping viable businesses operating. Restoring a sound corporate financial structure would strongly benefit from the completion of the Capital Markets Union, which would allow firms to diversify their financing sources and raise equity on better terms.

Banks should rapidly process NPLs resulting from exposures to non-viable firms, and their recent positive experience on NPL disposals and management will be valuable. Public authorities should be ready to explore solutions for safeguarding the system's stability; they should consider preventive tools – such as publicly sponsored asset management companies – to help banks maintain a healthy balance sheet. Adjustments to the European bank crisis framework should also be considered, to guarantee the orderly management of any troubled institutions, regardless of size.

The pandemic shock has accelerated the digitalisation of the production and distribution of goods and services. The transition to a digital economy requires corporates to undertake substantial investments, and bank financing will be crucial, especially for SMEs. Digitalisation is both a challenge and an opportunity for banks, and they too will need to invest heavily in innovation to survive and prosper. Indeed, while coping with the short-term and acute effects of the crisis, they must still take the long view.

Ultimately, the long-run health of both the economy and the banking system depends on effective fiscal and structural policy actions to ease the pain of the crisis for firms and households and foster balanced growth. In the meantime, supervisors and regulators should continue to exploit the flexibility of the regulatory framework, striking the right balance between allowing banks to absorb the impact of the downturn as smoothly as possible, and maintaining safe and sound risk management practices.

Othmar Karas

Vice-President, European Parliament

The impact of the COVID-19 crisis on EU financial market legislation

We are living through unprecedented times. The COVID-19 crisis is affecting the health of our loved ones and profoundly impacting our economy and financial markets. A global challenge of this kind needs to be tackled with determined and coordinated action at all levels. It is essential to have a common European response, which preserves the integrity of our Single Market, avoids national fragmentation, and ensures that the financial sector can be part of the solution. Unlike in the 2008 financial crisis, financial institutions are not the source of the problem this time. The banks' higher liquidity, capitalisation and leverage undoubtedly serve us well during the current shock. The fact that we are much stronger now than when the financial crisis hit us over ten years ago shows that continuing to strengthen our Economic and Monetary Union is the right way forward. And if we all live up to our responsibilities, we will emerge stronger also from this crisis. Just as in the spirit of Robert Schuman who knew 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 pandemic is also impacting the EU agenda on financial market legislation. The Commission's proposal on the comprehensive Basel-III reforms has been postponed given the announced one-year deferral by the Basel Committee's oversight body. A decision which I very much welcome since it increases the operational capacity of banks to support our real economy at these exceptional times. At record speed, the European Parliament and the Council have adopted a Banking Package offering capital relief to boost extra lending potentially worth up to 450 billion euros to households and businesses throughout the EU. At the same time, public authorities, supervisors and bodies at Union, Member-State and international level have taken swift and decisive action, complemented by an Interpretative Communication by the Commission. And still in July, the Commission proposed a Capital Markets Recovery Package with the objective to make it easier for capital markets to support the European economy to recover from the crisis.

In particular the swift adoption of the revised banking rules shows how quickly the EU legislator is able to act at times of crisis. Amid the application of the ordinary legislative procedure, the setting of tight procedural deadlines and the continuous dialogue between the co-legislators and the Commission allowed the adjustments to enter into force still in the second quarter of 2020. This sets a positive example for the upcoming procedure on the Capital Markets Recovery Package, which should encourage greater investments in the economy, allow for the rapid re-capitalisation of firms and increase banks' capacity to finance the recovery. The changes to MiFID II, the securitisation, prospectus and benchmarks rules should ideally be adopted before the end of the year. Waiting for the comprehensive reviews on these rules – scheduled for MiFID II/MiFIR in 2021 and for securitisation in 2022 – would mean missing the opportunity to use the full potential to help the Union to recover from the crisis. In the same vein, the amendments must remain targeted and focus on the COVID-19 recovery.

> *The necessary completion of our Banking and Capital Market Union is gaining ever more importance due to the current crisis.*

In fact, the necessary completion of our Banking and Capital Market Union is gaining ever more importance due to the coronavirus crisis. On the Banking Union side, whereas the benefits of the first two pillars – the single supervision and resolution – are delivering, the gradual implementation of the third pillar on a European Deposit Insurance Scheme as well as the regulatory treatment of sovereign risks must gain momentum. While the EU legislative train on the Basel-III reforms is delayed, it must continue being loaded with the practical expertise from all affected stakeholders. At the same time, a successful Banking Union also needs well-functioning capital markets. On the CMU side, the common objective must be to ensure equal access to investments and funding opportunities across the Union. One important aspect is the harmonisation of core elements of national insolvency regimes to improve comparability and predictability for investors. Following the publication of the final reports by the Next CMU High Level Group and the CMU High Level Forum, the European Parliament is currently adopting its position ahead of the Commission's CMU action plan to be proposed in September. Undoubtedly, the experience of all public authorities and financial institutions with the consequences of COVID-19 must be at the heart of both projects.

Alban Aucoin

Head of Public Affairs, Credit Agricole Group

Time to design a new normal

"When men find themselves in a new situation, they adapt and change. But as long as they hope things can stay as they are or be compromised, they are not willing to listen to new ideas" Jean Monnet, Memoirs.

The outbreak of the Covid is a game changer. The unprecedented magnitude of this exogenous shock will have long-lasting consequences such as aggravating the prior over-indebtedness of households, companies and States.

In this context, the European Union agreed on a major recovery plan, with great ambitions in terms of sustainable development, climate change, digital revolution and finally assumed defence of its industrial sovereignty. The EU has been able to change and adapt to this new context, by approving an exceptional budget reinforced by the new instrument Next Generation EU, directly financed by the issuing of EU bonds - a fine symbol of a new European solidarity.

However, the European Union and the Member States will not be able to support the economic recovery by their own, as their room for manoeuver has been reduced by high levels of public indebtedness. From this background, the financial sector will have a key role to play alongside and in partnership with public authorities as it has already shown, by massively providing liquidity support to companies. Given the predominance of bank-based financing, due to the lack of a strong European capital Market, the bulk of this financing effort is borne by banks. Thus, they have seen their balance sheets growing dramatically.

Therefore, the European banking framework must also adapt and change. The crisis has highlighted the procyclicality of many regulations, which instead of stabilizing the economy have significantly amplified the movements. To mitigate some of these effects, supervisors and regulators have quickly adopted a broad range of relief actions. In the same vein, banks have welcomed the targeted legislative changes of the prudential framework known as the CRR Quick fix. Nevertheless, an in-depth review of the prudential framework, in which some measures are structurally very pro-cyclical, must be undertaken.

Future regulations such as Basel 4 are also pro-cyclical over time. Indeed, an increase of capital requirements reduces the financing capacity of banks, as the SSM admits in its press release of 20 March 2020. The last EBA estimates of a 24% increase of capital requirements resulting from the transposition of Basel 4 into EU law, would freeze a lot of capital necessary for the massive financing of the recovery and greening of the European economy. European banks' financing capacities would be further weakened by the impact of the pandemic crisis: the SSM estimates the impact of the crisis on the banks' CET1 ratio between 1.9 and 5.7 pp, depending on the scenarios, with a peak in 2022.

Future regulations such as Basel 4 are also pro-cyclical over time.

In this context, the current situation leads us to question the transposition of a framework designed to address the issues of a crisis which occurred more than ten years ago, and based on an agreement which does not respect the mandate of no significant increase in capital requirements given by the European institutions. While banks are living a large-scale stress test, bringing uncertainty to the financial and banking sector, the SSM has recognized in its July 28th vulnerability analysis the adequate capitalisation and liquidity of banks.

It is therefore essential to put into perspective the need to finance the ambitions of the European Union and the objective of financial stability, which is already at an appropriate level. Prior to the publication of the legislative proposal to transpose the 2017 Basel Agreement and its impact assessment, a meaningful and thorough political debate and a close dialogue between regulators and industry should be seriously considered. This is necessary to make a sound decision on such a consequent regulatory reform that would not match with the European interests anymore.

Kinner Lakhani

Head of Group Strategy & Development and Head of Investor Relations, Credit Suisse

Europe needs a healthy banking system to build back after Covid-19

The European banking system has proved to be resilient in the wake of the COVID crisis but the outlook has become ever more challenging in the context of lower-for-even-longer interest rates; a likely uneven recovery; the burden of higher levels of non-performing loans; and the need to rebuild balance sheets. However, unlike 2008, the need for refinancing and recapitalization are greatest for the corporate sector. Banks – both traditional and central – together with sovereigns have and will continue to play a central role. The recovery of the European economy is inextricably linked to the health of its banking system, the largest in the world. After all, Eurozone banks provide three-quarters of corporate and nine-tenths of household financing – double and triple the proportion in the US[1].

In the context of an ever more challenging outlook, the need for structural reform of the financing of the European economy is greater than ever. The Achilles heel of Europe is the overdependence on its banking system. The fragmented structure of European banking – the top five banks have less than one-quarter of banking assets while the US market is twice as consolidated[1]– structurally weighs on returns. This fragmentation is equally evident in cross-border banking – representing a mere 1% of mortgages and less than 10% of corporate loans[1]– as well as in capital markets. Regulatory reform of the banking sector, while it has been critical to its resilience through the health crisis, could remain in train for almost two decades after the Global Financial Crisis.

We support the renewed political momentum, under the Germany EU Presidency, to complete Banking Union. This is critical to breaking down the barriers to cross-border consolidation – including national ring fencing of capital and liquidity – and allow for a more integrated banking system. While consolidation is necessary, we believe it is insufficient. Policymakers also need to bring down the barriers to consolidation in the non-listed part of the banking system, often with implicit state support.

The other side of the coin is Capital Markets Union where we welcome the reinvigorated focus, especially in the context of Brexit. The need for deeper, more liquid, more integrated capital markets is greater than ever not just to support the recapitalization of the corporate sector but also financing the investments needed for digitalization and the sustainable economy.

The recent health crisis has shown both the effectiveness of post-crisis banking reform but also exposed its pro-cyclicality, as well as the need to address liquidity risks in capital markets. Whilst regulatory forbearance to counter pro-cyclicality has been effective, it has been unevenly applied - a reminder that banking is global during normal times but national during crises. The final phase of Basel 3 reforms should incorporate lessons learned from the crisis and that temporary forbearance measures, including IFRS 9 relief, will reverse over time serving as headwinds to banks' capital ratios. The overall capital buffer should embed a larger counter-cyclical component to serve as a more effective 'shock absorber'. The negative impact of the inevitable expansion of central bank reserves on the leverage ratio from central bank programs is clearly counterproductive.

The recovery of the European economy is inextricably linked to the health of its banking system.

Banking and capital markets continue to play an important role in supporting the nascent economic recovery. However, policymakers need to be ambitious in "Building back better" to support corporates and households recover from the tragic effects of the COVID crisis. For European banking, this means completing the long overdue Banking Union, Capital Markets Union and a considered approach to completing Basel 3 reforms, now well into the second decade after the Global Financial Crisis. ●

1. How to fix European banks and why it matters, Lakhani, Folkerts-Landau, Reid et al

Johanna Lybeck Lilja

Executive Adviser, Nordea Bank

Banks' support to the economy; in normal and distressed times

We are currently living in difficult times. The pandemic Covid-19 has severely impacted people, countries and economies around the world. Governments, central banks and other authorities have implemented measures at an unprecedented scale to support their economies. Compared to the financial crisis of 2008, the financial system and in particular the banks are not the problem, but part of the solution.

This is true especially in countries where banks have strong capital and liquidity positions in combination with robust earnings. The Nordic region is one example where the banks have been able to support their customers and subsequently the economy through these difficult times. Taking Nordea as an example, active credit management over the last ten years has significantly de-risked the credit portfolio, resulting in the loan book being well-diversified with a strong underlying credit quality. This has enabled the bank to continue to support customers during the Covid-19 outbreak; e.g. lending to households and corporates has increased in both of the first two quarters of 2020 and many customers have asked for, and been granted, an amortisation-free period. A significant management judgement buffer has recently been put in place to cover future losses.

In addition, Nordic banks have made use of the government guarantee programs for the extension of credit to corporates. This has enabled further much-needed lending to support the economy. Going forward, it is crucial that the support measures are sustained to support the starting-up of the economies.

Looking ahead, one of the most important legislative files is the implementation of the final part of the Basel III capital requirements in the European Union. Work is ongoing in the EU Commission and several impact studies have been performed. These show a significant proliferation of the expected impact on banks of the revised capital requirements.

This is true at the global level, but significant differences are also found within the EU, e.g. the expected rise in the minimum capital requirements is estimated to around 30 percent in some of the Nordic countries. Taking into account the important role that banks have in the real economy and the society, including the potential societal impact of problems in the financial sector, we clearly support strong requirements on all financial institutions, also capital requirements. At the same time, it is important that regulatory capital requirements adequately reflect the risks that the bank takes. In the end, capital bears losses and losses are driven by risk.

So why are the Nordic banks characterised by low-risk assets? Firstly, the Nordic banks learned the lesson of prudent credit extension focussing on the ability to repay the loan the hard way in the respective financial crises the Nordic countries experienced in the early 1990's. Secondly, a large share of the loans by the banks are household mortgages collateralised with property. Thirdly, Nordic societies have well-structured social safety nets, strong fiscal positions and effective legal systems. This means that citizens are protected from severe economic situations and can most often continue to repay the loan and that, should it become necessary, the process of claiming the collateral is comparatively efficient.

> *Regulation of the financial market needs to be strong, balanced and risk-sensitive.*

Consequently, the EU implementation of the final part of Basel III should avoid penalising low risk portfolios and ensure that the regulatory framework matches the actual risks. If part of the intention of Basel III was to further disincentivise the holding of high-risk assets then this will do the opposite, creating a penalising effect for holding assets like low risk household mortgages and loans to high (credit) quality Nordic corporates. This would clearly distort the incentives for banks when it comes to business selection and pricing and can create a negative impact for the financing of Nordic corporates and households, ultimately making the Nordic financial system less robust.

Had the final part of Basel III been implemented in the EU at the time of the outbreak of Covid-19, Nordic banks would not have been able to support the household and corporate customers to the extent that we have thus far. To sum up, the regulation of the financial market needs to be strong, balanced and risk-sensitive. ●

Does the Covid crisis reinforce the case for Banking Union?

Edouard Fernandez-Bollo

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

The coronavirus pandemic and banking integration

The spread of the novel Coronavirus disease (COVID-19) has once again shown how interconnected the world is. Within three months, a virus had spread from a province in Central China to six continents and, in particular, to every single Member State of the European Union (EU). A common challenge deserves a common response, with work underway not only to contain the spread of the virus but also to mitigate the socio-economic impact of COVID-19 and to support the recovery in the EU. Today, I wish to reflect on its impact on another area of the European integration project, born out of the insight that our economies and banking systems are deeply interdependent: namely the European banking union.

Thanks to the banking union, banks have entered this crisis in a much better shape than in previous crises: they have stronger capital levels, better liquidity positions and more stable funding structures. The results of our vulnerability analysis[1] show how this more robust position is allowing banks to withstand the current economic shock. Even before the COVID-19 outbreak, the European banking system suffered from a number of known structural weaknesses, such as low profitability, as reflected in high cost-income ratios implying little capacity to invest in new technologies.

This persistently low level of profitability is linked to an overcapacity in the European banking sector. Further integration and consolidation of the banking sector may therefore help in terms of economies of scale and scope, but also by contributing to better revenue and risk diversification, in particular in a cross-border context.

In response to the crisis, significant decisions have been taken to allow banks to continue lending to the real economy while preventing the risk of abrupt deleveraging processes. Some of these decisions were taken at the European level. Others were adopted by national governments, reflecting the allocation of competences in the EU. While national responses were deemed necessary for a fast response in some areas, the inherent risk of fragmentation needs to be carefully managed. Thus, it is of the utmost importance to ensure that existing European structures and fora are used for coordination. In our role as Supervisor we will ensure a consistent approach in the treatment of such national support measures.

Targeted further harmonisation of the prudential framework may also be needed to allow banks to exit the market in an orderly fashion without hampering the economic function of funding the real economy. The support given to the economy will be best used by allowing banks to address their structural problems rather than perpetuating overcapacity.

For this purpose, it is very important to ensure that, once the European Central Bank has declared a bank as failing or likely to fail (FOLTF) and the Single Resolution Board (SRB) has determined that there is no public interest for resolution, the bank exits the banking sector in a relatively short timeframe, even in cases where the FOLTF decision is based on likely insolvency, likely illiquidity or likely infringement of prudential requirements.

This could be ensured by the transposition of Article 32b of the Bank Recovery and Resolution Directive. However, with the same goal in mind, it is also important to further align the grounds for FOLTF and withdrawal of licence. As regards a wider revision of the resolution/liquidation toolkit, it should be ensured that at least the failure of all significant institutions/groups and other cross-border groups under the SRB's remit can be dealt with via EU-managed tools and processes across the banking union.

> *Further integration and consolidation of the banking sector may therefore help.*

This would not only enhance predictability and the level playing field among failing banks but would also enable the banking union to turn banking crises into an opportunity to achieve a less fragmented banking sector.

Last, we may also need to improve the framework for intra-group support agreements to provide sufficient assurances that entities within a group support each other in times of stress. Having in place such safeguards necessary for local financial stability issues would help to dismantle the impediments to the free flow of resources within cross-border banking groups in normal times. ●

1. https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200728~7df9502348.en.html

Dr. Eva Wimmer

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Never waste a good crisis - the Banking Union for a better recovery and lasting prosperity

The COVID-19 pandemic has affected all aspects of the European economy. Given sensible regulation, banks were better prepared with more capital and liquidity than in previous crises. Thanks to the single supervisory mechanisms, the ECB and national regulators were able to act swiftly and coordinate a response to free counter-cyclical buffers, introduce supervisory flexibility and providing operational relief. Sustained efforts to reduce risks have increased the resilience of the banking sector and freed capital previously tied up in non-performing loans. These measures enabled European banks to provide much needed liquidity to businesses hit by the crisis and to play a crucial role in mitigating the economic impact of the pandemic. All these examples are testament to the proper functioning of the regulatory and supervisory framework designed following the Global Financial Crisis in 2008.

However, the crisis has also highlighted that one must not become complacent. European financial markets are still fragmented and barriers to the free flow of capital and liquidity persist. Not leveraging the full potential of an integrated banking market may affect profitability, and thus, financial stability and the sovereignty of the common currency globally. The political impasse has also handicapped European banks competing with US and Chinese peers. Thus, important work remains to complete the Banking Union.

One of the priorities of Germany's presidency of the European Council is to improve the crisis management framework. The single resolution mechanism provides a reliable regime for dealing with systemically relevant banks in crisis. Two issues remain unresolved: First, frictions between the resolution framework and national insolvency procedures impair a smooth and effective crisis management. Second, there remain smaller banks below the threshold of public interest and unable to build-up sufficient MREL for bail-in in resolution. While market exit of non-viable banks must be ensured, we need to avoid that piecemeal liquidation negatively affects the efficient provision of banking services and depositors' confidence. Some of the tools proven useful in resolution could also minimise the disruption caused by the liquidation.

Cross-border consolidation in the European banking sector would help to reduce the fragmentation of European financial markets. This requires further efforts to eliminate barriers to doing banking business across borders. For instance, banking groups should be able to allocate capital and liquidity freely within the groups while maintaining comprehensive safeguards for host countries in times of crisis.

Of late banks have increased their holdings of sovereign debt. While this is necessary to fund governments' expenditure to support households and businesses in tumultuous economic conditions, we must not forget the viciousness of the sovereign-bank nexus. Gradually introducing capital requirements that reflect credit and concentration risks of sovereign holding in banks' balances could restore the incentives to hold a diversified portfolio. By contrast, failing to counter the sovereign-bank loop poses a threat to financial stability, discourages investors to hold Euro denominated debt and thereby weakens the sovereignty of the common currency.

The COVID-19 crisis proved once more that the banking union has been a game changer for the European banking sector and the economy at large. And while the COVID-19 response measures are currently on top of everyone's agenda, the long-term objectives of the Banking Union remain as relevant as ever: a strong banking sector, characterised by financial stability and the ability to provide reliable and low-cost funding, are vital for the European economy. The benefits of completing the banking union are clear – the way to achieve it is, too.

Luis Garicano

MEP, Committee on Economic and Monetary Affairs, European Parliament

Towards an innovative European solution to bad loans

According to the vulnerability analysis published by the ECB[1] on July 28, 2020, the banking sector will be sufficiently resilient to resist the coronavirus crisis. However, the analysis of the ECB also found that lending growth will be instrumental in the recovery[2], estimating that a broad deployment of bank's buffers and supervisory flexibility could bring as much as an additional 3% GDP growth by 2022.

It is thus essential to ensure that loan deterioration does not hamper growth. To this end, the legislative work on NPLs carried out before the crisis must continue. Moreover, avoiding the impact on the deteriorating loan book (partly inherited from the financial crisis) on growth requires, as Andrea Enria (head of the SSM, then at the EBA) has

proposed since 2017[3], that we set up a European "bad bank" (technically, an Asset Management Company, AMC).

Is a bad bank a solution for the COVID bad loans?

The nature of the NPLs from the Covid crisis is such that a traditional AMC may not be fully appropriate. In the previous crisis, the fact that the bad loans had clearly identifiable collateral (real estate) made them easy to transfer and be managed by AMCs. More importantly, the relationship and information sharing between the bank and its client were not as valuable.

However, this crisis is different. Although many bad loans will be from large loans to corporates, a substantial share of the NPLs are likely to be small loans to SMEs with little collateral. Moreover "soft" information is key[4] in this context, and thus keeping the relationship between the bank and the SME is central to promote lending.

Nevertheless, it is clear a bad bank could bolster lending and help mitigate the economic downturn. An innovative solution is required. I would suggest we need to find solutions that preserve the existing banking relationship, such as the purchase of collateralized debt obligations by the AMC instead of individual loans, to foster the creation of NPL markets, of which some tranches would be left within the bank itself to ensure some skin in the game.

A European vs National solution

The idea of an "EU bad bank" is not currently viewed favorably by regulators and national politicians[5]. Instead, the current debate points towards the EU level replaced by efforts towards a "network" or "federation" of bad banks. Each Member State would establish their own AMC, but they all would follow common rules on matters such as governance or funding. There would be no risk sharing, yet the network could, it is argued, gain the economies of scale that are often key for bad banks.

This language of "coordination" is familiar to us from other European efforts. Before we had a Single Supervisor, many advocated for further coordination of national supervisors. With each new scandal (now Wirecard) there is always some call for "more coordination" between national regulators, rather than a European centralized action.

But the drawbacks are evident. Experience shows that enforcing common interpretation of European rules would be impossible. In matters such as asset transfer prices, which are the core driver of this kind of aid, it is hard to see Member States tying the hands of their own AMC.

Also, as the Wirecard example shows, we would face massive regulatory nationalism, where each regulator generally seeks to "wash their dirty laundry at home", and thus avoids, for far too long, uncovering information (such as low asset prices) that may shed negative light on national champions.

Finally, the widely different levels of available funding at each country would make for vastly different levels of recapitalization in different banks and thus lead to further fragmentation of the financial services market.

Thus, innovative AMC´s, if needed, should be set up at a European level. The European legislative framework (BRRD) already allows for the creation of EU-wide AMCs to be funded by the Single Resolution Fund. However, since the aid would be granted outside of resolution, we would need to leverage other sources of funding, such as the ESM, the EIB, or private funding at the pan-European level.

Following the BRRD, aid outside of resolution would be allowed through precautionary recapitalizations if it is not granted to offset losses that have already been incurred or are likely to be incurred. With the ECB's recent analysis potentially serving to draw these lines, we should prevent aid from compensating banks for pre-Covid toxic assets.

In sum, an innovative European AMC would be essential to maintain loan growth. The following months co-legislators at European level should focus on making it possible.

1. https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200728~7df9502348.en.html
2. https://www.bankingsupervision.europa.eu/press/blog/2020/html/ssm.blog200728~0bcbafb8bc.en.html
3. https://www.euromoney.com/article/b12khnx-qgfghwd/ebas-enria-says-europe-wide-bad-bank-is-essential-to-avoid-japan-style-stagnation
4. https://onlinelibrary.wiley.com/doi/epdf/10.1111/j.1540-6261.1994.tb04418.x
5. https://www.ft.com/content/15d17d1d-8e1b-4f84-97b4-b62e6ae8f962

Elke König

Chair, Single Resolution Board (SRB)

Paths towards a clear and predictable liquidation regime

When talking about the predictability of the resolution framework, one has to state clearly, that we have a viable system in place, providing clear rules on using resolution tools and allocating losses in case of a bank failure. For example, a harmonised creditor hierarchy provides clarity and transparency to authorities and investors alike as to who has to bear losses and in which order.

Moreover, the rules provide that it must be determined if the resolution of an institution, which is failing or likely to fail, is in the public interest or not. The public interest assessment (PIA) performed by the SRB is therefore the clear line of separation between sending a failing bank into resolution or into orderly wind-down in accordance with national insolvency procedures (NIP). The SRB mentioned in the past that resolution is for the few and not for the many, which holds true looking at more than 3,000 banks in the Banking Union. In contrast, for most

▶ of the 128 banks under SRB remit, resolution is the way forward in case of failure. The SRB published its methodology for the PIA in 2019 and clarified it further in a recent blog post; the SRB also published its Expectations for Banks, a compendium of best practice to guide banks in making themselves resolvable.

Unfortunately, Europe lacks key legal elements to enhance the consistency of a bank failure, when the resolution of a bank is not in the public interest. In this case, the failing bank must be wound down in line with NIP. In practice, the outcome of NIP can vary considerably depending on factors such as the national insolvency system, and national handling, including discretions, of the respective deposit guarantee scheme. Equally, important practical aspects such as the licence withdrawal from a failed bank are unharmonised legally and thus different from country to country. Thus, we have repeatedly stressed on the urgent need for legislators to introduce measures that would harmonise NIP and liquidation procedures for all banks and increasing robustness, predictability and trust in the resolution and insolvency regime for banks.

Another topic of discussion among experts remains the challenge faced by some deposit-funded medium-sized banks, without easy access to wholesale funding markets, which might be too small to be resolved, while at the same time being too big to be liquidated. It is argued that the current framework does not seem to provide a perfectly suitable set of tools for these situations, which could lead to an inefficient piecemeal liquidation process for those banks. There is currently no easy solution available, as losses must be allocated and these banks too have to become resolvable.

For most of the banks under SRB remit, resolution is the way forward in case of failure.

One option could be to provide resolution authorities with administrative powers to transfer assets and liabilities in liquidation with the support of deposit guarantee systems. If done at national level, such measures could increase the efficiency and reliability of managing those failures, but divergences in NIPs among Member States (MS) would remain and the fragmentation could increase. Allocating these powers to a centralized European authority would ensure consistency in the treatment of banks, could lead to efficiency gains and enable the transfer of assets or liabilities to interested bidders in several MS. For these banks to be resolved, the focus might need to be on so-called "transfer strategies", in particular sale-of-business, when working on making these banks resolvable. This work must reflect on the role, which a national DGS or a European system can play to allow and support such interventions.

The creation of a common deposit insurance scheme remains an essential component of any solution in the long term. We welcome the efforts by the German Council Presidency to try to break the political deadlock with further technical work on the so-called hybrid model. However, we should maintain the ambition of the original idea, and work towards a European framework for bank liquidation with a fully mutualised European Deposit Insurance scheme. By contrast, with other more complex options discussed, a strong centralised fund will provide sufficient firepower and ensure that not least a timely pay-out could take place. We should not repeat past mistakes of leaving the house half-built and, thus, finalise the Banking Union by erecting and completing its third pillar. ●

Martin Merlin

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

Fostering market integration and completion of the Banking Union

The focus of regulators, supervisors and central banks the last months has been on managing the COVID-19 pandemic and ensuring we have the right tools and framework to facilitate the recovery. The reforms we implemented following the financial crisis have shown their merits and the banking sector has so far proven resilient, but the second-round effects on the banking sector will become clearer over time. We have to make sure that we have in place a completed Banking Union, to weather the fall-out from this and any future crises, and protect the single market for banking.

Market integration is a key objective of the single market because of its benefits for economic growth. One of the aims of the Banking Union is to strengthen the resilience of the banking sector and reinforce financial stability. The challenge is how to reconcile financial stability in each Member State with European financial integration. The EU legal framework contains a number of mechanisms to address this challenge, yet the EU banking sector remains less integrated than it was before the financial crisis. Controlling of resources in local subsidiaries of banks, including restrictions of cross-border movements of capital, liquidity, and loss absorbing capacity persist, as local authorities are ensuring pre-positioning of resources in advance of potential stress conditions.

Within the single market, as recovery from the impact of COVID-19 proceeds, enhanced integration and consolidation in the banking sector will become all the more important. However, banks' appetite for consolidation and cross-border expansion is very low. Progress on revisiting some aspects related to fragmentation will not be possible without addressing the main concerns of host authorities, including the ▶

absence of effective and enforceable mechanisms that ensure a timely and credible transfer of non-prepositioned resources (i.e. capital, liquidity and loss absorbing capacity) by the parent to its subsidiaries, including in time of stress.

Another critical element that is missing from the Banking Union architecture and that would help fend off fears of contagion and address the sovereign-bank nexus is a European scheme for depositor protection. Such a scheme will ensure the protection of depositors regardless of the location of their bank. It will be important to get the financial safety nets for the Banking Union up and running. This includes the European deposit protection scheme, as well as the backstop to the Single Resolution Fund.

Such advances will be key in order to deal with ring fencing. Creating a new home-host paradigm will require restoring and consolidating trust and aligning incentives in terms of liabilities versus control both in a going concern and in a gone concern perspective.

Work on all aspects should continue in a comprehensive way.

Work also needs to continue on a further strengthened and aligned crisis management framework, to increase its efficiency and consistency. There is a broad consensus that the review of the resolution and depositor protection rules will provide a solid foundation to move forward with the completion of the Banking Union. We believe it is crucial that the resolution framework is fit for purpose and that adequate and proportionate solutions are available to address the issues of potentially any bank. An array of tools and sources of funding are available, which can and should be employed. In order to ensure that these are adequately used, a holistic reflection on the components of the framework, encompassing the tools, the available funding means, including the use of deposit guarantee schemes, and the interaction between resolution, liquidation and national insolvency rules is warranted.

We should also continue the work on the sovereign-bank nexus and in particular on how the impact of COVID-19 pandemic and the economic fallout will affect banks' exposures to sovereigns, financial stability and the need for safe assets at the EU level.

Work on all these aspects should continue in a comprehensive way, given their close interrelation, whilst taking into account any relevant lessons learnt from the current crisis or monitoring of the economic situation. In a well-functioning and strong Banking Union, banks will be better able to play their part to mitigate the effects of COVID-19 and support the recovery. It is important that all actors continue the work on Banking Union completion.

Dr. Karl-Peter Schackmann-Fallis

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

Shaping the Banking Union and allowing for diversity in the EU's banking sector

Europe is experiencing an unprecedented economic shock. Its future development is still highly uncertain, including its eventual impact on the banking sector. Throughout this crisis, it will be crucial that banks maintain their lending activities to the real economy. As with the Global Financial Crisis of 2009, regionally focused institutions play a crucial role in supplying credit to SMEs, proving once again the great value of diversity in the EU banking sector. Maintaining this diversity has to be a guiding principle for every step taken in further shaping the Banking Union, be it with regard to supervision, crisis management, or depositor protection.

The European Commission's proposal for a European Deposit Insurance Scheme (EDIS) from November 2015 prominently failed to account for diversity – and this did not change with its later communication from October 2017. The Deposit Guarantee Scheme Directive (DGSD), which already completed the Banking Union, recognises Institutional Protection Schemes (IPSs) that have been used for decades by small and regional credit institutions, such as the German Savings Banks. IPSs are vital for independently governed credit institutions as they offer an overarching element allowing for network building and economies of scale. EDIS, a tool of centralization and transfers, would draw all financial resources from national guarantee funds and IPSs to the EU level, rendering their continued existence economically non-viable.

Being limited to providing depositor compensation only in the event of insolvency, EDIS would be unable to perform any of the fundamental tasks of an IPS. Institutional protection measures are a form of early restructuring to prevent insolvency through liquidity loans, equity injections, and potentially transfers of assets or a merger.

The current economic shock also shifts the focus on the negative systemic effects inherent to EDIS: creating moral hazard and ignoring effects of national economic policy on banking stability by mutualizing the resulting financial consequences; increasing contagion risk due to closer interconnectedness; decoupling risk and responsibility, thereby encouraging high-risk affinity of credit institutions – at the expense of banks with less risky business models.

Nonetheless, several steps remain to further improve the effectiveness of the Banking Union potentially, including:

- Increasing the predictability and credibility of the EU crisis management framework is important. A key component will be a sufficiently large and readily available backstop that provides liquidity in resolution. There is also further room for clarity regarding the interplay of different national triggers for bank insolvency.
- It is almost inevitable that the ratio of non-performing loans will increase. A sustainable solution to keep NPLs from burdening banks' balance sheets and disrupting lending must be found.
- Solving the so-called "home-host issue" does not need EDIS, as restrictions on the free flow of capital and liquidity are set by supervisors out of a prudential perspective. An improved and more equal regulatory treatment of parent-subsidiary-structures and parent-branch-structures in deposit insurance could be discussed to ensure a level playing field in this area.

The debate should be on improving the proper functioning of the Banking Union and not focus on EDIS.

- Backstop mechanisms for national deposit insurance funds could be considered, e.g. via the ESM. It has to be emphasized however that this must not be a starting point for mutualisation.

EDIS would stand in sharp contrast to the harmonized requirements put in place via the DGSD, which allow for the coexistence of IPSs and ensure common standards for depositor protection in every Member State of the EU.

EDIS would eliminate diversity in the EU's banking sector, increase contagion risk and moral hazard. Going forward, the debate should turn to improving the proper functioning of the Banking Union and focus on how to maintain the diversity of the EU banking system and its stabilizing effects in times of crisis. ●

Santiago Fernández de Lis

Head of Regulation, Banco Bilbao Vizcaya Argentaria (BBVA)

Banking Union in times of Covid

The Banking Union (BU) was launched at the peak of the euro crisis in 2012, involving the transfer of large parts of the regulatory and supervisory framework from the national domain to the euro area. The Covid crisis implied a significant fragmentation of EU financial markets, which threatened to take us back to the pre-banking union era. Fortunately, EU leaders reacted swiftly and decisively, especially with the Next Generation EU package, and the risks of a further strengthening of the bank-sovereign doom loop have diminished substantially. What is left to be done now is to complete the banking union, to avoid being again in a vulnerable position.

The completion of the Banking Union is a matter of consistency: a common regulation, supervision and resolution authority (and resolution fund) is incompatible with deposit insurance remaining in national hands. The incentives of such a scheme are not properly aligned. Decisions taken (and in its case mistakes made) by European authorities cannot be backed by national deposit insurance funds, and ultimately national taxpayers. EDIS is not only about risk sharing but also about risk reduction. It implies diversifying the safety net of bank failures to a much wider and diversified group, thus preventing financial contagion between interdependent banks and reducing the likelihood of spillovers.

Over recent years we have seen different proposals for a common deposit guarantee scheme, with different degrees of ambition. Recent proposals seem to focus on the so-called "hybrid model", which is based on the idea of coexistence of a central fund and national Deposit Guarantee Schemes. The design of the transition phase could rely on a combination of national and European funds, as was done in the case of the Resolution Fund. But in any case, the final objective of a fully mutualised EDIS should be made clear from the outset. Otherwise, the full scheme will lack credibility and national funds will continue relying on the implicit backing of national Treasuries, maintaining the banking-sovereign loop.

The remaining steps towards banking union are well identified and will be easier to adopt with the recently agreed recovery package.

Another crucial element of the banking union that is missing is a European safe asset. The use of the German bund as a proxy is a source of fragmentation that needs to be corrected. Fortunately, the new EU recovery package includes a compromise to issue what should be the embryo of such common asset. Although the details of this issuance are yet to be decided, it is very likely that it will evolve to become a true European safe asset.

Another aspect that needs to be further refined is the application of the bank resolution framework. There is considerable dissatisfaction on its application to recent banking crisis, with very different approaches in different countries that imply an uneven playing field. Some recent proposals put the blame of this lack of consistency on the excessive automaticity of the bail in requirement. There may be improvements on a more flexible approach to the early intervention and recovery phases, including in the use of deposit guarantee schemes. But the absolute priority and a condition to further progress towards banking union should be to protect taxpayers' money.

In the Covid crisis the EU has shown once again its willingness to progress to a closer union and its capacity to overcome the difficulties. The decisions taken in recent months are bold and decisive. The remaining steps towards banking union are well identified and will be easier to adopt with the recently agreed recovery package.

Diederik van Wassenaer

Global Head Research and Regulatory & International Affairs, ING Group

Covid-19 reinforces the case for the completion of Banking Union

For the banking sector, Covid-19 again shows the importance to break the link between sovereigns and domestic banks – in order not to amplify the divergent forces at play in the Eurozone. The Banking Union urgently needs to be concluded, by creating a European deposit guarantee scheme and a truly single market for banks with harmonised European rules.

While Covid-19 is an unprecedented symmetric shock, its effects differ per country. Within Europe, some countries had to impose more severe lockdowns than others. Moreover, lockdowns hit some sectors more than others. As the sectoral composition of economies differs across countries this too results in diverging economic effects.

Likewise, NPL developments will differ per sector, and given sectoral composition differences, will diverge across countries. NPL effects will take time to materialise, also given generous govt aid packages and regulatory arrangements. This gives both borrowers and lenders welcome time to prepare for absorbing the losses caused by Covid-19.

It is unfortunate that Eurozone countries with weaker starting positions, in terms of economic resilience, unemployment and fiscal room, appear to be more severely hit by Covid-19. As such, Covid-19 lays bare and adds to the inherent instability of the Eurozone, which is based on the different economic and fiscal profiles of its constituent member states, combined with insufficient mechanisms to counterbalance these divergent forces at Monetary Union level.

The Eurozone continues to have underdeveloped tools for Eurozone-wide public sector stabilisation, while Banking Union and Capital Market Union could be further enhanced to facilitate private sector stabilising flows.

The response to Covid-19 from the ECB and other EU authorities has been swift and strong; the regulatory and supervisory flexibility aimed at increasing banks' capacity to continue financing the economy demonstrated Europe's ability to act in a joint manner.

However, for the banking sector Covid-19 again clearly shows the importance to break the link between sovereigns and domestic banks – in order not to amplify the divergent forces described above. The Banking Union urgently needs to be concluded, by creating a European deposit guarantee scheme.

The prioritisation by the Germany Presidency of this topic is therefore most welcome. In addition, a truly single market for banks with harmonised European rules in all major areas, ranging from prudential to AML and digital ID must be achieved. As EBA has stated, increased levels of cybercrime, Covid-19 -related frauds were observed, these can only properly and effectively be addressed by a European approach.

Furthermore, it has been clear for a long time that a Europe-wide safe asset would help the process of reducing home bias in bank sovereign bond holdings. A deep and liquid market for a risk-free EU asset would allow banks to diversify their holdings. The European Recovery and Resilience Fund is a welcome step in this regard. It – temporarily – makes the EU the third-largest sovereign issuer after Germany, France and Italy by 2021.

> *For the banking sector, Covid-19 again shows the importance to break the link between sovereigns and domestic banks.*

Of course, the Covid-19 crisis and recovery are not primarily about banks. Primary concern is helping businesses and households recover. Banks are instrumental in this and are able to play that role thanks to sufficient buffers going into the crisis, and helped by regulatory relief measures that were quickly arranged. But bank loans, while an important source, cannot solve all funding issues.

European business equity also needs to be repaired. Therefore, policymakers should consider equity participation as well. While some initiatives are taken in this direction at country level, this is par excellence an opportunity for a Europe-wide approach. Unfortunately, solvency support was scrapped in the package agreed in July by the EU Council.

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What does the Covid crisis mean for insurance companies and their regulation?

Gabriel Bernardino

Chairman, European Insurance and Occupational Pensions Authority (EIOPA)

Lessons for the insurance sector from the Covid-19 pandemic

Without question, Covid-19 has been one of the most globally disruptive events of the century. Much more than just a health crisis, the pandemic has caused upset and uncertainty for people and businesses, resulting in a severe economic crisis and triggering extraordinary fiscal support measures and recovery initiatives at national and European level.

The insurance industry has not been immune. As with every other business, insurers have had to take steps to maintain business continuity and services to customers, while also ensuring the safety of employees. Through their own preparedness and supervisory measures taken place to alleviate regulatory burdens, the sector has, by and large, weathered the crisis well.

While the crisis is far from over, there are already some lessons that we can draw from the crisis.

The Covid-19 outbreak has severely affected macroeconomic and market conditions worldwide which, coupled with the persistent low interest rate environment, increases the likelihood of a 'low for long' scenario with adverse implications for the insurance sector. As a result, insurers are significantly challenged in terms of asset allocations, profitability, solvency and business model adaptation.

Measures designed to alleviate the impact on the economic activity are likely to contribute to the continuation of the low interest rate environment.

While European insurers were on average well capitalised at the end of 2019, ultra-low interest rates affect the sector through the balance sheet channel both on the assets and liabilities side, but also through the income channel. Considering that market yields are at very low levels, this might have an impact on insurers' profitability in the medium to long-term horizon.

Viewing the pandemic through the lens of Solvency II underscores the risk-based nature of the framework and how, overall, the regime works well, even considering the volatility in equity markets.

As we prepare to conclude our 2020 review of Solvency II, we have seen that the proposals set out in our holistic impact assessment – notably on measures related to interest rate risk, proportionality, fostering long-term investment, and completing the macroprudential elements of the framework – published before the onset of the crisis, appear to have been validated.

It is also worth considering the Solvency II review in the wider context of European economic recovery. Our proposals related to sustainability, climate change and environmental, social and governance factors will help foster long-term investment in the green economy, thereby supporting Europe's Green Deal.

The pandemic has also shone a spotlight on protection gaps: in this case non-damage business interruption insurance. Again, in the wider context, Covid-19 has demonstrated the need to strengthen society's resilience to severe shocks as a whole, whether these are health-related, such as this pandemic, stem from climate-related natural catastrophes or large-scale sophisticated cyber attacks.

At EIOPA, we recently set out different approaches to shared resilience in a staff paper. The widespread nature of pandemics means traditional insurance risk transfer mechanisms may not be appropriate, making them too great a burden to be shouldered by insurance companies alone.

Instead, solutions involving both the public and private sector are needed. In short, we need to develop 'shared resilience' solutions that encompass proper risk assessments, investment in prevention measures, appropriate product design, and residual risk transfer.

> *For a resilient post-pandemic world, at least one thing is certain: insurance should be part of the solution, not part of the problem.*

Insurance companies play an important role in Europe's financial services industry and economy and the strength of Europe's economy is underpinned by our ability to insure against the costs of future pandemics.

It is in everyone's interest to have a strong economy and a resilient society. To achieve this, we need solidarity and shared responsibility across all sectors of society: governments, public institutions, industry and civil society. Working together, with a common purpose, we can facilitate shared resilience.

Covid-19 has left us with many uncertainties. Nonetheless, for a resilient post-pandemic world, at least one thing is certain: Insurance should be part of the solution, not part of the problem.

Romain Paserot

Deputy Secretary General, International Association of Insurance Supervisors (IAIS)

Covid-19: Impact on the global insurance sector and supervisory responses

The IAIS has been closely monitoring the impact of Covid-19 on the global insurance sector and is facilitating the sharing of information and discussion among its membership on supervisory responses.

Non-life insurers are impacted through increases in claims, particularly in business lines such as business interruption, travel and liability. Life insurers can be impacted through mortality shocks but also through investments, including the escalation of credit risk exposure to non-financial firms and sovereigns and the procyclical impact of large-scale rating downgrades. The IAIS is undertaking a targeted assessment of the impact of Covid-19 on the global insurance sector, focusing on solvency, liquidity, profitability and overall balance sheet exposures. The Covid-19 data collections have a quantitative and qualitative component and include data from insurers and IAIS member supervisors. By complementing the IAIS' quantitative analysis with the qualitative insights from insurers and supervisors into their own risk assessment, the IAIS obtains a more holistic view of the potential build-up of risks and vulnerabilities in the insurance sector during the Covid-19 crisis.

Initial analysis indicates that, so far, there has been a significant, but broadly manageable, impact on insurers' solvency and profitability, due to financial market turmoil and a disruption in new sales combined with increases in claims in certain business lines.

The Covid-19 crisis has served to further highlight the importance of cross-border supervisory cooperation and coordination. The global standards adopted by the IAIS in November 2019 provide more tools in the supervisory toolkit to take a coordinated approach to insurance group supervision. Firstly, ComFrame provides a globally consistent framework for both assessing (through, for instance, supervisory review and stress testing) and coordinating (through supervisory colleges and crisis management groups) a cross-border supervisory response for internationally active insurance groups (IAIGs). Secondly, the IAIS' holistic framework for the assessment and mitigation of systemic risk provides an enhanced set of supervisory policy measures for macroprudential purposes, designed to increase the overall resilience of the insurance sector and help prevent insurance sector vulnerabilities and exposures from developing into systemic risk. When a potential systemic risk is detected, supervisory powers of intervention should enable a prompt and appropriate response.

The Covid-19 crisis has also highlighted the relevance of a global group capital standard for IAIGs as part of ComFrame to provide a common language for group solvency discussions. Supervisory cooperation is paramount to the supervision of IAIGs and resilience of the sector. A global insurance capital standard is even more important in periods of global stress for the insurance sector. It would provide increased mutual understanding and greater confidence in cross-border analysis of IAIGs among group-wide and host supervisors, as well as contribute to better cross-sectoral dialogue.

The Insurance Capital Standard (ICS) Version 2.0 is currently at the beginning of a five-year monitoring period. The purpose of the monitoring period is to assess the performance of the ICS throughout the business cycle, to ensure that it appropriately and adequately captures and reflects risks in varying economic and financial market conditions. The current situation makes this year's monitoring exercise even more important, as the reliability of supervisory risk-based tools is critical in times of significant market movements and stresses. By collecting year-end 2019 data and a stressed balance sheet based on actual holdings as at end-March 2020, the IAIS will receive important information that will help deliver a sound global, group solvency framework at the end of the monitoring period.

In closing, while the global insurance sector has shown its resilience thus far, there are still many unknowns including the duration of the crisis and its full impact on the global economy. This highlights the need for continued dialogue between supervisors, insurers, policyholder representatives and standard setters in the face of continued uncertainty. The IAIS remains committed to support this global dialogue on appropriate responses to the crisis, by facilitating the sharing of information and analysing relevant data from global insurance groups and supervisors. ●

Alberto Corinti

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

Lessons learned during the Covid crisis for consideration in the SII review

In general, the insurance sector has navigated the crisis quite well, but supervisors can certainly draw a number of lessons for the future. I would like to highlight three of them.

First, this crisis, mainly due to its non-financial triggers, is highlighting the urgency to take account of a number of risks that are normally not a priority for supervisors. I refer, for example, to those risks associated to the ability to continue to do business in a context of confinement measures, to the capacity, stability and security of IT platforms, to the legal and reputational risks deriving from unclear policy wording or, more generally, to the lack of fairness and transparency in the relationship with policyholders.

Certainly, these risks could be better mitigated before they materialize, through enhanced ERM policies and pre-emptive supervisory measures.

As to the more traditional risks for prudential regulation, in my view ▶

this crisis has confirmed the need to reinforce the management of liquidity risk by insurers. This risk, for understandable reasons, has not been considered key for the insurance business. We also have to acknowledge that no significant issues have emerged in this regard, at least at the current stage of the crisis. However, at least at the beginning, liquidity has been an obvious concern for both insurers and supervisors.

Supervisors have promptly set up enhanced supervisory reporting and some of them have even investigated the possibility to activate forms of extraordinary access to liquidity for insurers. It is clear, though, that what we would need first are proper measures on the governance of this risk by insurers. Supervisory reporting and other supervisory tools would work better in an appropriate ERM context.

Last but not least, the crisis has stressed the need to continue to work on how the prudential regulation behaves in times of financial market turmoil and, more precisely, on how to avoid that the interventions triggered in these situations by the solvency indicators end up to be too penalizing, useless or, above all, pro-cyclical. This includes at least two aspects. First, addressing the short-term, excessive volatility of market factors.

In Italy, during the hardest days of the crisis we had activated a weekly monitoring of the SCR ratio, which highlighted the extreme volatility of the indicator. Obviously, this could pose problems when it comes to transforming the warnings into concrete action, as the flexibility left to supervisors by the current framework is limited.

Addressing the excessive volatility of market factors, by the way, is an objective to achieve independently of the occurrence of a crisis. Secondly, it would be important to be able to activate a set of emergency measures that could reasonably soften the requirements when needed, to provide further flexibility for supervisory interventions.

> *The ability of insurers to stand difficult times depends on the risk measures that are in force in normal times.*

These measures, although contingent to specific situations, should be applied in a timely manner and, for this reason, they should preferably be embedded in, and coherent with, the regular solvency framework.

The Solvency II revision should ideally consider all these aspects. Very often, the ability of insurers to stand difficult times depends on the risk measures that are in force in normal times. ●

Dominique Laboureix

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

Adjusting the supervisory framework in light of the crisis: keeping momentum

The Covid crisis has showed the robustness of the insurance sector and the flexibility of the regulatory framework.

At present, two main first lessons can be drawn from the crisis. First, the current Solvency II counter-cyclical mechanisms have proved to be useful to mitigate the impact of market volatility on the balance sheet of insurers and to avoid pro-cyclical behaviors. For instance, the risk of incentivizing fire sales of equities has been limited, although there may still be the need to carefully analyze the consequences of the crisis and potentially strengthen these counter-cyclical tools. In that respect, European supervisors decided to have a closer look at the potential pro-cyclicality of the downgrades of certain debt instruments and bonds by credit rating agencies. Second, no specific liquidity issue among insurers has emerged so far. Insurers have built adequate liquidity reserves and have not been confronted with high demand in liquidity: claims remained constant and lapse rate drastically dropped.

> *If the insurance supervisory framework responded well so far, cautiousness is still warranted.*

In addition to the use of Solvency II tools, supervisors took unprecedented supervisory measures to face the crisis, showing their ability to adapt to an

unexpected situation. On 2 April, EIOPA urged companies to temporarily suspend dividend distributions in order to strengthen their ability to deal with the crisis. Most European supervisors, namely the ACPR in France, followed this orientation, later extended by the ESRB to 1st January 2021.

It is also worth noting that the deferral of the implementation of IFRS 17 to 1 January 2023 will provide companies with additional time to review their transition options and adequately reflect the current economic outlook in the valuation of their obligations.

Looking ahead, regulators and supervisors have initiated discussions on a potential mechanism to cover losses related to business interruptions and to fill in the observed protection gap. As full insurability is probably not automatically possible, one of the key prerequisites for such a mechanism will be to find the appropriate mix between public and private financing.

From now on, ensuring sound and sustainable financing conditions for corporate, especially for small and medium-sized companies, to foster economic recovery, will be the main challenge. European insurers have a decisive role to play in this regard, given their business profile conducive to long-term investments. European insurers will also play an important role in supporting a sustainable transition. Finalizing and implementing the EU green taxonomy can contribute to this goal.

The impact of the crisis on insurers was dampened thanks to the Solvency II framework, but some targeted adjustments are worth being considered to improve it.

The pandemic has also, once again, shown that clear wording for insurance policies is essential and that insurers must accept claims when a pandemic situation coverage has not been clearly excluded by the contract. Globally, IDD is the other directive that insurers must comply with and take more into consideration.

Dr. Frank Grund

Chief Executive Director of Insurance and Pension Funds Supervision, Federal Financial Supervisory Authority, Germany (BaFin)

Covid-19: a long-term challenge for insurers' resilience

The Covid-19 crisis has dealt the insurance industry a double blow. The liabilities side of the balance sheets reflects the claims of the insureds arising from coronavirus-caused losses.

So far, the providers of credit and surety insurance, event cancellation insurance and plant closure insurance in particular have compensated their customers to the extent agreed by policy. In cases of doubt, they have often found amicable solutions. In Germany, while the increased claims expenditures have not overwhelmed the insurers' capacities, the impact on the undertakings' profitability has certainly been significant. We expect insurers to consider this in their capital planning and thus when making future distributions. What is more: when it comes to designing product features, the industry urgently needs to address the impact of pandemics. It is clear that this risk was not included in past calculations.

> *The crisis has dealt the insurance industry a double blow.*

On the assets side of their balance sheet, insurers have now benefited for several weeks from the fact that the market turbulence in March was followed by a stabilising effect and that the market values of their capital investments have recovered. The undertakings are reporting an increase in share prices and a decline in spreads. Both developments are having a favourable impact on the coverage ratio of the solvency capital requirement (SCR), which is at the same time under pressure again due to a declining yield curve. Moreover, quantitative data provided by the undertakings show that the volatility adjustment (VA) during the market turbulence has had a significant positive, stabilising effect on the solvency results.

The COVID-19 crisis is thus supplying valuable information on whether crisis instruments such as the VA are ultimately fulfilling the tasks they were designed to fulfil. But the undertakings' leeway for dealing with additional strain is becoming increasingly limited.

This means growing pressure to reach balanced solutions in the Solvency II review. Importantly and appropriately, EIOPA is postponing its recommendation to the European Commission regarding the overall Solvency II review from the end of June to the end of December 2020, to be able factor in the initial obvious lessons learned from the crisis. But it is also appropriate that we are not discarding the work done so far. Certain aspects of the review, such as reporting and thresholds, are largely independent of the coronavirus. In other respects, it is too early to draw any conclusions from the crisis for regulation.

The industry's resilience is not equally indicative of all undertakings. Some institutions for occupational retirement provision in particular were already experiencing major difficulties prior to the outbreak of the pandemic – especially in light of the low interest rate environment. Of the 135 *Pensionskassen*, about 35 are under intensified supervision. "Intensified supervision" means we increase the rate of contact and work with the undertakings to find suitable solutions for improving their situation, such as having sponsoring undertakings or shareholders provide financial support. But where these themselves end up in economic difficulties due to the pandemic, their willingness and capacity to support the *Pensionskasse* will also diminish.

Mireille Aubry

Head of Prudential Regulation Standards & Foresight, Covéa

Impact of the Covid-19 crisis on insurers and main lessons learned for the forthcoming S2 review

The Covid-19 crisis has so far manifested itself in four main ways. Firstly, and causing a marked impact on the solvency ratios of (re)insurance companies, the Covid-19 crisis has caused a financial turmoil associated with great volatility. In short and as a result, we are witnessing an exacerbation of the low interest rate environment and a repricing of spreads and risk premiums. German rates have initially fallen 70 bp then 20 bp and currently 40 bp compared to their end of 2019 levels. Equity indices remain around 20 percent lower than at the end of 2019. The solvency losses for insurers associated with these market movements are often around 20% to 30% of SCR coverage ratio points. But we must bear in mind that the impact of financial shocks on solvency ratios has been contained due to massive interventions by the European Central Bank (quantitative easing) and public authorities to varying degrees (solidarity funds, stimulus policies, unemployment benefits, various forms of allowances and aid, state-guaranteed loans.

Secondly, and resulting in a loss of profits, the impact of the Covid-19 crisis is mainly observed in the field of non-life insurance, with contrasting short-term positive and negative aspects depending on the lines of business, with the final net real impact still to be apprehended at the end of 2020 or even 2021. The positive short-term impacts come from the drop in the claims ratio, particularly in motor insurance. Conversely, the impacts are negative on the operating result of business interruption and event cancellations. Losses remain to be measured in the medium term in credit insurance.

Thirdly, a strong operational impact due to containment decisions has resulted in a need to organize business continuity for clients with employees on the basis of massive recourse to teleworking. The management of the crisis here has revealed a good degree of adaptation of insurers in particular thanks to the activation of business continuity plans with crisis teams. Yet, the situation proved to be conducive to the exacerbation of the cyber risk.

Finally, and fourthly, this crisis did not improve the image of insurance in the public eye and a reputational risk arose with business interruption guarantees poorly worded, which has been a source of litigation. This issue is related to the more general question of the place of insurers in resilience solutions and has led to discussions on the forms that insurance against the risk of a pandemic could take and what should be the place of insurers in the resilience solutions that our societies must develop for the greatest number of people. With regard to pandemic insurance, it emerges that effective coverage can only be assumed by insurers if adequate modelling of the frequency and severity of containment decisions associated with the management of a pandemic can be carried out and the burden of claims can be sufficiently distributed among policyholders and/or over time. We need to keep in mind that the effects of the crisis remain to be assessed against further developments both on the coronavirus and the economic sides.

As far as underwriting issues are concerned (claims and premium income) more adverse consequences are expected. For instance, what will future more broader changes in behaviors and business norms be and which consequences on the economy should be expected from current sovereign debts levels. More than ever, there is a greater need for volatility resilience. This should be a driving force for the coming solvency 2 revision. ●

Frédéric de Courtois

General Manager,
Assicurazioni Generali SpA

The role of the insurance sector in a changing economic landscape

In what we can define today as the greatest economic slump since the post-war period, the insurance sector continues to represent an element of resilience for the economy and for society as a whole. Equity indices clearly demonstrate the stability of the sector. The annual solvency capital generation remained strong: a drop of about 25% in solvency ratios was observed across Europe in Q1, well above the regulatory limit, and a rebound of about 10% is expected in Q2. The sector reacted promptly to face the impacts of the Covid-19 pandemic, maintaining operational continuity and customer service, protecting at the same time agents and employees, thanks to the intensive application of digital technologies and smart working.

On the business side, while the Life business has been impacted by the extremely low interest rates, a temporary reduction in claims in the Motor line will keep Non-life profitable almost everywhere, ▶

even with additional services and discounts to customers. Health insurance is projected to grow steadily in a scenario of increasing demand for supplementary private health services.

In order to cope with the Covid crisis from a technical and operational viewpoint, the first task of every insurer is to accurately analyse and study its characteristics in order to predict its short- and long-term developments. It is crucial to manage all metrics, including asset valuation, solvency and accounting balance sheets. Our expectations are of prolonged government and central bank involvement, coupled with continued low interest rates. Medium/Long-term investments with considerable diversification - also in innovative and sustainable investments - are the strategies to be followed. On the liabilities side, there will be a delay in both premium payments and claims reporting; companies should carefully evaluate their claims and premium reserves.

Long-term insurance investments in sustainable/green assets should be better incentivised.

Regarding the current revision of Solvency II, this crisis has clearly indicated two areas on which to focus. First, we must be bold and take this opportunity to review our business approach in line with the European Commission's commitment to the new "Green Deal". I believe we have all realised that what we perceive as a possible future problem is actually much closer and concrete, whether it is a global pandemic or the challenge of climate change. Long-term insurance investments in sustainable/green assets should be better incentivised.

The private sector is ready to make its contribution, but strong public institutions must enable the power of the financial industry to channel unprecedented amounts of capital towards innovative, sustainable and environmentally friendly economy. Second, the discernible volatility in the solvency ratios in the early stages of the crisis was mainly due to the inadequate functioning and calibration of the Volatility Adjustment mechanism. This tool is currently under revision at European level, but it is crucial to introduce further enhancements to make it more effective. ●

Joseph Engelhard

Senior Vice President, Head Regulatory Policy Group, MetLife, Inc.

Carpe Diem. Let's learn from this crisis

While the current crisis continues to play out, to date it has generally served to illustrate the resilience of the insurance sector. This is in part due to good management but also integration of lessons learned from the 2008 crisis into existing robust forward planning, risk and capital management, and investment portfolio adjustments. Faced with current headwinds, insurance companies are effectively navigating uncertain and volatile economic and market conditions. Moreover, insurance products and investments continue to protect customers, stabilize markets and invest in bonds that finance communities and national governments.

While we will be learning from this crisis for some time to come, one important point it drives home is confirmation of industry's consistent call for recognition of the impact of market consistent approaches, such as the ICS, to insurer solvency. Recent reports from various institutions continue to downplay the impact of market-consistent regulatory frameworks on the sector. While the persistent low interest rate environment is a key concern, the impact of inappropriate regulation should not be ignored. Frameworks that require approaches to liability valuation and asset liability matching that are overly sensitive to short term market movements sacrifice the ability to hold assets matched to liability duration to spot-in-time transparency.

The ultimate adverse impact is at consumer and market level with the withdrawal of much-needed long-term guarantee products and corresponding stabilizing investment in assets to match those liabilities. The IAIS have committed to an ICS economic impact study and are collecting data under monitoring period confidential reporting to assess how the ICS reacts under stressed situations. This is a good start, and we suggest it be extended and refined to assist with an evaluation of how the ICS might impact product availability and insurance markets if broadly adopted. However, much more needs to be done to understand and weigh the pros and cons of a market consistent approach, considering anticipated prolonged low interest rates and credit downgrades, to avoid unintended adverse consequences on consumers and markets.

...the impact of inappropriate regulation should not be ignored.

The current crisis also demonstrates the relevance of the IAIS Holistic Framework as an effective means to manage systemic risk in the insurance sector. The IAIS and FSB are now appropriately focused on examining, in light of the current crisis, what activities might be transmitting risk to the financial sector or real economy. The unique origin of this crisis in particular highlights the importance of dialogue among diverse public and private sector participants to understand how risk transmission might occur. We applaud the IAIS for their launch of the Global Monitoring Exercise and its formation of "search parties" comprising IAIS, supervisors and IAIG CROs. These dialogues will prove invaluable in the identification of emerging risks and of the means to best manage them. ●

IV. FUTURE STEPS OF THE CMU

Content

CMU: is the High Level Forum report the right way forward?

John Berrigan

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

Getting Europe's money to where it can do the most good financing the economy

Capital Markets Union (CMU) is our plan to establish a truly single market for capital across the EU. It aims to get investments and savings flowing across all Member States – to benefit citizens, investors and companies, regardless where they are located. CMU is about getting Europe's money from where it is, to where it can do the most good. To finance recovery and create new jobs. A fully functioning and integrated market for capital will allow our economy to grow and be more competitive, while delivering on the EU's commitment to green its economy.

The efforts to a build a single market for capital began with the Treaty of Rome. We are not done yet. The 2015 Action Plan on CMU set out some necessary measures to establish CMU. In 2017, the Commission complemented it by strengthening existing actions and introducing measures in response to evolving challenges. Many proposed measures were adopted and are being implemented. While we have made progress, much remains to do to establish a deep and efficient single market for capital.

CMU is undeniably more urgent in light of the COVID-19 crisis. Public support and bank loans helped businesses address the short-term liquidity squeeze caused by lockdowns. However, in the medium and longer-term, businesses need a more stable funding structure. Re-equitisation of EU industry, facilitated by CMU, is essential. Market financing will be the lifeblood that sustains recovery and growth.

Brexit also has an important impact on CMU. It strengthens the need for the EU to have well-functioning and integrated capital markets. After Brexit, EU capital markets consist of multiple financial centres. A single rulebook and effective supervision will be crucial to prevent regulatory arbitrage, forum shopping, and a race to the supervisory bottom. A strong and complete CMU also goes hand in hand with the promotion of a stronger international role of the euro and an effective policy to protect the EU against extra-territorial effects of measures taken by third countries.

However, deepening the CMU that Europe deserves will be difficult. Remaining barriers, conditioned by history, customs and culture, are deep-rooted. They will take time to tackle. There is no single measure that will complete our vision. The only way forward is step-by-step, in all areas where barriers to free movement of capital still exist. This requires commitment and determination from all parties, especially Member States. Building CMU is a gradual process, based on delivering many small but important changes, so it is important not to lose sight of the global vision for CMU.

> *CMU aims to get investments and savings flowing across all Member States - benefitting citizens, investors and companies, regardless of where they are.*

In November 2019, we brought together 28 industry executives, experts, consumer representatives and scholars in the High Level Forum on CMU. It published a report with 17 recommendations for us and the Member States to advance CMU. This final report now provides, and feedback on the specific recommendations will provide the Commission with valuable input from stakeholders. That will feed into the new CMU Action Plan coming later this year.

While we are still developing specific actions of the next CMU Action Plan, it is clear that areas such as SME access to finance, market infrastructure, retail investor participation, and removing barriers to cross-border investment will be at the heart of the new vision. CMU will make it easier for our businesses to get the funding they need to invest in our economy. Capital markets are vital to the recovery and to the EU's future, because public financing alone will not be enough to get our economies back on track, nor to build the green economy we have committed ourselves to. ●

Jörg Kukies

State Secretary, Federal Ministry of Finance, Germany

Using the momentum: our work on strengthening the CMU to support the recovery

The Capital Markets Recovery Package and the expected Action Plan on the Capital Markets Union by the Commission are key steps for continuing work on strengthening EU capital markets. This important work has gained new momentum following the report by the Next CMU High Level Group, which was set up by France, the Netherlands and Germany, the subsequent Council conclusions under Finnish Presidency in December 2019, and the recent report by the High Level Forum. This momentum has developed at the right time: First, the Covid crisis has further increased the importance of access to finance. Well-functioning capital markets will be essential to overcome the COVID 19 crisis. Second, strong EU Capital markets have become even more important in light of the United Kingdom's exit that is providing a strong cause for developing them further.

It will be key to create a vibrant and competitive business environment that supports recovery and growth by facilitating the access to funding for companies across the EU. This includes the lifting of barriers to financing for small and medium-sized enterprises. With regard to the expected CMU Action Plan, one starting points could be the establishment of an appropriately designed European Single Access Point (ESAP). Enhanced visibility of companies and better investment decisions would allow for a more efficient allocation of capital.

The attractiveness of capital-markets based financing would benefit from an improved ecosystem. Especially for small and medium-sized enterprises, costly and burdensome requirements might discourage listing on public markets in the European Union. As another element, measures to strengthen long-term and equity-based investments are worth striving for while safeguarding financial stability.

Building a stronger and more efficient market infrastructure will be another priority. Apart from settlement services, this could include the establishment of a post-trade consolidated tape. Further elements could be a harmonization of rules on shareholder identification and the exercise of rights associated with the ownership of shares, i.e. voting rights and shareholders' participation in general meetings of corporates.

Beside enhancing the business environment and strengthening the infrastructure, we should also focus on retail investors. We need to think about how to tackle the lack of an investment culture and the low participation of retail investors in capital markets. Enhancing these investors' confidence represents an unused opportunity that we should address by finding a sustainable balance with consumer protection concerns.

Beyond these areas, work on insolvency systems and withholding taxes will be important as well. The question of improving supervisory structures at the European level has gained even more importance against the background of recent events. It turns out that we need supervisors with forensic skills and all the necessary competences, not only in relation to monitoring and enforcement of financial information requirements for listed companies and auditor supervision, but also to money laundering. This will require further attention and an assessment of the need for action.

Well-functioning capital markets will be essential to overcome the Covid-19 crisis.

The future work on CMU will need to focus these important elements in the four areas outlined above. Some elements could potentially be addressed more adequately by complementary work on digital finance and sustainable finance.

More than ever, we need to work on ensuring future-proof financial markets in the Union. Further steps are required to promote capital market-based financing, to integrate and strengthen the European capital market further and to make it internationally competitive. Hence, it is also a key deliverable under our Presidency and we certainly want to use the momentum to achieve meaningful progress.

That means, in the short term, that we are committed to pass legislation putting in place Covid-19 response measures as quickly as possible. And it means, in a more medium term, that we will be working on Council Conclusions on the broader set-up of a true European Capital Markets Union until the end of the year. This should give clear political support for the subsequent legislative work and also underline our common commitment at EU level to bring forward a Capital Markets Union that serves both EU businesses and citizens the best way possible. ●

Steven Maijoor

Chair, European Securities and Markets Authority (ESMA)

The priority areas for deepening the CMU

It is clear that the Covid-19 pandemic and its economic impact result in an urgent need to support the recovery of the European economy. Indeed, helping companies to raise the necessary funds in order to support their recovery is an urgent priority.

While the banking sector will undoubtfully play an important role in supporting this recovery, further development of the CMU will be necessary to ensure additional funding from capital markets. This may reduce the risk of further increasing the reliance on bank lending and give a more important role to (equity) capital.

The proposals made by the HLF on the CMU provide some good initiatives that would contribute to a further development of EU capital markets. The four pillars of the report, namely business environment, market infrastructure, retail participation and cross-border activities are all essential for a deep and efficient CMU. Especially an increasing retail participation is essential to develop the CMU.

Firstly, a successful CMU requires a large retail investor base that would enable financing the economic recovery, digital and green transformation of the European economy. Multiple initiatives could improve retail participation as there is no single measure that would achieve this goal.

While significant efforts need to be devoted to financial education and improving financial literacy, other measures, such tax incentives, insolvency proceedings or pensions rules, are also very important albeit outside the scope of financial market regulators.

Inspiring trust and confidence in the efficiency and integrity of the capital markets is a pre-requisite for the CMU. Information that retail investors receive must be fair, objective and timely but also clear and understandable. Further review and alignment of disclosure requirements for investment products across sectors will be required in order to facilitate their cross-border distribution. Further analysis is also needed on the role of the incentives of financial advisors.

Secondly, easy access to comparable and reliable information on all listed companies in the EU is indispensable for the development of an integrated EU capital market. Indeed, the creation of a single access point to financial and non-financial regulated information based on one harmonised format would facilitate investment on both a national and cross-border basis.

In this context, also the development of the EU consolidated tape with comprehensive coverage and standardised high-quality data would contribute to price discovery and market efficiency.

Furthermore, integrated capital markets require an efficient integrated supervision system that ensures harmonised application of the rules in a manner proportionate to the risks. This requires further progress in harmonising supervisory practices as well as safeguarding sufficient supervisory resources at both national and European levels.

Inspiring trust and confidence in the efficiency and integrity of the capital markets is a pre-requisite for the CMU.

Even though the ESAs' review introduced useful changes to the available supervisory convergence tools, they are less ambitious than originally proposed. In addition, certain parts of the available toolkit prove to be burdensome for the national authorities and ESMA.

The coordination and centralisation of supervision at European level needs to go hand in hand with the development of the CMU. Since the establishment of the ESAs, there has been steady and significant progress in this respect, and based on recent legislation, an increasing number of entities will fall under ESMA's remit in the years to come.

The current environment and developments only reinforce the need to strengthen the role of European coordination and supervision to support a successful CMU.

Carlos San Basilio

Secretary General of the Treasury and International Financing, Ministry of Economy and Business, Spain

The CMU is key to Europe's recovery

It has been 5 years since the European Commission adopted the CMU initiative and since then, EU institutions and Member States have managed to hammer out over 30 measures in order to establish the building blocks of an EU wide, integrated capital market. If one looks back to the impressive array of legislative actions adopted, it is fair to say that the EU has delivered on its promise. And yet, it would be naïve to believe that we already live in a truly integrated European single financial market.

Despite the efforts undertaken by EU regulators and market participants, EU capital markets are still fragmented and relatively fragile. The EU's unparalleled economic and commercial strength is not commensurate with the comparatively small scale and fragility of EU capital markets; it remains an economic giant, but a financial dwarf.

However, we should also avoid overly simplistic comparisons with other international financial strongholds, or with the progress achieved in the Banking Union. Capital Markets are by nature very complex, ever more sophisticated and diverse. Whereas the Banking Union essentially affects banks, the CMU project comprises a myriad of very different financial 'creatures' and their encompassing regulatory frameworks. This complexity makes it hard to tell the progress made, and to assess the true impact of CMU. Take for instance the dynamics of crowdfunding. At first sight, crowdfunding might seem to be a negligible part of the financial system, but if one takes a closer look at this phenomenon, it soon realizes the potentially disruptive change in the way new ventures are funded, that crowdfunding entails.

Despite all the work done so far and the modest figures in non-banking financing across the EU, we should not fall in self-indulgence, conformism or despair. CMU should remain a high political priority for the next years and, to this end, the HLF report represents a very good starting point. This second batch of legislative measures should be issued and negotiated in the same vein as the ones adopted under CMU I: we need to adopt concrete and pragmatic measures and, at the same time, have a clear sense of direction. If we do so, it is entirely possible for this project to succeed—we just need to proceed one step at a time.

In this regard, the CMU II project will have to overcome important challenges. That is the case of the still very divergent and fragmented national taxation and insolvency regimes. Another challenge where a consensus on how to face it is still lacking (as pointed out in the HLF report) is the issue of the European supervisory architecture. It is commonly accepted that ESMA has established itself as a highly competent, agile and reliable supervisor. However, the question of whether or not it should be the building block of a single supervisory mechanism, in the way of the Banking SSM, remains open. Thus, instead of spending valuable resources in trying to advance stuck negotiations, we could for instance further focus on fostering convergence between national competent authorities, with the leadership of ESMA.

> *EU leaders, capitals and market participants need to take swift and decisive action for completing the CMU.*

But obviously, the greatest challenge for the CMU in the short and mid-term is the impact of the Covid 19 pandemic. In this new context, one has to ask himself: what can the CMU do in order to mitigate the impact of this crisis? How can it contribute to absorb the impact of the Covid crisis and at the same time deliver a more diverse and balanced financial system that meets the demands of households, SMEs and companies, and strengthens the international role of the Euro?

SMEs, which are the backbone of the European economy, haven been very hard hit by the pandemic. Therefore, I am very glad that the report includes such a detailed and comprehensive set of recommendations towards SMEs. Certainly, it is essential to facilitate financial resources to SMEs, with a proper balance between banking and non-banking financial resources. Hence, proportionality will be one of the key tools to promote SME's access to capital markets, by adjusting compliance obligations to the size and nature of these companies.

In the post Covid-19 recovery scenario it will be of the utmost importance to count on smooth functioning and reliable capital markets, that are able to efficiently channel vast amounts of financial resources to the real economy. To this end, we shall double our efforts and work together for overcoming this crisis and drive forward the Capital Markets Union.

Robert Ophèle

Chairman, Autorité des Marchés Financiers (AMF)

CMU: a key opportunity for the EU to recover and compete

Completing the Capital Markets Union (CMU) is an essential milestone to create a true Single Market in financial services that provides businesses with a greater choice of funding, offers new opportunities for investors and makes the financial system more resilient.

While Europe is facing its most severe crisis since decades, and with the UK leaving the Union, a new impetus based on a renewed narrative and a strong political commitment is more than ever needed. A few key principles should guide all forthcoming initiatives aimed at completing the CMU. There are not new but they have taken a more acute relevance over the last months in light of the Covid19 crisis.

Boosting European equity markets should be a central focus of the CMU. European firms will need to have access to capital in the recovery phase. IPOs by issuers of all sizes should be facilitated, as well as recapitalizations for issuers seeking to rebalance their debt / equity ratio. Retail investors' savings should be channeled more into equity investment. The long-awaited consolidated tape for equity instruments must be established in the forthcoming review of MiFID.

There is no CMU without safe and efficient cross-border investments and services. The EU passport regime must be enhanced, and so should relations between 'home' and 'host' supervisors. Regulatory arbitrage should be avoided and, in absence of a centralized supervision, regulated firms should not elect a 'home' jurisdiction in a Member State where they do not intend to conduct their business in practice. On another front, the architecture of asset management regulation should be revisited to clarify the framework applicable to cross-border activities and address divergent implementation across Member States.

The long-term needs and interests of EU investors must be at the heart of all initiatives under the CMU flagship. This entails making sure that retail investors receive proper advice before making their investment decisions and that all pre-contractual information delivered to clients (prospectuses, key information documents, marketing materials) are fit for purpose, coherent and not prone to mislead them. This also implies fostering long-term savings and investments by creating a pan-European vehicle for employee share-ownership and revisiting the EU framework for existing long-term vehicles (ELTIF).

Resilient financial markets rely on competitive infrastructures and players. In a fragmented landscape, fostering the competitiveness of the EU27 markets should be recognized as a core component of the renewed CMU. To that end, in future legislation, the impact of any proposed measure on the competitiveness of the EU, its markets and stakeholders - and its relations with third countries - must be taken into account, without affecting market integrity and financial stability. In the long run, this is key to ensure Europe's financial autonomy and economic sovereignty.

Enhanced supervision at EU level is another cornerstone of a well-functioning Single Market.

With a major financial hub at its doorsteps, enjoying full legislative autonomy, the EU will have no choice but to improve its legislative agility. The shortcomings of the EU rulemaking are well-known (regulatory inflation, excessive level of detail at level 1, lack of proportionality, unrealistic timetables, ambiguities in wording, too many national options ....). To compete on a global scale, the EU must have the ability to amend its rules swiftly, in response to market developments or when rules prove to be inapplicable or inappropriate. The EU cannot postpone any longer establishing the necessary forbearance tools that are respectful of the prerogatives of EU co-legislators.

Enhanced supervision at EU level is another cornerstone of a well-functioning Single Market. Taking stock of the fact that ambitious proposals towards more integrated European supervision have not received the necessary political support from most Member States, other ways should be explored to ensure the supervisory convergence that is crucial for all financial market players. For instance, the EU should strive to systematically legislate by way of regulations (as opposed to directives) and ban national options and scope for national gold-plating. In any case, if no further direct supervisory task is to be given to the ESAs, we must avoid any overly burdensome and costly administrative processes. ●

Bernd Spalt

Chief Executive Officer, Erste Group Bank AG

Strengthening Capital Markets as a prerequisite for the EU's economic recovery

The development of the EU single market is without doubt one of the greatest achievements of Europe. Despite the progress achieved, Europe and especially its capital markets are still far from the finish line. However, strengthening capital markets will be an important element in ensuring a full recovery from the Covid-19 crisis – and we should seize the momentum to do so.

In their early attempts to create a Capital Markets Union (CMU), the EU leaders aimed for the "low hanging fruits", such as the review of the Prospectus Directive or STS securitisations, while the underlying issues remained unresolved: Europe's economy is still too dependent on bank financing, European citizens still prefer to keep their savings in low-yielding bank accounts and the EU's capital market is still too fragmented to be called a capital markets union.

Europe's inability to stimulate entrepreneurship and to be attractive for innovative, growth-oriented companies is a consequence of its focus on regulation, instead of playing offense and supporting digital and technological advancement. Meanwhile, the power of US and Chinese tech giants is growing in Europe every day.

Recognizing this, the European Commission initiated in late 2019 a High Level Forum consisting of 28 experts from a wide spectrum of professional and national backgrounds. This working group produced a set of very practical, very clear recommendations to improve the business environment, the market infrastructure, to foster retail customers participation and to address cross-border aspects such as taxes, insolvency and supervision. All these aspects are highly welcome and will help to build our CMU.

However, the core mindset of the working group was pre-Covid-19. In light of the ongoing pandemic their recommendations have become more urgent. We must act faster and be more ambitious to secure the European recovery. So far, we have been protected from the worst, thanks to swift government and central bank action. But this relief is only temporary. We must realize that currently parts of our economies rest on monetary and fiscal crutches.

What we now need is a way to operate without them. This is a challenge and a big chance at the same time. It is a chance because rebuilding our economy leaves us no option but to ensure new financing sources and to strengthen the equity base of European businesses. Increasing the capitalization of businesses in the EU is important to recover from this crisis – it is however equally important to prepare the European economy for future crises.

When it comes to capital markets, we now must have the ambition not only to improve their operating environment, but to create a Capital Markets Union that truly covers our tremendous financing needs. This will be even more necessary when we tackle our biggest challenge – climate change – by financing new and sustainable ways of growth and prosperity. Going forward, this defines a couple of important priorities: first and foremost, capital market finance must become a true option for SMEs.

> *Increasing the capitalization of businesses in the EU is important to recover from this crisis.*

Therefore, we need to create a full level playing field between bank finance and market finance. As long as it is tax-wise or convenience-wise much easier to rely on loans, no significant moves can be expected. Tangible incentives for raising private and public equity must be introduced not only for SMEs themselves but also for institutional investors like banks and insurances. Second, EU-savers have to be motivated to put parts of their savings to better use via the capital market.

Here we need concrete material incentives, such as easier and wider access to financial instruments and attractive taxation. Of course, this requires every member state's full commitment to adapt taxation rules with a clear long-term objective to create a coherent, capital market friendly tax environment throughout the entire single market.

In the upcoming months we need bold political decisions on the national and the EU-level. The current situation has created the momentum to take these decisions and to deepen European integration. The banking community is ready to support such decisions, because a truly integrated capital market will serve all of us, from consumers to small businesses to global champions made in Europe – including banks.

Stephan Leithner

Member of the Executive Board, Deutsche Börse Group

A rolling stone gathers no moss: Capital Markets Union now!

In light of the unprecedent global health, economic and social crisis created by Covid-19, tangible progress on the Capital Markets Union (CMU) is ever more critical for the EU's recovery. With a new political and economic reality for the EU at the global level, we need to ensure that our regulatory frameworks support the key functions and competitiveness of our capital markets in the interest of our society. Clearly, the CMU 1.0 has not brought the results we had hoped for. But there are good reasons to be optimistic that we can make important steps towards a real and efficient CMU in near future.

The Commission's CMU High Level Forum (HLF) of which I am a proud member – has produced an important report outlining key milestones to progress. We expect the Commission to publish a new Action Plan based on these recommendations in September, as well as an Own Initiative Report from Parliament. Furthermore, Germany's Presidency has made the CMU a special case for their term. It hence seems as if the stars are finally aligning, real progress is on the horizon. Europe has a number of success stories on which we should build. This is an important lesson to learn, as much of the discourse has focused on what the EU does not have. But: The G20's financial reform agenda has made our financial system much more stable and resilient compared to the years of the great financial crisis. Covid-19 has acted like a live stress test where exchanges, CCPs and CSDs have once again served as a safe haven amid unprecedented market turmoil due to their transparent, efficient and reliable price formation and risk management processes. Does that mean we can lean back? Quite the opposite. Building on this foundation of stability, time is ripe to foster the growth contribution capacity of EU capital markets.

As a starting point, the EU needs deep and liquid euro markets, ensuring the proper functioning of resilient private risk transfer mechanisms and limiting costs for investors and end-users. Hence, we should build on success stories, such as the market in Eurobond instruments, while avoiding harm to other well-functioning euro-denominated markets, such as in the sphere of exchange traded derivatives where no other jurisdiction applies the "open access" provisions. Rather, the growth of key euro-markets should be further supported while helping new euro-denominated markets emerge in asset classes where the EU is underperforming. Some key steps have already been taken in this regard with the proposed amendments to mitigate the negative impact of the position limits regime and promote the development of competitive euro-denominated energy derivatives markets.

Let us not forget that massive investments are needed to tackle the consequences of Covid-19 during the years to come, and the EU should seize this unique opportunity to reduce its reliance on bank funding, and shift towards equity financing to create an ecosystem that fosters sustainable economic growth. With banks' balance sheets saturated with non-performing loans, increased access to capital raising solutions is key to provide alternatives for companies and an additional route of relief on public finances.

The CMU HLF has pointed out some of the essential to-dos in this respect and the Commission is expected to include them in its Action Plan, such as removing barriers to capital markets (e.g. fiscal disincentives to equity financing such as taxation and insolvency procedures). However, it is also about putting the right incentives into place by promoting the availability of SME research, as well as further tailoring SME Growth Markets to the needs of SMEs. Market operators have already taken steps in this direction by introducing their own programs to support SMEs. At Deutsche Börse Group (DBG), for example, we help to bring smaller enterprises together with investors through our Venture Network or Scale market segment. Yet, in order to fully unlock the potential of the CMU, we must not forget that well-functioning secondary markets are a prerequisite for the successful development of capital markets. With more than 300 registered execution venues, the equity trading landscape across the EU is highly fragmented and does not contribute sufficiently to the growth of the EU. Importantly, MiFID II/ MiFIR has failed on "transparency". A consolidated tape will not be the solution, it would rather erode the level playing field further and inject new costs for investors and end-users of EU capital markets.

Our efforts should hence focus on addressing the flaws in equity market structures and the quality of the price formation process. Measures for a simplified market structure and well-calibrated transparency regimes should therefore be an integral part of completing the CMU to fully support efficient, liquid and resilient capital markets. Finally, we should create an efficient and globally competitive post-trade environment. I therefore highly welcome the HLF's focus on strengthening the CSD passport and improve supervisory convergence among national competent authorities, facilitating the integration of the internal market and spurring a true, competitive cross-border settlement business in Europe. This will ensure to make the euro area a more attractive destination for investment and helps to strengthen the sovereignty of the EU.

Time has come to build on these proposals and to ensure swift and meaningful progress, especially in light of the new pressure created by Covid-19. A rolling stone gathers no moss, CMU now! ●

Leonique van Houwelingen

Chief Executive Officer, The Bank of New York Mellon SA/NV

Capital Markets Union - The need for a strategy for retail investors

In an article published in April 2020 by Eurofi, I argued that we needed rapid, clear and incisive policy measures to build a capital markets union.

I do believe that the Capital Markets Union High Level Forum (HLF) has put such a set of policy measures on the table, and I do urge the European Commission to act on the recommendations contained in the Final Report. In his introduction to the Final Report, Thomas Wieser, the Chair of the HLF, stresses that the recommendations of the HLF are "mutually reinforcing, and dependent on each other".

This is a very important point that I want to illustrate by looking at some of the HLF recommendations that are particularly relevant for retail investors. The perspective of retail investors is especially important because retail investors, namely, households, are the ultimate investors in capital market instruments, and because, in the words of the Final Report, "households often refrain from investments because they do not trust or understand financial markets". This is a damning statement, and a statement that raises a point of key importance. For the Capital Market Union project to be a success, a critical pre-condition is that households do have a better understanding of, and a greater trust in, financial markets, and, in particular, capital markets.

The Final Report does contain a valuable recommendation (Recommendation 12) on financial literacy and education. But by itself this recommendation will not achieve results. This is because the problem is not just that households understand financial markets insufficiently; part of the problem may be that they understand some aspects of financial markets too well. From the perspective of a household, engaging with European capital markets, investing in, and holding, capital market assets, and managing the fiscal procedures and obligations, is complex, opaque, and burdensome.

The heart of several of the recommendations of the Final Report is to create common definitions, common standards, and a common access to information. Common definitions and standards reduce complexity; they provide greater transparency; they facilitate access to information; they reduce barriers to accessing markets; and, in addition, they create the possibility for fair, accurate, and easily understandable narratives that explain how capital markets function in channelling funds into socially and economically useful investments, and how they provide investment income. The single most important recommendation in the Final Report that delivers simplicity, comprehensibility, and tangible benefits to households is Recommendation 15 on withholding tax processes. This recommendation is critical, precisely because tax procedures are currently so opaque and burdensome, and because fiscal impacts are critical for the return on a capital markets investment.

A second critical recommendation that builds on common definitions and standards, and that delivers transparency and legal certainty and reduces operational burdens for investors and intermediaries, is Recommendation 9 on shareholder rights. In August, the Association of Global Custodians published a hard-hitting paper that sets out why we need Recommendation 9 as a matter of urgency.

> *They create the possibility for fair, accurate, and easily understandable narratives.*

Embedded within Recommendation 1 on a European Single Access Point is a requirement for the harmonisation and standardisation of content and format of European company data. Building a pan-European Single Access Point allowing free and unrestricted access to pan-European issuer data will be game-changer in the creation of pan-European capital market narratives.

In the April 2020 Eurofi article, I also wrote that we needed three things. We needed measures to bring investors to the market; we needed measures to bring issuers to the market; and we needed measures that reduce cost, complexity and risk in the use of infrastructure and intermediaries.

I stand by these words. But, I think that we need more. We need a strategy that makes capital markets attractive and understandable for retail investors. The recommendations contained in the Final Report of the CMU HLF will be an important part of this strategy. ●

Christian Staub

Europe Managing Director, Fidelity International

Resilience, purpose and the Capital Markets Union

Financial crises often bring with them a reassessment of social purpose. Following the 2008 crisis, Adair Turner, chairman of the UK Financial Services Authority at the time, described some aspects of the credit derivative market as "socially useless." In the 11 years since those comments were made, concerns over the social utility of finance have moved from fringe products to the mainstream core of equity itself.

Greater attention is being paid to the role of equity in our system of financial capitalism, to how it can be more effectively harnessed to support the real economy and to how to address the balance between shareholder and stakeholder value.

The goal of policy will be to address these issues in a practical way. And, at Fidelity International, we firmly believe the European Union's Capital Markets Union (CMU), and the recommendations from the High Level Forum (HLF), present a real opportunity to bring together the common interests of finance and society for the purpose of reinvigorating Europe's economy. Here's how.

Finding purpose in the CMU

Household financial resilience plays a central role in the framework. The job of a socially embedded capital market is to disperse household savings to the real economy for its use and profitable return, and the CMU reminds us of this in the very structure of its design – with households in need of investment opportunity at one end of a chain and industry in need of funding at the other.

From this flows an ambition to stimulate retail participation in the EU's economic growth, seeking to transform salary-earners into asset-owners. There is an implicit need for greater financial education for this to happen successfully, so that citizens understand how to map their own particular set of liabilities on to the assets available to them.

An increased investor base needs a broader and deeper pool of corporate issuances to pick from, and so the CMU and the HLF's support for greater SME participation in capital markets, either via the channels of Solvency II, Basel III or ELTIF, is a necessary central pillar.

SMEs are one of the main engines of economic growth at a national level and improving their access to funding will fuel job creation and greater investment. To encourage these companies to issue equity for the first time, they should have some relief from market abuse regulations aimed at larger institutions.

And so, a solid plan to encourage greater participation in equity markets would not only boost the financial resilience of households, but of companies too. In rebalancing the funding mix away from debt and towards equity, SMEs will become less vulnerable to sudden credit and liquidity crunches.

The need for resilience

If the interests of society and firms are to be more closely bound by equity, then corporate resilience becomes an end in itself. Non-resilient companies bring fragility both to their employees and investors, as well as to the economic system as a whole.

There are elements of the CMU that will enable asset managers to guide corporates towards more resilient business models through capital allocation or stewardship. And the HLF's proposals around shareholding are a step in the right direction, as well as proposals to re-invigorate SME research and the EFAP.

However, there is room to widen the scope. In creating a new system of capital, as much as possible must be done to mitigate the systemic risks capable of puncturing it. We return once again to 2008, the response to which provided a policy blueprint for models of financial resilience.

Here, policymakers could make good use of bank and insurer recovery and resolution planning legislation, leaving capital adequacy rules aside but seeking to embed the same culture of resilience into non-financial firms. Here, policies from stress-testing to annual reporting may be applicable.

The CMU initiative clarifies the social purpose of equity, supported by the two pillars of increased retail participation in equity markets, and more dispersed corporate issuance. However, fragile companies risk breaking the virtuous circle of value creation and increased economic activity, as well as the trust of wary retail investors, requiring policymakers to consider a third pillar: that of corporate resilience. ●

Bjørn Sibbern

President European Markets, Nasdaq

Capital Markets Union - keep it simple

CMU is a flagship initiative for valid reasons. Europe needs to diversify funding alternatives for companies in order to unlock the potential for sustainable growth across the continent. Progress has been made, but more is needed.

The CMU High Level Forum report – where my Latvian colleague Daiga Auzina-Melalksne participated – puts forward a number of important and concrete measures, ready to be realized and implemented.

One point to highlight is the already initiated idea of an EU IPO Fund. Structures for government fund investment already exist in some countries, and institutions such as EBRD, EIB and EIF are more active in other countries. An EU IPO Fund will add immense value to the current landscape, especially if it can be flexible, i.e. cross-over the IPO moment and be active pre as well as post-IPO, supporting also secondary capital raisings. In the Nordic as well as Baltic markets, the IPO moment is not always the important point of fundraising. Instead this happens post-IPO. Allowing the IPO fund to support companies in this phase is a condition to make it a useful tool for economic recovery.

The majority of listed companies on European markets, and even more so those in the listing pipeline, are in fact SMEs. This is true even on the main markets, the regulated markets. The regulatory framework should be adapted to better suit SMEs, and not just the blue chips. Clarifications and simplifications can be done in legislative pieces such as MAR, the Prospectus Regulation and the Transparency Directive. Cross-border financing will be supported by simpler rules on for instance insider lists and information disclosure. When rules leave less room for differences in interpretation, application and enforcement, investors will hesitate less on cross-border financing.

Retail investors want to be part of the capital markets. They want to invest in innovative companies, contribute to the transition to a more sustainable world and be part of the growth journeys of new companies. In fact, throughout the Covid-19 pandemic, we have seen participation from retail traders increase, adding crucial liquidity for companies in a critical time. Capital markets provide opportunities for long-term financial engagement by retail investors, while at the same time unlocking financing opportunities for growth companies. These opportunities for retail investor engagement should be facilitated.

There is room to adapt some of the paperwork burden for intermediaries, when it comes to especially experienced retail investors. I support the initiatives of the European Commission in this respect. Intermediaries are needed to facilitate retail investments, and the administration around it should not be disincentivising, but appropriate for investor protection.

> *Europe needs to diversify funding alternatives for companies in order to unlock the potential for sustainable growth across the continent.*

An important factor for investor protection is the transparency and fairness in the functioning of the markets. MiFID II has not brought more transparency to the equity markets and large parts of matching still takes place outside the regulated markets and MTFs. I believe MiFID can be simplified, providing for simpler market models that support price formation and establishment of reference prices. The purpose of serving smaller investors trading in smaller lots needs to be balanced with the need to cater for execution of blocks which are big enough to have an impact on the price of a share. The LIS waiver serves the latter purpose and should be maintained. Systematic Internalisers play an important role for large orders and their services should be offered exclusively for such large trades in order to restore a fair playing field for equity trading. Retiring the reference price and negotiated trade waivers would make the complicated double volume cap mechanism redundant, provided the market structure is adapted to ensure full transparency of small trades, which is necessary for attracting and protecting retail investors. These are bold measures, but I believe they would achieve a market model which is more likely to deliver on end investor needs, in being simpler to implement and enforce.

I am convinced that keeping it simple, and keeping a focus on smaller companies and smaller investors, will help us develop the capital markets in the best direction for providing the urgent financial support needed in the recovery from the Covid-19 crisis. ●

Can the EU manage without the City?

Katharine Braddick

Director General, HM Treasury

How are EU-UK financial relations expected to evolve post-Brexit?

The United Kingdom and the European Union have a long, shared history in financial services regulation. We can, and should, build on that history as we tackle the challenges of the present and of the future. Whatever the outcome of the current negotiations on the future relationship, I am confident that we will remain close partners on the issues that will face, and indeed are facing, the financial services sector, legislators and regulators – and most importantly consumers.

I do not think it is hyperbole to say that we are living through a period of unprecedented technological change, and the challenges and opportunities posed by rapid technological innovation are a good example of a space in which we will continue to work together.

The growth of cryptoassests, including stablecoins, is a case in point. This new technology transcends national borders and demands cooperation by the international community if we are to understand the risks it presents and the future role it may play in the financial system.

Research from the Financial Conduct Authority shows that only 5% of British consumers of cryptoassets, including stablecoins, use UK-based exchanges for buying and selling. Of the top five exchanges used in this country, only Binance has a European Union or United Kingdom domicile – the others are based in the United States or Hong Kong. The picture is similar in the rest of Europe.

In the United Kingdom we are working through the G7, G20 and the Financial Stability Board to build consensus on regulatory approaches to global stablecoin and I know that the European Union will be too.In 2018 the United Kingdom's Cryptoasset Taskforce – HM Treasury, the Bank of England and the Financial Conduct Authority – published a paper discussing the opportunities and risks presented by blockchain technology and to consumers.

One of the principal risks is the familiar conduct challenge of consumer detriment arising from inadequate information and we have moved to address this by bringing cryptoassets into scope of anti-money laundering legislation and consulting on the inclusion of certain cryptoasset promotions in financial promotions rules.

> *The UK will work with partners to ensure that the world's financial system remains safe.*

These rules are enforced by the Financial Conduct Authority and backed by criminal sanctions. Looking further ahead, the UK Government has committed to consult on a broader regulatory approach to cryptoassets later this year.

The European Union faces the same risks and questions as the United Kingdom and a Commission proposal for an EU crypto asset regime is widely anticipated. As we move forward we can continue to learn much from each other's approaches, which will be geared towards the same goals: protecting financial stability, protecting consumers, and ensuring that the financial services sector continues to drive growth.

The United Kingdom and the European Union will continue to be members of the same international regulatory organisations, working together with other partners such as the United States and Japan to ensure that the world's financial system remains safe, stable and effective. We look forward to working together with our European partners in the future. ●

Christian Noyer

Honorary Governor, Banque de France

EU-UK Financial relations post-Brexit: where are we heading for?

To understand where we might be heading for after Brexit in the domain of Financial services, one needs to remember what the Single market is all about.

When it was created, the key consideration, strongly supported by the United Kingdom, was the following: if you have a single regulation, with a single jurisdiction providing for a single case law, then you can have a single market, wherever actors providing services are located.

Within the single market, the UK succeeded in developing the City of London as the major EU financial center, which progressively attracted most of the international institutions that were until then operating in several places on the continent.

Later, we realized that having a single market without a single currency was creating significant problems of all kinds. We then decided to include in the EU institutional setup a single currency and a single central bank, although the UK decided to stay out.

Nevertheless, because of the single market rules, there was no obstacle to the concentration of market operations of the single currency in London : most trading rooms that were active in major financial places (Frankfurt for the DEM, Paris for the FRF, Milan for the LIT...) concentrated in London (in fact, only a few remained in Paris, but nowhere else). We then came to an extraordinary situation, where the market liquidity of the Euro was dominantly outside the reach of the issuing central bank, the ECB-Eurosystem.

After the Global Financial crisis, we realized that we had missed another important aspect, which was the risks for Financial stability stemming from a diversity of regulators and supervisors, who in extreme circumstances, might give preference to national interests rather than the interest of the EU – or, as it might be, of the Eurozone - as a whole.

It was then decided to add two major institutional setups: the creation of four supranational regulators and the creation of a single "federal supervisor", the single supervisory mechanism.

The problem we are facing today is not only that the UK is formally leaving the EU. It is that it has decided to diverge from EU regulations in the future, to refuse the case law of the European Court of Justice. and not to be submitted to the supranational regulators just mentioned.

Therefore, it is just impossible to accept that London would remain the financial center of the European Union. That would create unbearable systemic risks that we can simply not stand. No country in the world, no central bank of systemic importance, would tolerate not to be in control of the liquidity of its currency, and of the major financial players of its own market. In effect, there is no choice than to organize the migration of the bulk of financial services from London to the EU.

The EU has no other choice than to force the relocation of most of its financial sector.

Part of it has already happened, and the movement will continue, according to the decisions that will be taken by the European Commission, the Supranational agencies, and the various regulators, including in particular the ECB/SSM. For instance, trading activities will have to move during the coming years, as well as asset management activities, and the extend of back-to-back operations and delegation will need to be progressively limited.

Is there a risk, as is often advocated, for the funding of the EU economy? I do not believe so. The players will remain the same, they have started to migrate their operations, with the key objective of continuing servicing their clients at the same level of quality. Is there a risk of fragmentation across several financial centers? There will be most likely less concentration, although the bulk of activities will tend to concentrate in a limited number of financial places, in particular for market activities.

But most importantly, with modern technology, a certain diversity of locations does not mean that the market cannot function in an integrated fashion and provide the best level of liquidity. ●

James von Moltke

Member of the Management Board - Chief Financial Officer, Deutsche Bank AG

Building an open and competitive financial market for Europe

Brexit comes at a time of dramatic change. In COVID-19, the world is confronting one of the great peacetime challenges of the modern age. Digitalization is transforming our personal and professional lives, and the pandemic will accelerate the pace of technology adoption. Relationships between the world's superpowers, the US and China, are increasingly strained.

As Europe strives to assert its place in a more competitive and uncertain world, well-functioning financial markets are vital for the strength and competitiveness of Europe's economy. Designing Europe's financial markets to thrive in the post-Brexit environment represents a challenge, but also an opportunity.

In the near term, continuity is key. For over 40 years, the City of London has been Europe's financial center. Financial services firms and their clients will need to adjust their activities and manage the complexities inherent in providing services across borders previously covered by single market passports. Supervisors will need to establish new modes of cooperation and regulators will have to deploy equivalence to avoid unnecessary disruption.

This transition will not be without cost or effort. Financial firms and businesses have already spent tens of millions of euros preparing for Brexit, and goodwill is necessary on both sides of the channel. Our goal must be to ensure that, as Europe's economy recovers from the impact of the pandemic, businesses across the EU continue to have access to financing and risk mitigation opportunities through deep, liquid and well-diversified financial markets.

In the short term, many of these markets will remain in the UK. Closing the door to EU firms accessing these markets – ie through the operation of trading obligations in the absence of equivalence - will do nothing to promote the attractiveness of EU capital markets. It may, however, make financial market access narrower and more expensive. Avoiding permanent frictional costs and loss of EU market efficiency is key. Equivalence needs to be understood with this goal in mind.

Brexit, however, needs to be more than a near-term challenge. In the longer term, it can serve as a catalyst for the development of an ambitious, strategic vision for an open and competitive European financial market. One which is integrated with other capital markets across the globe: an essential enabler of economic recovery post-COVID, the shift to a low carbon economy, and Europe's efforts to remain competitive in a fast digitalizing world.

The path to achieving that goal will require delivery of an ambitious Capital Markets Union (CMU). Furthermore, given the unique role that banks play in the financing of Europe, it demands further progress on Banking Union. The removal of intra-EU regulatory barriers and further harmonization of rules relating to trade and post-trade activity is an essential pre-requisite to further development of Europe's sub-scale capital markets.

That is the prize that CMU can deliver - for Europe's businesses, investors, governments and supranational institutions. Also, in this context, discussion of a Financial Transaction Tax must take account of the added cost for businesses accessing much-needed capital, and the risk of eroding the competitiveness of Europe's financial markets.

> *Managed correctly, Brexit can be an opportunity for Europe.*

For EU financial markets to flourish, however, we will need European market makers – banks with the scale and capital to support trading activity – and a prudential regime that is calibrated to support that role. This is what the completion of the Banking Union can offer. By clearing the path to a true single market for banks, and removing barriers to free movement of capital and liquidity within EU banking groups, it will support overdue consolidation in the banking sector and greater resilience and profitability.

Managed correctly and combined with a clear vision for EU financial markets, Brexit could be an historic opportunity for Europe. To grasp that opportunity will, however, require co-operation across international borders and decisions that supersede national interests. It will require political courage, ambition and a pragmatic approach to regulatory cooperation. Defining our vision for Europe's financial markets, and moving swiftly and decisively to turn vision into reality, is all-important, given the uncertainties and competitive pressures facing Europe in the 21st century world.

Markus Ronner

Group Chief Compliance and Governance Officer, UBS

A healthy financial ecosystem to strengthen the European recovery

As the world emerges from the initial phase of the COVID-19 pandemic, it is clear that the consequences will be far reaching. The IMF now predicts that global GDP in 2021 will be 6.1% lower than projected prior to the pandemic, while global government debt is predicted to reach a record high of 101% of GDP. In these circumstances, Europe needs to pursue a strong and coherent strategy to recover from the recent – and indeed previous – crises and address long-standing structural issues. An efficient banking and capital market system will be a prerequisite for this strategy to succeed.

A clear strategy to boost integration of the banking sector and deepen EU capital markets will help to finance the recovery.

Overall, banks performed well in responding to the crisis, with high levels of capital and liquidity as well as operational resilience. However, in order to fulfil their role of supporting the economic recovery, banks must contend with several key challenges. The first is a further prolonged period of negative interest rates as the ECB continues to pursue a very expansive monetary policy. This further aggravates a situation in which most European banks were already struggling pre COVID-19: Eurozone banks' Net Interest Income was 45% lower at the beginning of 2020 compared to 2007. Thus, revenues from traditional banking activities have been significantly squeezed. The second key challenge is the extension of credit by the unregulated non-bank financial system: According to the Financial Stability Board (FSB), non-bank financial, or shadow banking, activities in a narrow sense have grown by almost one-third over the last decade to 59% of GDP. The FSB also finds that almost three-quarters of these investments are held in instruments "with features that make them susceptible to runs". Despite the risks it poses to the financial system the non-bank sector is not subject to the same standards of regulation as the traditional banking sector which also leads to less transparency and an increasingly unlevel playing field.

The pandemic will also lead to substantially higher Non-Performing Loans, an increase in bank funding costs and, over time, additional costs for liquidity buffers. As a consequence, European banks will struggle to return to sustainable profitability and generate attractive returns for investors. The market is already pricing this in: In the first six months of 2020, Eurozone bank valuations had on average deteriorated by one third whereas most broad market indices were only down by single-digit percentage points.

In response to these challenges, policymakers and banks need to take joint action to strengthen the European financial ecosystem. This should involve the following:

- Further integration of the European banking sector by completing the Banking Union, demonstrating that this is a win-win for all EU countries. Removing barriers to cross-border consolidation should therefore be a priority, in particular eliminating regulatory fragmentation across the EU, including different national regimes for many prudential, accounting, insolvency and AML rules, as well as excessive limits on the fungibility of capital and liquidity within a banking group.
- A clear strategy to deepen Europe's capital markets and diversify sources of finance. It is well known that capital markets in the EU are only around one-third as deep as in the US, but even more importantly, while US capital markets have grown relative to GDP over the past decade, they have shrunk in 80% of EU member states. Deepening European capital markets in a transparent manner, with appropriate regulation for non-bank financial services, will provide greater resilience to the economic cycle and to idiosyncratic shocks such as COVID-19.
- A pragmatic and open approach to market access for third country participants. Third country banks can play an important role in deepening the CMU by facilitating global capital flows to the EU. This will allow Europe to benefit from investment from jurisdictions with deeper and more liquid markets, boosting innovation and competition. Equivalence is an important part of this, which should be outcome-focused and take into account relevant international standards.

This strategic approach, alongside an enabling regulatory framework, will support the European banking industry in adopting the new business models that the digital revolution demands. Together with deeper and more vibrant European capital markets this will help to create a healthy financial ecosystem to strengthen the European recovery.

Shinsuke Toda

**Managing Executive Officer, Head of EMEA,
Mizuho Financial Group, Inc. / Mizuho Bank, Ltd.**

Regulatory fragmentation may affect allure of City for international banks

Our view is that the City will not lose its position as an international financial centre, at least in the immediate aftermath of the Brexit transition period, due to the significant financial market infrastructure and depth of talent that exists and will remain in the City. London has historically been the gateway for third country investors to access the whole of the EU market, but, in the mid to long term, with that access potentially being severely restricted, such investors may need to consider entering through an EU hub as well, or instead.

Third country banks primarily consider the economic growth of a region, the size of its capital markets and its overall attractiveness when deciding whether to continue to invest there. Real GDP growth on an annual basis for the APAC region is around 5% in recent years, being a key driver of the world economy, whilst the US and Europe's figure is around 2%.

However, in terms of the scale of the opportunities in capital markets (by reference to the annualised fee pool), the US is the biggest (USD 39 billion in 2019) due to developed capital markets through a large single market with no territorial boundaries, followed by Europe (USD 15 billion), and then the APAC region (USD 13 billion).

According to the Global Financial Centres Index (GFCI), which measures five broad areas of the competitiveness of a city for business (business environment, human capital, infrastructure, financial sector development, and reputation) London lost its top position in March 2019, which seems likely due to Brexit considerations. Financial cities in the US and APAC region have consistently occupied the top 10 places in the GFCI.

When considering our global operations, it is clear that capital efficiency in EMEA business is inferior to that in the US and Asia. For example, the average cost to income ratio of European banks is around 10-20% higher than that of US banks, which itself is around the same factor higher than for APAC banks.

The increased costs associated with regulatory and market fragmentation, for example operational overlap and higher transaction and compliance costs due to varying regulatory regimes, will further impact the strength and efficiency of European banks – and thus make the overall region less attractive for third country firms to invest in. Third country entities may look to allocate capital elsewhere if their EMEA business is not sufficient to maintain sustainable growth as part of their global operations.

Therefore, it is expected that EU and UK legislators and regulators will work closely to ensure there is as little disruption as possible to the financial services industry at the end of the transition period, as they have been doing thus far. Market participants would want a harmonised regime to avoid fragmentation and the increased regulatory and operational burden that comes with it.

> *We urge policymakers to adopt outcomes-based equivalence.*

The increased scrutiny and consequent increased risk of withdrawal of any unilateral declaration of equivalence as a result of the proposed enhancements to the EU equivalence mechanisms poses material risks to business continuity for market participants and the wider health of the European economy. There is an inherent paradox whereby compliance with internationally agreed standards does not necessarily result in the maintenance of equivalence.

Therefore, we urge policymakers to adopt outcomes-based equivalence, depending on whether third country regulations meet internationally agreed standards, rather than line-by-line comparisons to local regulations which may be gold-plated to global standards, for example KYC requirements. Where requirements stem from globally agreed standards, it is arguable that equivalence should be presumed until the contrary is proven.

This would be a step towards re-establishing the primacy of international standards, enhancing the global level playing field and reducing the cost and burden of regulatory fragmentation – all of which would also make European financial markets more attractive internationally.

Kay Swinburne

Chair of KPMG's EMA Risk and Regulatory Insight Centre (RRIC) and Partner, KPMG in the UK

Capital markets: open or closed?

Whether capital markets work best – most efficiently, effectively and safely – if they are open or closed is a long-standing policy debate. The high volatility seen in the early stages of the spread of COVID-19 has re-opened that debate yet again. The full economic impacts of the pandemic are not yet fully understood, but it is certain that businesses of all sorts will need to tackle debt burdens not seen on such a scale before.

The crisis has also highlighted that all business sectors are deeply interconnected across borders and that economies of all types and sizes are vulnerable. Financing channels – in particular, the capital markets – need to reflect this reality in order to help support recovery. Achieving sustainability goals, both environmental and social, will require additional and large levels of private funding.

In the face of such extraordinary circumstances, it is understandable that some temporary measures were introduced to protect capital markets and sovereign debt. They should be temporary. The building of more permanent protective walls around economies, including limiting access to national financial markets, must be avoided.

History has shown us time and time again that closed capital markets damage the very economies that officials are trying to protect. I sincerely hope that the debate within the EU will not be as stark as open or closed, but about whether access should be limited in anyway and the optimal degree of regulation.

In the retail markets, a greater degree of regulatory protection is understandable and necessary. In the wholesale capital markets, while customer protection should not be forgotten, the focus should be on financial stability, market integrity, fair competition and the prevention of regulatory arbitrage. To achieve this, there needs to be a commitment to developing deep constructive relationships with third-country regulators, including dialogue on enhancing supervision and coordination.

Clearing, for example, is a global business and is key to financial stability in the capital markets. Both globally and in the EU, the regulation around the recovery and resolution of clearing houses is consistently developing. The intention is that all market participants can plan for and will know how to act if a clearing house becomes distressed or starts to fail. Regulators are encouraged to work closely together in their supervision of clearing houses through regulatory colleges and crisis management groups, sharing information and helping ensure a smooth system. Strong regulatory cooperation is essential. To be truly effective it requires trust on both sides.

Access to EU markets largely falls under equivalence provisions. The equivalence process is meant to be outcome-based: assessments should be determined not only by reference to the content of law and regulation, but also considering the approaches of the respective parties to supervision and enforcement.

> *I would urge the EU to make a strong commitment to open and well-regulated global capital markets, in words and in action.*

Line-by-line analyses of a third country's rules can miss the point and, potentially, limit market access, adversely impacting EU economies, businesses and citizens. Barriers to capital markets will result in European corporates having less access to liquidity and choice, and potentially higher cost of financing, which will be a cost to the overall finance system.

This underlines the importance of regulatory dialogue and coordination. It requires a framework for strengthening the processes for granting and withdrawing access to and rights within the EU markets.

It should ensure greater legal and regulatory certainty, while protecting regulatory autonomy. It is also paramount that central banks and banking regulators co-ordinate actions to ensure they do not inadvertently jeopardise systemically important, global FMIs.

Regardless of the outcome of the negotiations between the EU and the UK, and ongoing discussions with other key third countries, I would urge the EU to make a strong commitment to open and well-regulated global capital markets, in words and in action. ●

Steven Maijoor

Chair, European Securities and Markets Authority (ESMA)

Brexit and the changing landscape of EU financial markets

2020 has so far been a year that has been dominated by the impact of the global coronavirus pandemic, which has unprecedented repercussions for financial markets, the broader financial system and economies. One would be forgiven for overlooking the fact that back in January, Brexit was viewed by many as being the biggest challenge for the year ahead. In reality, the scale of the Brexit challenge has not changed, but the difference is that it is now taking place in the midst of a global pandemic crisis with far-reaching consequences, including for our financial markets.

On 31 December 2020, the UK's transition period after Brexit will come to an end. At the moment, we do not know how an agreement on the future partnership of the UK and EU will look, or even if one will be in place by the end of the year. However, we know that the landscape of the financial services sector will inevitably change significantly with the largest financial market leaving the EU single market.

With Europe's largest financial centre leaving the Union, the question of how this affects EU financial market policies needs to be answered. While the EU's equivalence framework is a very useful tool that can provide benefits and access to the EU for some third-country firms, it obviously does not replicate the advantages of the single market. It only covers some specific areas where third-country firms can directly access EU markets, for example, in the area of central clearing counterparties (CCPs).

Moreover, the extent to which equivalence will be granted to the UK is not determined yet, as these decisions are subject to a positive assessment of the UK's legal, regulatory and supervisory framework. This uncertainty only underlines the need for the EU to re-enforce its efforts to build and develop its own capital markets, which is why support for the ambitions of the Report of the High Level Forum on the Capital Markets Union (CMU) is key. A successful CMU will help mobilise investments throughout the EU, lower the costs of funding, offer new opportunities for savers and investors, and make the financial system more resilient.

At the same time, the EU will need to remain an open and globally integrated financial market, meaning that the EU and third countries, including the UK, will together need to continue to contribute to the smooth functioning of global financial markets, and so avoid fragmentation and ensure financial stability.

One area identified by the EU as presenting potential financial stability risks as a result of the UK's withdrawal is in relation to the central clearing of derivatives. To address these risks, the European Commission has announced that it will adopt a time-limited equivalence decision for UK CCPs, and that they may continue providing clearing services in the EU after the end of the transition period.

> *It is vital that constructive UK-EU supervisory relationships are maintained between regulatory bodies to achieve common objectives.*

With the third-country landscape evolving, it is imperative that appropriate supervisory oversight is in place. EMIR 2.2, and the changes introduced by the Investment Firms Regulation for third-country investment firms, are examples of how supervisory models can be adapted to face new challenges presented by non-EU firms that play a significant role in EU financial markets. Within the EU, the current supervisory model combines both EU and national level responsibilities, with most day-to-day supervision of capital markets conducted at national level. Within this mixed model it is essential that supervisory activities regarding third-country firms is conducted or coordinated at EU level.

Third-country firms have typically quite some discretion regarding their choice of location, which increases the risks of regulatory arbitrage. In addition, differences in supervision of third-country firms results in barriers and undermines the single market.

Finally, above all else it is vital that constructive UK-EU supervisory relationships are maintained between regulatory bodies to achieve common objectives like stability, investor protection and orderly markets. ESMA has already established cooperation agreements with its UK counterparts to achieve this and will seek to maintain close supervisory relationships with these authorities in the years to come. ●

Hubertus Väth

Managing Director, Frankfurt Main Finance e.V.

Never waste a good crisis

EU and UK are still in negotiation mode. In absence of an extension of the transition period, a no-deal Brexit has once again become a plausible scenario. The advice “hope for the best and prepare for the worst” is as valid as ever in this saga.

We advise financial institution to not plan based on equivalence. Even in the best of cases, equivalence doesn`t cover all relevant areas. What’s more, neither the very rational of the Brexit - taking back control - nor the way negotiations are going, point to equivalence as a solution.

Market participants acted accordingly. The loss of passporting rights will lead to a shift of roughly 50 percent of EU business on UK based bank balance sheets to the continent. We have seen bookings move into Frankfurt of about €300 billion so far. We expect another €100 billion before the end of the year and we know of another €400 billion ready to move.

Will all that lead to more inefficiencies? Not necessarily. Fragmentation may, but does not necessarily, lead to higher costs. Notto forget that costs occur not only on banks profit and loss accounts, but eventually also in state-budgets. Given the impact on financial stability, standing on your own two feet is better than standing on one, especially if that one is beyond your control.

It was a key project of the G20 under the stewardship of Japan fighting global fragmentation of financial markets and rightly so. At the very same time Japan continued on its endeavour in bringing the Yen clearing back to Tokyo, at least to a sufficient degree.

Take Eurex as an example: We are nearing 20 percent of Euro denominated interest rates swaps, were clearing moved from London to Frankfurt, and growing. This was achieved with costs and spreads on par for market participants. Social risks could be reduced and at the same time costs for market participants been avoided. If it sounds like the holy grail, it probably is. Let’s remember the scaremongering numbers of up to €100 billion additional costs European banks would have to bear once clearing would have to move. So clearly there can be a good fragmentation, leading to a healthy competition and more financial stability – at no additional costs for the industry. Fragmentation can, but doesn’t have to be bad and may even be good.

The train of shifting business is in motion. In a world ever more polarized and global powers increasingly self serving, Europe can ill afford to loose control of it’s financial ecosystem, given the geopolitically relevance of the industry. Naturally the UK will always be invited to be the EU’s preferred partner.

> *We need to ask ourselves: Do we witness the early days of a new European safe asset class?*

The corona virus created a push towards digitalization and solidarity in Europe, at a spead, that was surprising even for optimists. As a result, we need to ask ourselves: Do we witness the early days of a new European safe asset class? And if so, could it accelerate the creation of the common EU capital market. Europe’s ability to move under stress has repeatedly been underestimated. I’m bullish on Europe living up to its challenges, not wasting this crisis. ●

How to maximize the role of investment funds in the post-Covid recovery?

Ugo Bassi

Director Financial Markets and Acting Director, Horizontal Policies, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

The role of the EU Asset Management regulation in the post-Covid recovery

As the COVID19 pandemic continues to rattle the economies and financial markets across the globe, the year 2020 has proved to demonstrate the remarkable resilience of the EU investment funds sector. Looking ahead, the relative calm of the markets should not be a reason for complacency but be used as an opportunity in maximizing the value for European savers, supporting our communities, and ensuring green, smart and sustainable growth of the European economy in line with the CMU objectives.

Resilience of the EU asset management framework

While the industry has witnessed some funds redemption suspensions, predominantly in the commercial real estate sector and mainly caused by valuation-related uncertainties, the EU funds sector has functioned relatively well. Notably, the liquidity management tools functioned as they should, the investor protection rules functioned properly and the money market funds (MMFs) sector has not witnessed serious redemption suspensions, while the ESAs and the national regulators were constantly monitoring the markets to ensure their orderly functioning and prevent the markets against systemic risks.

Key challenges for the EU fund sector in the years ahead

There are always clouds on the horizon ranging from geo-political tensions and trade wars, Brexit, and the climate crisis. The EU fund industry continues to face challenges in terms of integration and competitiveness, including fragmentation, transparency and fees. The bulk of the cross-border supply of the EU funds are directed to Member States with large markets to the detriment of investors in smaller Member States and poorer choice for investors, competition, level of fees and net returns.

> *The EU Commission is focused on strengthening the CMU and promote green sustainable post-Covid 19 recovery.*

However, many of these perceived challenges could be turned into opportunities: by attracting a rising numbers of investors keen to place their savings in green or more sustainable investment options, improving the framework for investments in long-term growth and promoting sustainability and responsible business practices, by simplifying distribution, product and costs structures. By seizing these opportunities, the industry can reshape its business models and strategies and become more resilient.

Initiatives aimed at improving the competitiveness of the EU fund sector

As a constant advocate of the CMU and a strong Single Market, the Commission (EC) is focused on strengthening the CMU and promote a green sustainable post-COVID19 recovery by continuously improving the functioning of the EU investment funds market. The role of regulation is to support the implementation of these policies. The EC continues to execute on the initiatives underpinning an efficient functioning of the asset management sector, among others:

- The Commission's work on the review of the AIFMD is well underway and is seeking to identify areas for potential improvements and propose targeted legislative amendments.
- Pan-European personal pension product (PEPP) should very soon offer transparent and long-term savings solutions for consumers; EIOPA is currently about to finalise relevant rules. Once approved, first PEPP products might be launched.
- The Disclosure Regulation will apply as of March 2021.It will have considerable behavioral effects on the markets, in terms of the consideration of negative externalities caused by investments or clear explanations of how claimed sustainability of a given financial product is achieved.
- In line with the legal mandate and the recommendations of the High Level Forum for the Capital Markets Union, the Commission has started the review of the European regime for long-term investment funds with a view to identifying the areas for possible improvements and proposing legislative amendments towards Q3 2021.
- The EC also intends to open up the EU Eco-label to financial products; a number of preparatory steps necessary for the legislative change have already been taken.

While the Commission is focused on the smooth operation of the EU funds sector and removing the obstacles to the Single Market, the EU asset management legal framework continues to serve the industry and the investors as a robust, predictable and well-regulated regime. The EC is known for constructively engaging with the regulators, ESAs and the stakeholders and will continuously execute on its policies in helping the sector to unlock unrealized opportunities and speed up the post-Covid-19 recovery. ●

Marco Zwick

Director, Commission de Surveillance du Secteur Financier (CSSF)

Contribution of Asset Management to the post-Covid-19 economic recovery

European households own significant bank deposits, but often show limited interest in capital markets. The contribution of asset management to the post-Covid economic recovery requires a large-scale distribution of European fund products to investors, and more specifically retail investors. The following main considerations are likely to increase the attractiveness of these products:

- Focus on the adequacy of the cost-performance ratio of UCITS distributed to retail investors to manage the significant impact of costs on the final value of investments.
- Structuring the post Covid-19 world around sustainability with private actors being key to finance the green transition.
- Increasing the outreach of investment fund products to a larger investor base by way of measures already put in place under the EU Regulation on cross-border distribution of funds, like uniform rules on the publication of national provisions concerning marketing requirements and on marketing communications addressed to investors, and via setting up a framework on the marketing of funds through digital media and increasing the possible investment horizon of UCITS funds while still complying with the retail investor focus.

With the European asset management sector being expected to grow further as a result of both the European initiatives related to the Capital Markets Union and a possible contribution to the post-Covid economic recovery, a continued close monitoring of related financial stability aspects remains important. The 2017 FSB Recommendations[1], the IOSCO follow-up work[2], the 2017 Recommendation of the ESRB[3] with the related ESMA implementation work (e.g. ESMA Guidelines on Liquidity Stress Testing in UCITS and AIFs) are central policy contributions in that respect and address in particular financial stability risks related to liquidity mismatches in open-ended investment funds as well as leverage within funds.

During the recent COVID-19 crisis, outflows in investment funds and tensions in market liquidity were observed in less liquid market segments, such as high-yield and emerging market fixed income markets. Also, difficulties in the valuation of certain asset classes (e.g. real estate) and strains in some MMF segments became apparent.

In Luxembourg, the large availability of liquidity management tools revealed their particular importance under these exceptional circumstances from both an investor protection and financial stability perspective.

It will now be important to thoroughly analyze these developments and examine how the substantial policy work carried out so far addresses the tensions and whether possible gaps exist. ●

1. FSB "Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities", 2017.
2. IOSCO "Recommendations for Liquidity Risk Management for Collective Investment Schemes", 2018, "Open-ended Fund Liquidity Risk Management – Good Practices and Issues for Consideration", 2018, and "Recommendations for a Framework Assessing Leverage in Investment Funds", 2019.
3. "Recommendation of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds (ESRB/2017/6)".

Gerry Cross

Director, Financial Regulation Policy & Risk, Central Bank of Ireland

Strong regulatory frameworks are the foundation of effective capital markets

The path of economic recovery from the COVID-induced shock remains unclear at this point. What is certain is that economies will need to rely on a range of sources to finance recovery, including banks and capital markets. If capital markets are to fulfil their potential, investors must be better protected and systemic risks further mitigated. A regulatory framework which prioritises these goals remains necessary to ensure the confidence that is needed for the financial system to function effectively in support of the economy.

With this in mind, regulatory authorities have long been focusing on matters related to appropriate liquidity management by fund managers, their use of leverage, and their capacity to appropriately oversee their activities and manage risk. These matters were in focus given the significantly increased role of the asset management sector following the ▶

financial crisis and subsequent regulatory reforms and were given further emphasis by events relating to Woodford, H20 and GAM funds and in light of the challenges and risks of a disruptive Brexit.

The performance of capital markets generally, and the asset management sector in particular, during the recent period of significant Covid-19-related market disruption has underlined the need to enhance the regulatory approach to these matters. It appears likely that the turbulence that was experienced during this period was exacerbated by a dynamic in the asset management sector that reflected liquidity expectations that were misaligned with the underlying assets. Moreover, the degree of central bank intervention that was required to restore the normal functioning of markets indicates the need for enhanced regulatory requirements to more appropriately apportion the cost of liquidity risk.

It will be important to enhance the framework relating to liquidity mismatch and leverage in funds.

In order to ensure that capital markets and the asset management sector are able to meet their full potential in supporting the economy it will be important to enhance the framework relating to liquidity mismatch and leverage in funds. It will be important to address the collective action issue whereby actions taken by funds and managers in periods of stress, while rational at the individual level, may be materially suboptimal at the systemic level. This implies the need for enhanced macroprudential rules. Work underway internationally and in Europe to address the issue of leverage in the funds sector needs to be continued and brought to an impactful conclusion.

A well-regulated asset management sector plays a significant role in supporting the functioning of the financial system and wider economy. The convergence of the next phase of work on Capital Markets Union, and the review of AIFMD, with the lessons learned from the Covid-19 crisis provides the opportunity to leverage and enhance work previously underway to deliver a better performing asset management sector more effectively supporting the economy.

Tim Friederich

Head of Risklab,
Allianz Global Investors GmbH

How to secure a sustainable recovery

The human and economic costs of the Covid-19 pandemic have refocused minds on the challenges facing societies globally. They also remind the asset management industry of our core purpose. As stewards of our clients' assets, we must help secure their future and the future of the planet – and investing responsibly will be a vital part of our collective success. In the post-Covid economic recovery, this means focusing on sustainable investing, managing risk and providing customised solutions.

Sustainable investing must be a priority

Although sustainable investing was once seen as a separate category, it is becoming an intrinsic part of many more investment strategies – a trend that is accelerating. According to Morningstar, sustainable funds attracted more than USD 20 billion in new assets in 2019, compared with USD 5.5 billion the year before.

...active asset management has an ever-more critical role to play...

Institutional investors increasingly prioritise environmental, social and governance (ESG) factors in their decision-making – not just to manage risk, but to drive returns by funding opportunities with long-term potential.

We also see increased demand from a young generation of retail investors who refuse to separate investment outcomes from responsibility – a trend further fuelled by regulation.

The United Nations Sustainable Development Goals (SDGs) provide a blueprint for directing investments towards global challenges that need funding – from climate action to improving access to food and clean water – and the pandemic has only increased the urgency.

Meanwhile, private market investments will be critical for building the social, environmental and energy projects that will support the well-being of future generations.

As active asset managers, we can help structure these deals in a way that multiplies their financial and societal impact, and we can form new and innovative partnerships to deliver these results.

Risk management is critical

As the crisis crystallises investors' priorities, risk management should be at the top of the list. Today, a wide array of approaches exists, ranging from dynamic risk management to tail-risk hedging. The asset management industry must reinforce the need for a holistic risk management strategy – one that considers the entire portfolio, not just a sleeve. Only then can correlations be taken fully into consideration and managed against investors' risk budgets.

As investors push into new means of diversification, they need help understanding the implications on their portfolios' risk-return profiles. This is especially true when it comes to sustainability – investors want to know that they are achieving their goals because of their responsible investment strategy, not despite it.

At the same time, we think active asset management has an ever-more critical role to play. Passive investment strategies must, by definition, track their respective index – regardless of what the index contains. Yet this crisis has shown that investors need to be selective and choose the companies that are most able to weather unexpected storms.

Customisation is king

One common thread that links these emerging trends is the need for customisation. With the help of technology and academic research, asset managers have a greatly improved ability to optimise portfolios and investment strategies for institutional clients. Digitalisation and new developments in the areas of machine learning and artificial intelligence will allow us to bring this customisation gradually to retail channels.

What cannot be automated, however, is the first step in any successful investment strategy: understanding clients' investment goals, risk profiles and constraints.

This can be solved through education and dialogue – and a commitment from industry and regulators to work together. As the world focuses on securing a post-Covid recovery, such collaboration will be more important than ever.

Daniel Kapffer

Chief Financial Officer &
Chief Operating Officer,
DekaBank Deutsche Girozentrale

Let asset managers provide targeted services to retail clients

Currently European asset managers were managing total assets of 23 trn EUR out of which over 70 % invested in equities and corporate bonds. These numbers clearly show the importance of asset management for the financing of the economy.

7 trn EUR are managed for retail clients directly. Another 12 trn EUR are managed for pensions funds and life insurance. These numbers have to be compared with 4,7 trn EUR of corporate loans issued by European banks.

It is a general flaw in various European regulations to adapt the concept of one single group of retail investors. We see clients that want to delegate the investment decision, clients that run a monthly savings plan, mainly in one financial instrument, and retail clients doing a significant amount of transactions each year in a very self-guided manner.

The clients with a monthly savings plan will get lots of information around financial markets and various types of financial instruments. Most of it irrelevant but scarring for the investor.

The client delegating the investment decision does so knowing that managing assets is a very specialized discipline. It requires significant know how in financial markets and instruments as well as a complex infrastructure. For this client it does not make any sense to educate him – he wants to receive a service.

Finally, for the self-guided retail investor the current requirements also don't fit. The required information especially pre-trade is an obstacle for him not providing any value for his order execution.

The EU has recognized this with the quick-fix to exempt professional clients and eligible counterparties from requirements like pre-trade cost transparency. However this needs to go further. We very much support the idea of a non-professional Qualified Investor as proposed by the CMU HLF.

Four levers will further increase the contribution by investment funds to finance the European economy. The first is to develop the investment culture. Investing in capital markets needs to become an integral part to cover retail clients long term financial needs. Pension schemes will play an important role in this. However, reporting or auto-enrolment will not help. There must be private pension schemes supported by the state through tax benefits or contributions. They must have rules and risk implications that are manageable for providers in the low interest rate environment.

> *We need to provide a standardized framework to promote ESG investments.*

Secondly, the role of investment advice and investment funds needs to be strengthened. Questioning inducements repeatedly which are the basis to finance investment advice or providing clients with comparison tools go the wrong direction. If there is a perceived issue with the quality of advice, we need to address it. But we must not deteriorate the fundament it is based on. In addition, I am worried by the intensity in which retail clients are pushed into single stock investments or ETF. Both products have no active risk management component – as we have experienced again in the turmoil in March this year.

The third point – the need to increase the flexibility of the regulatory requirements has been touched upon already. Asset management in the EU is already embedded in a sound legal framework, including the UCITS Directive and AIFMD, for the benefit of market participants and investors. We support the EU in taking an ambitious approach to improve the framework but not to add even more requirements.

Lastly, we need to provide a standardized framework to promote ESG investments. Asset managers need clear standards and harmonization of rules that will support the growth of sustainable finance.

Stéphane Janin

Head of Global Regulatory Development, AXA Investment Managers

How to upgrade Investment Fund regulation to benefit EU citizens and businesses?

The recent Covid crisis, which is not over yet, requires to reflect further on how to upgrade the EU fund regulation framework in the short term. And in the longer term, the Sustainability critical issue must be properly tackled by the asset management industry.

Data show that market-based finance, mainly developing through the regulated fund industry, has increased its footprint in the economy – in particular since the 2008 crisis – and therefore bears more responsibility vis-à-vis society. Through funds, citizens as savers are increasingly contributing to the financing of companies. As employees, they benefit from that easier financing of their employers. As retirees, they enjoy higher private pensions.

During the Covid crisis, the EU fund industry reacted well. From a systemic perspective, no major failure occurred – showing that the current UCITS and AIFM Directives' framework is appropriate. The only area where few issues happened was related to the lack of Liquidity Management Tools in some Member States. Apart from that lack which should be solved at EU level, we think that Europe should not take the political risk of changing a regulatory framework which has made the proof of its appropriate design, including in highly stressed conditions.

Instead, policymakers should assess how positively the fund industry could contribute to the post-Covid recovery – in the short and longer terms.

In the short term, clearly a re-designing of the ELTIF Regulation would be key. In theory, the ELTIF is an ideal tool to boost the pan-European retail financing of key EU assets which will need to recover post-Covid, such as SMEs (which are a core component of job creations) and real assets (infrastructures and real estate). But up to now, ELTIF failed to deliver due to too many constraints (too high minimum amount to be invested by retail investors, unclear eligibility of real estate assets). Integrating a clearer and consistent Sustainability criterion for eligibility of assets, in particular for real assets, would help converging between that product new design and the EU Green Deal. The first priority should be for the Commission to ensure a harmonized tax treatment, otherwise the regulatory reshaping might be done for nothing.

In the longer term, the EU fund framework must embed Sustainability more widely. AXA IM has been a strong supporter of the 2018 Action Plan and current Green Deal. This is needed from a societal perspective, for the well-being of future generations. It is also needed from a competitiveness and business perspective, if Europe wants to take benefit from its political advance vis-à-vis its main non-European competitors. For instance, regarding ESG labels for funds, we have seen Member States developing various local ones: we are now calling for a European one, both to benefit from the Single Market and develop an EU brand externally.

> *We are now calling for a European ESG label for funds, both to benefit from the Single Market and develop an EU brand externally.*

However, policymakers must remain realistic in the practical contents to be implemented. As an example, the forthcoming implementation of the Sustainability Risk assessment within management companies is highly problematic: while the ECB made clear that for banks the environment and climate risk should be assessed "at least qualitatively", and therefore not systematically quantitatively, such a clarification from the Commission for UCITS and AIF management companies is still lacking – and crucially needed. ●

How to develop retail investment in the EU?

Carmine Di Noia

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

No Capital Markets Union without active retail investors' participation

Growth of retail (direct) investments has been a hot topic in recent years' lively debate about policies to increase participation in capital markets.

Fostering retail access to finance has been one of the main goals of the Capital Markets Union project since the initial 2015 Action Plan, and, in this respect, relevant suggestions have lately been provided by both "The Next CMU High Level Group" and the "High level Forum on the CMU".

Issues include a material rise of investors' financial literacy, the need of high-quality, fair and independent financial advice, and the overhaul of disclosure requirements leaving behind the current paper-based approach to dive into a new digital model able to promote intelligibility and comparability.

Particular attention has been especially paid, moreover, to the suggestion of a more proportionate MiFID classification by adding an additional client category ('semi-professional investors'). I think that it would be extremely important, but not enough: it is time to shift the focus from regulation to supervision.

In order to facilitate, or at least not to hinder, non-professional participation in investments, particular attention should be paid in the application and the enforcement of the whole legislative package (MiFID 2, UCITS, AIFMD) on financial products distribution.

A strict translation of the investor protection mission into an overly prudent set of conduct practices by intermediaries could indeed refrain non-professional investors, even in case of the welcomed introduction of the new semi-professional class.

I do understand that easing retail investors direct access to equity or bond instruments (particularly when issued by SMEs or negotiated on SMEs Growth Markets) is considered a controversial topic, particularly in a time, or in countries, recently hit by financial fraud and corporate bankruptcies.

At the same time, however, turning savings into new means of corporate financing becomes crucial in the aftermaths of systemic crises. Post COVID-19 recovery can be funded, after the paramount fiscal response, only with a huge support from private investors aiming at strengthening the capital structure of likely highly-indebted companies.

EU Capital Markets Recovery Package measures proposed by the European Commission at the end of July go in this direction of facilitating investments in the real economy and enabling recapitalisation of listed companies.

All these efforts could however be squandered by local supervisory practices and enforcements regimes that aim in good faith to "protect" retail investors – even those more experienced and financially sound - by means of implicit bans and prohibitions but it may end up in an overly paternalistic framework. Such a supervisory barrier results even more dangerous in the age of permanently low interest rates and historically expensive stock markets. Finding appropriate returns on the usually invested asset classes (large cap stocks, investment-grade bonds) is, and is probably bound to be in the long run, almost impossible for (retail) investors.

No trade-off between investor protection and capital markets development because there is no protection to provide in a world without retail investors.

Halting them from considering, in a well-diversified portfolio, more illiquid but remunerative alternatives and accessing the private (equity or debt) markets, poses a serious problem of inequality in the distribution of financial well-being pushing millions of European consumers into a definitive loss of trust in financial markets. The EU Commission and ESMA should play a fundamental Level 4 role: there will be no CMU without investors' active participation in financial markets.

It is not a matter of trade-off between investor protection and capital markets development, because there is no protection to provide in a world without retail investors.

Investors protection has always been and must remain the guiding light of securities supervisors.

But the lighthouse on the hill flashing towards a sea without ships plays no other role than giving rise to Sunday painters' vanity. ●

Martin Merlin

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

More participation of retail investors in financial markets: a worthwhile goal

The current macroeconomic picture confirms that the policies the Commission is pursuing in the financial sector are heading in the right direction. Indeed, everything points to the necessity of increasing the involvement of households in financial markets: public pension systems are under growing pressure due to the ageing population, public finances need to move more swiftly between priorities (today they are health and research, but in the future they could be different), and the current low-interest environment reduces the room for competition in the lending business, and the return on safe assets. According to Eurostat figures[1],in the last 20 years EU households have been saving on average between 11 and 13% of their gross disposable income (i.e. a bit over 2000 euros per household per year). ECB data[2] show that more than half of those savings are in low-yielding currency and deposits, whereas well-diversified long-term investments would have the potential to deliver a higher sustainable return and could, for instance, help provide citizens with a complementary retirement income. At the same time, such long-term investments would support the financing of the real economy and its green and digital transition.

These are important reasons why the Commission is working to further improve the foundations that will allow wider participation of retail investors in the capital markets. Financial awareness and a strictly enforced regime of legal protection of retail investors are necessary, but not sufficient pre conditions for this. The Capital Markets Union High Level Forum has covered many important aspects in its balanced and comprehensive recommendations. Financial literacy enables savers to ascertain which financial products correspond to their needs and preferences, and to understand what they are buying when choosing an investment product. The legislative framework should underpin a fair investment outcome for retail investors. The information provided on different investment products must be comparable, true, non-misleading and sufficient for investors to take an informed decision (including on the level of risk). The interests of advisors must be transparent and, ideally, as much aligned as possible with those of the client, to ensure that any advice provided is fair and adequate. Furthermore, with the objective of client interests, suitability assessments need to be thorough and must lead to a range of products that meet the expectations, the needs, and the profile of the investors. During the execution of the contract and afterwards, the consumer must have access to redress and out-of-court procedures in case anything goes wrong. The entire investor journey has to be rigorous, smooth and oriented towards the best functioning of the system.

Technology also plays a very important role, as it can facilitate some steps of the process and enable new functionalities that can make the lives of investors easier, if enacted safely. The Commission has recently launched several initiatives to interact with innovative digital finance companies in an effort to better understand how the latest innovations can help businesses to be more efficient and can help consumers to improve their user experience. Before discussing the possible need to revise some of the current investor protection rules, the Commission must thoroughly evaluate the efficiency and coherence of the legislative framework in place, which largely follows a sectorial approach.

To achieve the objective of increased participation of retail investors in capital markets, the cooperation of the EU with Member States and with industry is essential. With regard to the Member States, it is essential to harmonise the national policies that could benefit from more coordination and to iron out the national differences in laws and law enforcement or taxation that impede cross-border investments. Actors on smaller local markets should benefit from integration, notably access to a large investor base. For this reason, the Capital Markets Union is more urgent than ever. Industry must also cooperate and adapt its offer of investment products to facilitate a wider retail participation in the financial markets. The goal is a better allocation of capital, to the advantage of both consumers and businesses, and as such, it is worth the effort it will require.

1. Eurostat - https://ec.europa.eu/eurostat/web/products-eurostat-news/-/WDN-20180830-1
2. ECB data - https://sdw.ecb.europa.eu/reports.do?node=1000004900

Jean-Paul Servais

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

How to strengthen retail participation in the CMU?

The key to building a successful Capital Markets Union depends not only on the supply side, but also on the demand side. Consumers will invest in products only if they have the assurance that the products offered are sound, appropriate and well supervised.

A harmonised set of rules should ensure that financial products placed on the market are sound and appropriate. In this regard, important steps have been taken to improve transparency to consumers by introducing standardised key information documents. However, behavioural research has shown that transparency is not sufficient. Therefore, the regulatory system should also ensure that inappropriate or particularly complex products are not allowed to be marketed to retail investors.

It is important to assess the potential impact of the High Level Forum recommendations on consumer protection and market integrity. We need to sustain high levels of consumer protection and market integrity, as ▶

these foster retail participation in capital markets. In this respect, I wish to guard against the proposed easing of the MAR rules, as some of them (especially regarding the concept of inside information) may have a negative effect on the integrity of the market.

The HLF report highlights in many instances that barriers to investment need to be removed. While it is true that disproportionate or unnecessary barriers should be analysed, we need to be very cautious with removing measures that are intended to protect retail investors and foster investor confidence, such as marketing rules and MiFID II consumer protection rules.

We need to sustain high levels of consumer protection and market integrity, as these foster retail participation in capital markets.

We have seen that during the COVID-19 crisis retail investors, especially young people, have increasingly been investing in shares. In order to contribute to a continuing and durable trend of retail participation in financial markets, it is important to prioritize the measures aimed at fostering financial literacy and digital financial skills. A successful CMU can be strengthened by enhancing financial literacy, given the wide disparities in levels of financial education across the Member States. Faced with increasingly complex financial products, consumers and SMEs may make unwise financial decisions if they lack a proper understanding of the risks involved, or they may miss out on optimal investment or funding opportunities, especially cross-border ones.

Finally, we need to ensure that retail markets are well supervised. The toolbox of a modern financial regulator should include transparency requirements, rules of conduct, product governance and product intervention. Building on the progress made in the ESAs' review in terms of supervisory tools such as the coordination of mystery shopping at EU level, and in terms of supervisory convergence across the EU, the CMU project should further strengthen the resources available to regulators to reinforce consumer confidence in financial markets. ●

Gabriela Figueiredo Dias

Chairperson, Portuguese Securities market Commission (CMVM)

Europe needs to offer better alternatives and information to retail investors

As we deal with the challenges posed by the current health and economic crisis and the exit of the UK from the European Union, the contribution of retail investors to European capital markets has never been more important.

As rightly identified by the European Commission (EC) and by the High Level Forum (HLF) on capital markets union (CMU), Europe urgently needs to develop a suitable common capital market that enables the recovery to be financed by more equity over debt and allows retail investors to finance the recovery, and benefit from it. In this regard, both the recent CMU HLF report and actions already taken and envisaged by the EC should be highly praised.

That said, I would argue, however, that a vibrant and sustainable CMU will require a stronger focus on building retail investors' trust in the capital markets, namely by improving likely returns – through lower and more transparent costs and tax incentives – and ensuring better and simpler information to the public.

After the Covid-19 crisis and the Brexit completion, retail investors will be key to relaunch the CMU.

Of the 17 recommendations put forward by the CMU HLF, the creation of a European Single Access Point for companies' data and the promotion of an open finance approach that offers consumers a comprehensive view of their financial situation, are definitely a welcome step in the right direction. Their success will rely in the ability to offer 'usable' information to consumers when

making financial choices. On the other hand, financial literacy is fundamental and HLF recommendations address it properly. But it is equally important to offer simpler and safer instruments to consumers, with transparent and fair fee structures and, thus, higher and comparable returns. In this regard, the recommendation on distribution, advice and disclosure should never lose sight that the average EU citizen is looking for simple and trustworthy ▶

savings alternatives to guaranteed deposits, and that when new online and digital channels are involved (which may benefit investors), proper protection and supervision must be ensured.

Addressing retail investors' needs and their trust in EU capital markets should also translate into a stronger and more harmonised consumer complaints regime and analysis, that works alongside a horizontal and cross-sectoral policy approach to markets, products and supervision that promotes a real single European financial market. Finally, the current proposals would also gain from a stronger focus on ethics, professionalism and governance to prevent conflicts of interest, reinforce independent advice, and to foster ESG concerns more generally. The powers enshrined in several Directives allow regulators to assess and act on boards' culture, effectiveness and integrity and should be strictly enforced. Investors' trust in capital markets depends vertically on a critical cultural change in companies and on fierce adherence to the highest ethical and quality standards.

The relaunch of the CMU must be a priority, if we aim to regain our economies to full potential as soon as possible. For this to happen, the entire financial community needs to strengthen investor trust in the capital markets by being more transparent and clearer regarding instruments, fees, rules and procedures; by being more focused on investors' needs; and by improving professional and ethical standards.

Verena Ross

Executive Director, European Securities and Markets Authority (ESMA)

Unleashing the potential of retail participation in EU capital markets

With thousands of retail investors entering the markets in the turmoil caused by the COVID-19 pandemic, the retail investment gap in the EU seemed to be in reverse. Lured by relatively low valuations, many retail investors felt that this was the right time to open an investment account.

Retail participation in EU capital markets remains relatively low, especially when compared to the US. Data on EU household financial assets show that there is significant potential for increased capital market participation of retail investors. Unleashing this potential should be high on the agenda, not only because it may give consumers the opportunity to improve their financial situation, but also because it will increase the amount of funding available to finance the recovery from the COVID-19 pandemic and the transition to a low-carbon economy.

However, several mis-selling cases have eroded investor trust, coupled with the continued dominance of non-independent advisors distributing almost entirely self-placed and inducements-paying in-house products. In addition, ESMA studies show that high costs remain a critical component in lowering long-term returns, exacerbated by the low-interest rate environment.

Several policy actions should be considered to address these issues. First, the role of inducements and their concomitant conflicts of interests in the distribution of investment products should be assessed. ESMA's review of the MiFID II inducement regime demonstrated that MiFID II has had limited effect in steering investors towards independent advisors or on triggering changes to advisors' product catalogues.

Disclosure on its own appears insufficient as retail investors find it difficult to assess the impact of inducements on the quality and cost of the services and products provided to them. To ensure that retail investors have access to better services and low-cost products, ESMA has recommended that the European Commission conducts a more fundamental analysis of the MiFID II inducement framework. Such an analysis should review carefully the experience of countries that have banned inducements.

> *ESMA studies show that high costs remain a critical component in lowering long-term returns, exacerbated by the low-interest rate environment.*

A second policy action is to further align the various regulatory frameworks in the EU. Alignment of the MiFID and PRIIPS frameworks, currently under discussion, would for instance ensure that retail investors are provided with comparable and consistent information on their investments.

Moreover, to ensure a level playing field and a high level of investor trust across sectors, ESMA has recommended that comparable investor protection rules apply to the distribution of MiFID investment products and to MiFID-like insurance products, notably on the issue of inducements.

Third, the role of occupational pension systems should be reinforced, for example by introducing automatic enrolment across the EU. This could also contribute to fostering financial literacy of EU citizens, the other important driver of retail investor participation in EU capital markets. Financial literacy should be further enhanced by financial education initiatives; for example, the high level forum on CMU suggested developing an EU framework on financial competence.

Guillaume Prache

Managing Director, Better Finance

Develop "retail" investment in EU capital markets, really?

Despite all the barriers and deterrents that "retail" investment "advisors", Regulators and schools have raised for decades against equity culture and equity investing in Europe, a few individual shareholders are still hanging on. For how long?

One such deterrent is called mistrust.

On 10 June 2020, the EC publishes the Report of the High Level Forum on the CMU. It includes good recommendations to foster "retail" investments into capital markets[1], including one *"to not discriminate individual direct investments by retail investors in equity and fixed income instruments, by including them in the scope of the Directive on representative actions for the protection of the collective interests of consumers"*.

On 18 June 2020, the huge Wirecard scandal comes out, wipes out about 20 billion euros from abused EU pension savers, and lays bare outrageous failures in corporate governance, in public supervision and in external auditing. Yet today, despite the HLF recommendations to them, despite Wirecard, the EU Authorities are still determined to exclude individual shareholders from the scope of the proposed Directive on collective redress!

This is all the more a shame that we all know it is a must, and we all know how to do it.

It is a must as households are by far the main provider of funding for the real economy, i.e. they provide most of the net savings to the net borrowers of capital (Governments and corporations). Also:

- "retail" investors are more long term oriented than "institutional investors"
- they are less risk averse
- they invest and trade more in SME markets
- they are more "contrarian" investors.

How to do it is quite simple: provide the same levels of access to - and of promotion for listed stocks, bonds and cost efficient funds like index ETFs as for the much more complex, fee-laden, "packaged" products that are also much more estranged from capital markets and from real economy assets such as bank accounts, life insurance, multi asset funds and pension products.

This implies inter alia to:

- Allow adult education at the point of sale on capital markets and equity: end kickbacks on packaged products (as there are none on more direct low cost products);
- Develop equity education for adults at the workplace: promote and incentivize employee stock ownership (a hundred times more developed in the US for SMEs);
- Stop EU rules discriminating against direct investments (like PEPP as opposed to the popular IRA in the US)
- Empower and engage EU citizens as equity owners, i.e. give citizens the ability to vote with their smart phone[2];
- For Public authorities to lead by example and consider public equity infusions in addition to publicly guaranteed (taxpayer) loans for Covid 19 related help;
- End double taxation of investment income within the EU.

For too many years fostering EU citizens' investments into capital markets and the real economy has remained a story of good "recommendations" ... and of a la Wirecard abuses. Unless EU Authorities make it at last a true priority, this story will go on. ●

1. Disclosure: I was a member of the EC HLF CMU representing non professional individual ("retail") investors. Several of our recommendations were adopted by the HLF CMU.
2 See HLF CMU's Recommendation on shareholder identification, exercise of voting rights and corporate actions

Peter Scharl

Board Member, BlackRock Asset Management Deutschland AG

Delivering CMU by modernising rules and using technology

The HLF Report is one of the most comprehensive roadmaps to date towards realising the ambitions of a strong CMU. A policy framework that promotes greater investor participation and better market-based fundraising opportunities for companies would bring enormous benefits for the economy and savers alike. An investor-centric approach can deliver the capital needed to power the CMU's ambition of deep and robust European markets. Increased investment for the long term can also help finance the transition to a sustainable carbon neutral economy. While household financial assets have increased in the last decade, allocations to financial markets have, irrespective of interest rates, remained constantly dwarfed by holdings of cash and bank deposits. European savings rates have risen even further during the pandemic, with sharp increases in savings held in cash or products reflecting short-term fears. ▶

▶ We need to bring to life the potential CMU can have for savers, highlighting the risks of not investing to meet long-term goals, while not undermining necessary short-term financial resilience.

It should be made easier for people to invest in ways designed to meet their lifetime goals. Maintaining high levels of consumer protection is paramount. But we need to modernize the rulebooks to build intuitive processes for account opening, create new dynamic disclosure standards, and develop a complementary framework for financial education, generic guidance and a variety of pathways to personalized advice. Auto-enrolment into default products can encourage a focus on designing investment solutions which meet citizens' goals. This should be supported by a consistent framework for financial intermediaries to follow when servicing clients. We need to encourage the use of new technologies to speed up AML and KYC processes, deliver information in an interactive dynamic format and overhaul the risk analytics and data which underpin upfront and ongoing suitability assessments. These represent significant steps forward in helping investors take informed decisions and build up trust and knowledge in markets.

Furthermore, we encourage the development of a goals-based investment approach in which disclosure and advice are aligned to the needs of individual investors. This should be underpinned by interactive disclosure models away from the current static formats, encouraging engagement while not sacrificing legal certainty. Disclosures should support the delivery of individual investment goals, rather than being tied to multiple individual products allowing intermediaries to focus on the overall service or product solution offered.

The performance of sustainable investments stood out during the COVID-19 pandemic and the recovery from the current crisis provides a huge opportunity for investors and businesses to benefit from this shift towards a more resilient and sustainable economy. We welcome the many ambitions across Europe to lead the world in sustainable finance and we must ensure that competing domestic initiatives do not lead to new barriers such as gold plating or conflicting and confusing product labelling.

Stronger investor participation in Europe will help addressing longer-term challenges such as the pensions gap, and funding sustainable investment goals. ●

Simon Janin

Head of Group Public Affairs, Amundi

Boosting retail investment in capital markets: a priority for CMU

One of the striking consequences of the Covid-19 crisis has been the huge increase of European households' savings rates. According to preliminary estimates, additional savings from European households in Q2 2020 should amount to €1.3tn, representing 10% of the EU GDP.

It is still premature to assess whether this savings surplus will be reinjected into the real economy, especially in a very uncertain global environment. However, there is little chance that the European retail investors' strong preference for holding cash rather than investing in capital markets will change. Currency and deposits represent today around one third of EU households assets which almost matches the amount invested in investment funds, equity and debt securities. Even more concerning is the fact that the proportion of households assets in securities and funds has even decreased during the last 20 years. In this context, one of the key priorities of the forthcoming European Commission Action Plan on CMU should be boosting retail investment in capital markets.

This is not only essential from an economy recovery prospective (i.e. to reinforce the solvability of European companies) but also to ensure that retail investors can benefit from better returns in a persistent context of low interest rates, in particular to meet the financing needs of their retirement. A number of stakeholders share this sense of urgency, including the High Level Forum on CMU that notably recommended, in its final report, to review the uniform application of investor protection rules to all retail investors, irrespective of their experience and knowledge. Indeed, it appears essential to put an end to the systematic "tick-the-box" exercise, which too often contributes to the risk aversion of retail investors. In this respect, investor's education is also key, though however it may takes time before seeing any significant effects.

Furthermore, additional and concrete measures should be promoted. In this respect, the development of employee share ownership (ESO) at the European level could be a game changer for the multiple positive effects it can generate. First, it would be a real trigger to substantially increase households' investment in capital market instruments and favor a truly local based ownership for European companies. Second, ESOs often contribute to draw retails clients closer to financial education improving their attitude to financial matters. Unfortunately, these schemes are much less frequently used in Europe than in the US. Then, a proposal should be made to create a pan-European vehicle that would be a fund structure, recognized as a specific AIF. This would present a number of advantages, notably as it would benefit from the European passport: a fund created in Luxembourg or Belgium could be used for an ESO plan of a company based in Spain or Portugal and offered to its employees in all EU countries where this company has subsidiaries. It would also permit a liquidity mechanism, particularly useful for employees of SMEs and non-listed companies – as ownership in unlisted shares is facilitated by creating a common valuation method that provides for the repurchase of shares. ●

What more needs to be done to strengthen equity funding

Alain Godard

Chief Executive, European Investment Fund (EIF)

Funding businesses through the crisis and beyond

We are in the midst of one of the greatest socio-economic crises in history. Never before have we been forced to rethink policy support systems across the entire economic spectrum. Never before has the scale of recovery efforts needed to absorb an economic aftershock been larger than the efforts required to tackle the impact of Covid-19: hundreds of thousands of businesses are suffocating from the effects of the economic lockdown and entire industries need to reconfigure their business model. And while we try to get the economy back on its feet, we are also obliged to prepare it for the challenges ahead.

Being better equipped for tackling this type of systemic shocks differently in the future depends on our ability to leverage the potential of innovation. We need to unleash the potential of technologies encapsulated in artificial intelligence, in decentralised networks and ledger technology, and in quantum computing, to increase the pace of medical responses to pandemic threats, to enable human-centric computing to boost digitalised business models, and to enable decentralised supply chain management in a globalised economy, to name just a few.

At the same time, we need to build the resilience of our society in the face of a climate crisis that, if not tackled with urgency, will dwarf the damage of Covid-19.

Our task list appears endless. Yet, it is no longer a matter of choice of what we are going to tackle first: Keep businesses afloat? Enable innovation to pre-empt similar threats? Combat climate change? We need to respond to all – and we need to respond now.

Rescue measures already taken in the form of guarantees are equipping businesses with the necessary liquidity to reconnect with profitability as the economy will pick up again. Non-dilutive equity support instruments will maintain companies bankable and eligible for debt funding. But for high growth and innovative companies, this will not suffice. Here, risk-taking equity solutions are key.

Europe has an immense unexploited potential to lead this transition. To unleash it, Europe needs to embrace innovation and grow beyond its attributed role as a technology incubator for other geographies. For innovative companies in Europe the longstanding promise of a seamless funding chain from seed to IPO and liquid capital markets finally needs to come true. From start-up to category leadership, European companies need a funding ecosystem that is at the scale of their global ambition. However, to achieve this goal, IFIs and NPIs, acting at national and supranational level, need to step up their own ambitions and target unaddressed market gaps in a concerted manner rather than compete amongst themselves for the lowest hanging fruit. This will be a step outside of our usual financial comfort zones.

To date, VC and private equity instruments have served the EU well, but we need to go a step further in their risk-taking and firepower if we are to generate the innovations that will effectively tackle tomorrow's societal and environmental challenges and keep Europe globally competitive. ●

Sebastien Raspiller

Director, Treasury, Ministry of Economy and Finance and the Recovery Plan, France

Equity funding must be at heart of CMU 2.0

European banks, notably French ones, have been successfully mobilized to help businesses cope with a likely liquidity crisis at the climax of the lockdown. Still, if we all hope this stage of the crisis is now over, the ongoing economic meltdown may last much longer. In this context, our absolute priority must be to avoid turning a possible liquidity crisis into a solvency one. Yet, this dramatic period reminds us of how hard it can be for some companies, in particular SMEs, to benefit from equity funding provided through market-based solutions. This is why rebooting the Capital Markets Union is crucial to help our businesses diversify their sources of funding. This goal can only be achieved if we take bold measures to kickstart both supply and demand.

> *The upcoming review of Solvency 2 will be key.*

When it comes to supply, the recent economic challenges we have been facing must lead us to take tough measures to make a smarter use of the insurers' and banks' equity. Insurers must fully ▶

play their role in financing the economy and providing long-term savings opportunities for retail investors. The upcoming review of Solvency 2 will be a significant step to meet this objective. At the same time, we must keep defending strong and competitive European banks, operating on global markets and able to provide complex corporate advisory and risk management services. We will then carefully check that the transposition of the Basel III standards does not eventually result in significant differences with some other countries that end up being detrimental to our financial ecosystem.

While banks and insurers have a huge role to play, individual savers should also be given the opportunity to contribute to the economic recovery. This is all the more needed as the current context of uncertainty has led the level of the saving rate to spike. In this view, France will carry on striving to promote pan-European funds in a more active way. Further work will be required to ease the passporting and the development of European labelled funds ELTIF and EuVeCA.

The demand for market-based sources of funding must also be fostered through easier processes. The proposals put forward in July by the European Commission for a quick fix of MIFID are a positive move to waive some reporting requirements which have proven costly and complex, without improving the financial markets stability. The Commission's Capital markets Recovery Package will also contribute to ease SMEs' access to financial markets by allowing the rebundling of research and brokerage for capitalizations under € 1 billion. In the longer run, it will also be necessary to strengthen entrepreneurs' trust in the financial markets. To meet this goal, transparency should be fostered through simpler and more standardized information. MiFID II and PRIIPs, should be better suited to individual investors' needs. In the same line, the recent Wirecard case must bring us to scrutinize the current organization of our supervision to make it better at all levels and more efficient.

Finally, although simplifying the access to market-based sources of funding is a priority, we must acknowledge that it cannot be a cure-all and that it is not always the best suited solution. There are cases in which the panacea will probably rather be to help banks benefit from the financial markets in order to lend to businesses. In that way, we must promote securitization by an ambitious review of impediments - notably prudential ones - to the development of the European framework for Simple, Transparent and Standardized securitizations (STS).

Märten Ross

Deputy Secretary General for Financial Policy and External Relations, Ministry of Finance, Estonia

What more needs be done to strengthen equity funding in the EU?

To what extent can equity funding be realistically developed in the EU given the obstacles on the supply and demand side?

One should probably be realistic about the extent to which and how fast equity funding could develop. Reasons for that include supply side for capital (i.a. investor literacy) and also demand for changing equity structure from company perspectives (i.e. management literacy). Both sides are not helped by still high cost of equity investment, particularly for smaller companies and cross-border investments.

In addition, developing equity funding in the EU is probably coming more complicated in the aftermath of the COVID-pandemic. What is a bit paradoxic as the need to add fresh capital into companies is becoming actually more pressing.

While one reason for that is lingering additional uncertainty about the future potential returns created by the COVID-shock, also massive government financing schemes, needed as they are for macro reasons, could lower the demand for additional market funding. On one hand credit financing is possibly done one (further) notch too cheap relative to other forms of capital. And it is also clear that the capital injection schemes themselves hardly improve the cost structure and other investments constraints for wider public. Additional (speculative) question is whether governmental intervention into company holdings would add one further layer of uncertainty about finding out productive investments.

Do the adopted and newly proposed policy measures define an appropriate strategy for developing SME equity funding in the EU?

The measures proposed by High Level Forum are in good direction. One should continue working with costs hindering development of equity markets, both on issuing side and also with ones related to infrastructure. This does obviously matter for cross-border aspects, but not only.

Another question is if the SME is sufficiently well covering concept for equity financing problems as it attaches more attention to M and S gets less prominence. While medium sized companies have better outlook to go public and diversify their equity structure, the excessive cost question is more problematic for the smaller companies (even with good growth prospects).

One question here is whether we are realistic on what to wait for happening with small enterprise market financing (either on growth or full markets). Successes of crowdfunding and some fintech sector approaches could point that these are more promising avenues to diversify capital raising for them and regulation could take direction from these.

What are the priorities and what further actions might be needed?

Clear priority is to work on lowering further the costs of market financing. While marketing and prospectuses side (potential overregulation and inconsistencies in implementing the rules) are important in this regard, further attention should still be attached to the costs imposed onto the investors and arrangers by present central securities depositories framework as there might be unnecessary barriers to registering and safe-keeping capital, i.a. expressed in a new forms. Linked to that - but important also separately - are the costs related to payment infrastructure for cross-border equity holdings.

Stéphanie Yon-Courtin

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

More than a backbone: fleshing out equity funding for EU SMEs

"SME are the backbone of Europe's economy" earned a top spot amongst EU *clichés*. As the Covid crisis hits Europe, we need to move beyond slogans to ensure that our start-ups, entrepreneurs and SMEs get access to equity funding, for their very survival, and to be at the heart of the recovery.

Just as muscle is needed to put bones in motion, SMEs need appropriate funding sources to get moving.

Banks are a prime interlocutor for SMEs in search for funding opportunities. They have played a crucial role in ensuring the smooth rollout of liquidity to SMEs and have gained an acute expertise of SMEs' needs and growth potential over the past decades. However, as their prudent financing capacity could deplete, they should also act as a bridge to identify alternative market-based funding sources. This is why I support Renew Europe's proposal for a pan-European credit referral system, to which SMEs can voluntarily subscribe when their loan request has been rejected.

Muscle alone is not enough: entrepreneurs need coaches in the early stages of their existence. Business angels, venture capital and equity crowdfunding can provide an appropriate mix of funding and coaching, that should be supported in the EU through the sharing of best practices, for example on relevant tax incentives. Member States should also prioritise the transposition of the Directive on preventive restructuring, to help entrepreneurs facing financial difficulties to receive support for their second chance.

With muscle and coaching, our SMEs will be in good shape for the marathon of public listing. The new SME growth market and a lighter prospectus regime should be positive overtime. More fundamental changes should follow: facilitating investment research on SMEs should be more than a temporary measure, and Member States should tackle at last debt-equity bias in taxation.

Just as tendons are connecting muscle and bones, smoother connections between SMEs and funding opportunities are required to better transmit the entrepreneurial motion to the EU economy.

Through the SME lens, facing EU legislation is more of a hurdle race than a walk in the park. The definitions of SME in EU legal acts should be streamlined and reflect that diversity of the entrepreneurial landscape, including family and community businesses, self-employed workers, start-ups, cooperative businesses and mid-caps. Performing an 'SME test' for each CMU initiative is a welcome first step.

> *Fostering an equity culture for EU citizens as investors can bring SMEs closer to equity funding.*

From our viewpoint as EU legislators, SME related actions are at the core of many initiatives, but their visibility on the ground should be improved. Clear communication, involving all relevant actors at European, national and local level, will help making SMEs aware of the support available to them. The new EU SME envoy could also bring more visibility to SME-related concerns at EU level.

Fostering an equity culture for EU citizens as investors can bring SMEs closer to equity funding. Employee share ownership programmes, and easy-to-use digital tools allowing savers to act on their investments, are inspiring ideas to create a cohesive funding ecosystem, increasing financial awareness and reducing risk averseness.

With the muscle of equity funding, and the tendons of equity culture, the SME backbone will set in motion the EU economy recovery.

Javier Hernani

Chief Executive Officer, Bolsas y Mercados Españoles (BME)

Funding the way forward for SMEs

Following the last financial crisis, we are going through some of the hardest times due to the Covid-19 pandemic. SMEs will play a key role in the recovery after the Covid-19 crisis but a large number of them are finding it hard to raise capital.

In 2018 the European Commission proposed measures to reduce the administrative burden faced by SME Growth Market issuers, foster their liquidity and facilitate the registration of MTS as SME Growth Markets. The Capital Markets Union features new rules to ensure that smaller businesses in the EU have access to diversified sources of financing at each stage of their development. The idea of an SME IPO Fund that would specialise in IPOs of SMEs is very much welcome too.

In this scenario, it is essential to diversify financing sources and strengthen the balance sheet before bank financing dries up. Europe is heavily bank-based, and the lack of an equity culture is a major barrier to developing a solid SME IPO market.

Access to funding by SMEs lies too in the degree of visibility they reach via research coverage. Since 2018 the research quality and quantity of small and-mid cap stocks has shrunk, a trend that could be reversed if unbundling rules were changed.

SMEs must learn to finance themselves in the market. That involves not only having an attractive project, but also knowing how to pitch it at investors. This is why guiding them along the path to the stock market is key. On the opposite end, the low secondary market that smaller issuers' shares face after the IPO is another major barrier to SME IPO market development. Liquidity provision arrangements with investment service providers – market making - are necessary to increase and maintain efficient liquidity following the market debut.

The participation of retail investors in capital markets is paramount. There is a low level of retail investment across Europe, and increasing it is essential for boosting liquidity and should be promoted by incentivising the channelling of retail savings into SME Growth markets.

Policymakers recently agreed changes to requirements applicable to companies listed on SME Growth Markets. In line with the recommendation of the Next CMU High Level Group, further alleviations for SME Growth Markets should be considered. Special segments of regulated markets should benefit from access to SME Growth Markets and the threshold for companies for qualifying for SME Growth Markets status should be increased.

It is also essential to find the right balance between maintaining liquidity and trust in the market with reduced burdens for issuers paired with adequate levels of investor protection. SME Growth Markets should retain a certain level of flexibility whilst ensuring efficiency and integrity.

Another important consideration is the need to remove the tax bias in favour of debt to encourage equity investments. Rebalancing this scenario can encourage companies to strengthen their equity base and dissuade too high levels of leverage. Secondly, it should result in investors paying lower taxes on their equity investments, incentivising the provision of equity capital as an alternative source of funding. Furthermore, in the area of taxes, the implementation of tax incentives for SME investments should be promoted.

Supporting SMEs is strategic, which is why we must develop strong local SME markets. Much is at stake: they are the ones that have the greatest growth potential and the greatest capacity to generate sustainable and highly qualified jobs. ●

Cyril Roux

Deputy Chief Executive Officer, Groupama

SME Financing - a French insurer's perspective

Europe has long designed initiatives to develop equity financing of SMEs. The over reliance of European SMEs on banking credit compared to their American counterparts is a hindrance to growth, capital allocation and employment in the EU. Yet these EU initiatives are made somewhat ineffective by counteracting EU regulations: elevated information requirements of issuers embedded in the prospectus directive, and accounting standards e.g.

These initiatives are also up against insuperable national differences in language, legal regimes, including company law and insolvency law, and social expectations. Natural institutional investors such as EU insurers have two additional impediments to investing in this asset class: elevated capital charges stemming from EU regulations, and the adoption of IFRS 9, which obscures ▶

▶ the net income effect of their economic stewardship by mixing with it the change in market prices of listed equities held, including SMEs.

The pandemic has made this conundrum more acute. SMEs need more than ever a strong capital base to weather the protracted period of return to pre-Covid levels of economic activity. But investors are themselves in a weaker position to provide patient capital. The 750b€ Next Generation package proposed to the Parliament comes with reduced InvestEU and Horizon Europe programs and no Solvency Support Instrument. Next Generation monies will be disbursed at national level, alongside often larger national programs. So, despite the intense activity of EU institutions, most of the action takes place at national level. And the specific initiatives such as SME growth markets, SME listing package and CMU high level forum risk being made only incidental to the more consequential Covid-19 policy response.

Equity funding of SMEs is made in a crucible of conflicting forces.

While paying lip service to the single market and economic sovereignty at European level, national governments clearly expect economic actors to support employment at home. Re-domestication of production and employment figures are dominant objects of political discourse at the national level. Accordingly, the investment space for SME financing in the asset allocation of insurers is increasingly taken up by semi mandatory investment in government schemes. French insurers have 'willingly' allocated this Spring more than 1.5b€ of assets under a government mandate; failure to do so would have been met by supplementary taxation. Hence SME equity financing by French insurers goes where they are told to invest.

Whatever remaining asset allocation space there is goes to private equity financing, which at least provide a respite from IFRS 9 volatility. In the coming years, the inability of SMEs to refinance the abundant state-guaranteed loans distributed by banks this Spring will lead to a new round of 'voluntary' investment by insurers in those companies. This is admittedly a far cry from market economics, and greater capital markets access for SMEs in Europe. ●

Johannes Rehulka

General Manager,
Austrian Raiffeisen Association

Equity funding is key for Europe's recovery

Covid-19-is hitting enterprises across Europe. Companies in certain sectors have suffered liquidity shortfalls and equity losses to unprecedented levels which could easily produce systemic risks for the European Union. These companies need immediate help in the form of own fund injections in order to avoid bankruptcies. In this regard we welcome the recently proposed Solvency Support Instrument in the EU budget 2021-2027 which is designed to prevent insolvencies by supporting equity investments. In the framework of the European Fund for Strategic Investments (EFSI), it will use the EU budget to support equity investments in companies with solvency problems. Also the enhanced Invest EU-programme and the new strategic investment facility can be important contributions to support enterprises in their recovery phase. However these proposed measures have to be implemented and rolled out immediately. A swift adoption of the EU budget 2021-2027 by the co-legislators is therefore essential.

It is obvious that these new instruments can help to improve situation in the current COVID-19-crisis. However in a second step the European institutions should avoid new requirements in prudential regulation which impede institutional investor's ability, such as banks and insurers, to participate actively in equity funding. Without these institutional investors an efficient boost of equity funding will not materialize and the investors base for companies would be further narrowed. For this reason also the final report of the High Level Forum on Capital Markets recommends the European Commission to pay particular attention to the interpretation of the Basel III definition of speculative unlisted equity exposures so as not to impair the ability of banks to invest in long-term equity on terms which are economically efficient and prudentially appropriate. According to the current legal framework investments in such exposures would be assigned a risk weight of 100 % risk weights in the standardized approach. According to the new Basel framework these investments would have to assign 400% risk weights. According to the Basel III reform also other equity holdings have to be assigned a risk weight of 250% instead of current 100% risk weights.

Europe should avoid new requirements in prudential regulation which impede institutional investor's ability to participate in equity funding.

And in a third step the enterprises of the European Union have to stay competitive at the global level. Staying competitive will require large investments in technology, as the innovation gap between the EU and other global economies is widening. A key factor for the competitiveness of an economy is the access to venture capital for innovative start-ups. For the segment of venture capital further steps need to be taken and larger amounts have to be allocated on a European level to strengthen Europe as an innovative market. ●

We thank **the German EU Council Presidency** and **the partner institutions** for their support to the organisation of this event

How to relaunch securitisation?

Philippe Bordenave

Chief Operating Officer, BNP Paribas

A true revival of securitization is now urgent

The need to relaunch securitization has been discussed for quite some time, without any concrete progress. Now is urgent time to transform intentions into workable solutions, as banks see their balance sheets loaded by Covid-related loans and will have to play a central role in the financing of the recovery.

Indeed, securitization enables private risk-sharing by taking risks out of the banking sector and transferring them to other investors, thereby increasing the diversification of funding available to the economy. In these times of crisis, scaling-up the European securitization market by addressing the regulatory obstacles to their development must be a top priority.

The relaunching of the Capital Market Union provides an opportunity for a drastic change in mindset, from considering securitization as a toxic product (when used to securitize badly originated sub-prime mortgage loans in the US), to recognizing that securitization in Europe has been used for healthy risk transfer from banks to educated investors, and should be given an important role in the post-Covid toolkit.

I strongly support the set of proposals on securitization recently presented in the HLF report, which results from extensive technical work, in particular to:

- Unlock the Significant Risk Transfer Assessment process
- Recalibrate capital charges applied to senior tranches, in line with their risk profile
- Enlarge STS benefits to synthetic securitisation beyond SMEs
- Upgrade eligibility of senior STS tranches in the LCR ratio
- Review the Solvency II calibration of senior tranches
- Simplify disclosure requirements for private transactions

I am grateful to the Commission and the EBA that some of those measures are already on the table, in the targeted package submitted by the Commission in July and in the upcoming SRT report by the EBA. However, these proposals should not derail from their initial objective to address the current flaws. While the extension of the STS framework to non-SME synthetic securitizations is a concrete step in the right direction, even if limited to a better treatment for the senior tranches only, the other proposals in their current form do not address the real issues:

- NPE securitization: while the EBA's October 2019 opinion was recognizing the excessive conservatism of the current framework, and recommending useful adaptations to the NPL securitization framework, the BCBS has in the meantime made proposals that would make this instrument value destroying for the issuing bank, and hence de facto eliminate NPL securitization from the post crisis toolkit.
- SRT assessment: the initial proposals presented by the EBA to the industry are driven by a welcome intention to make the SRT assessment process more transparent and predictable. However, the process proposed, whereby the ECB has a 3-months delay after origination to remove its ex-ante approval is totally counterproductive, as it creates a major regulatory risk. No bank would want to issue an instrument in the market, at a significant cost, without having certainty that the risk transferred to investor will result into a commensurately lower capital charge. We sincerely hope that further dialogue with the industry can help converge on a workable process.

The currently proposed amendments have to be significantly improved to achieve their intended goal. This first step needs also to be followed promptly by a holistic implementation of HLF securitization recommendations as all those proposals are jointly necessary to create a viable securitization ecosystem. I urge the Commission to reconsider its target of Q4 2021 for the broader securitization package and to rather give it priority over the implementation of Basel IV, in order to pragmatically fuel the most needed economic recovery in 2021. ●

Martin Merlin

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

Strengthening the role of securitisation in the EU

The macro-economic and financial market shock caused by the COVID-19 pandemic puts additional emphasis on the securitisation market and on the need to contribute to the Capital Markets Union objectives. On 24 July 2022, the Commission proposed targeted amendments to the securitisation framework[1]. On the basis of the work of the European Banking Authority[2] and the Basel Committee on Banking Supervision[3], the Commission proposed to amend the Securitisation Regulation (SECR) and the Capital Requirements Regulation (CRR) to encourage a broader use of securitisation in the recovery phase.

The proposal defines STS criteria for on-balance-sheet synthetic securitisations that are consistent with those for traditional STS securitisations, and introduces new criteria to capture the specificities of using guarantees or similar instruments to tranche and transfer credit risk. This is coupled with a more risk-sensitive capital ▶

treatment for the senior tranche, held by the originator bank. The reduced capital charge reflects the fact that agency and modelling risks are substantially mitigated by the adherence to the STS criteria, and that these securitisations are no riskier than traditional securitisations. This proposal aims to provide additional incentives for securitisation to take place within the robust EU framework for STS securitisation, and help banks find ways to share risk with capital market actors.

As regards securitisation of non-performing exposures (NPE), the proposal recognizes that, by definition, this type of securitisation differs from typical securitisations because the securitised loans are already defaulted at the issuance of the instrument. The discount on the purchase price of the NPEs at the inception of the transaction is the key element in the valuation of the loans that are securitised. Thus, the proposals adjust the risk retention requirement so that the 5% material net economic interest is calculated on the basis of the discounted value of the exposures. In addition, a new prudential treatment of NPE securitisations is proposed in the CRR. The senior tranche of a traditional NPE securitisation would be subject to a flat risk weight of 100%, provided that the price discount applied when the underlying exposures were sold is at least 50% of the notional value of those exposures in the securitisation. This would be in line with the approach on which the BCBS is currently consulting. The proposal also clarifies how to calculate the maximum capital requirement provided for in Article 268 of the CRR for NPE securitisations.

> *Strengthening the role of securitisation in the recovery phase in the EU.*

The Commission remains fully committed to revive EU securitisation on a sustainable basis. The EU securitisation framework will also be subject to a comprehensive review, which is planned to take place in the course of 2021 accompanied, if appropriate, by legislative proposals. In addition, the EBA is working on a report on significant risk transfer in securitisation, which will also feed in the broader review. ●

1. https://ec.europa.eu/info/publications/200722-proposal-capital-markets-recovery_en
2. https://eba.europa.eu/eba-proposes-framework-sts-synthetic-securitisation; https://eba.europa.eu/eba-publishes-opinion-regulatory-treatment-non-performing-exposure-securitisations
3. https://www.bis.org/bcbs/publ/d504.htm

Sébastien Raspiller

Director, Treasury, Ministry of Economy and Finance and the Recovery Plan, France

The development of STS securitization is a must have

The development of securitization is a real opportunity to face both short term and medium term challenges the European Union has to cope with. The recent sanitary crisis shows how much it was necessary for corporates – especially SMEs – to have access to a diversified set of financing solutions, securitization being one of them. In this regard, by transforming loans and other illiquid receivables into tradable securities, securitization could free up bank capital for further lending and allow a broader range of investors to fund the economic recovery. In the long run, securitization should ease the ecological the transition, contribute to the building of a real Capital Market Union and, to a certain extent, support banks' efforts to adapt to the likely increase in RWA coming from the finalized Basel III standards.

Although European legislators agreed to strengthen the securitization framework in 2015, the effects have been rather subdued especially regarding the volume of issuance that has diminished in year 2019. The Simple, Transparent and Standardised securitization label has been implemented from 1st January 2019 to avoid perverse effects that led to the 2008 crisis. This was necessary but it is now time to improve European regulation in order to benefit from the securitization's positive effects. As of today, it is an understatement to say that securitization remains underused in EU: in 2018, while private securitization issuance amounted to USD 787 bn in US, there was only EUR 139 bn of placed securitization issued in Europe; all the recent surveys reports a decrease of securitization issuances in 2019 (between 6% and 15%, figures varying according to data sources).

> *Last but not least, green securitization has an important role to play to increase the capital allocated to sustainable projects and activities.*

Having this in mind, the European Commission has recently proposed to "quick fix" the securitization framework as part of a broader initiative to facilitate the economic recovery. First, the EC has proposed amending the framework to extend the STS label to balance-sheet synthetic securitization and to grant banks a preferential capital treatment to the senior tranche of STS synthetic securitizations, irrespective of the nature of the underlying ▶

exposures (whereas it was only limited to certain types of guaranteed SME loans). It is justified because synthetic securitization is easier and quicker to execute, often with tighter margins, than traditional cash securisation. Second, according to the wide consensus among supervisors that the current EU bank capital requirements overstate the actual risk and reduce bank's incentives to engage in NPL securitisations, the EC has proposed targeted adjustments to the framework.

The forthcoming 2022 review of the securitization framework should be the occasion to introduce more fundamental changes in it. Clarifications to the SRT test (significant risk transfer) would increase legal certainty for market participants; the margin for discretion, beyond the explicit criteria set out in CRR, should be framed. The EBA is expected to publish soon an analysis of supervisory practice in this regard. When it comes to risk weights, additional adjustments should be made to ensure quasi "neutrality" of this framework compared to RW that would be applicable to underlying exposures. The treatment of securitization in insurers' balance sheets should be made more risk-sensitive too, which would help broaden the investor base. Finally, although due diligence requirements should be the same for public and private transactions, there is room for substantially different sets of disclosure requirements.

Last but not least, green securitization has an important role to play to increase the capital allocated to sustainable projects and activities. If the specific features of a green securitization framework still have to be defined, the creation of a European "green / Transition STS" label and an Energy Performance Certificates could be seen as first steps as this should allow the identification of exposures eligible to such a framework.

Oliver Gilvarry

Head of Markets & CMU,
Department of Finance, Ireland

Building on what has been achieved to date from the securitisation regulation

The impact of the Covid-19 health crisis is a major challenge facing the European and global economy. It is important that we take measures to support our economies and companies in whatever way we can.

The intervention of central banks globally has provided unlimited amounts of liquidity to the financial system. Despite this support, our banks will face pressures over coming quarters in generating the organic capital required to support lending to the real economy due to the impact of Covid-19 on our economies and from the low interest rate environment.

We see the use of securitisation as an important mechanism to ensure companies can access the financing they need to manage the post Covid-19 recovery and to ensure banks have the capital available to provide financing to them, especially to the SME sector. Securitisation allows investors access credit exposures such as SME loans that would not usually be available to them and provides a mechanism for banks to transfer credit risk to other parties, improving financial stability. In order to support this important alternative funding channel, it is key that we seek to make targeted amendments to the STS framework now and we fully support the Commission's inclusion of these amendments via the COVID-19 recovery package for financial services.

While the introduction of the Simple, Transparent and Standardised (STS) securitisation label has introduced welcome practices to Europe's securitisation framework, we should also acknowledge that since its introduction we have not seen the increased levels of issuance we would have hoped. The number of STS securitisations issued in Europe increased from 143 in 2019 to 183 year to date, but the overall volume of European securitisations fell between 2018 and 2019.

The introduction of the STS label to balance-sheet synthetic securitisations, along with extending the benefits of lower capital requirements to the senior tranche of the STS synthetic securitisation is a welcome development. These changes are timely, as they will help banks to undertake such transactions, in particular SME securitisations, freeing up balance sheet capacity to undertake new lending. Similarly, the changes to NPL securitisations will help reduce some of the obstacles to banks issuing such structures. In particular, the changes to the calculation of the risk retention part of the deal are sensible.

> *Allows investors access credit exposures such as SME loans that would not usually be available to them.*

It is important that within Council and Parliament we reach agreement on the package quickly to ensure it has the best chance to support our economies and companies in the recovery phase. We must also remember that securitisation is only one funding channel available to our companies and banks.

It is important that we as policy makers continue to consider how we can support the increased use of different types of funding channels such as IPOs, easier debt issuance for smaller companies, increased availability of private equity and venture capital to support our companies at all stages of their growth. Therefore, the other proposals in the Commission package are as equally important for us to agree quickly, to ensure we achieve the maximum impact from the changes as soon as possible and help further develop our capital markets.

Andreas Glaser

Chief Financial Officer, Santander Consumer Bank Germany

Securitization the key instruments for a post Covid recovery

Europe is currently lacking capital markets comparable to the depth and strength of the US market. As we experienced during the last financial crisis, this can have severe implication on the recovery prospects of the European economy, which still relies heavily on banking financing.

So, why would securitization be not only helpful, but actually the key instrument to ensure a sustainable recovery from the upcoming crisis? I would like to stress 3 points to back up my statement:

- Given the current setup of the European capital markets, banks will continue playing a central role to finance the real economy. Banks have the expertise and network to support local businesses. The question is: how to bring capital markets to those businesses? In my opinion, the answer is securitizations. They are the link between the Banking Union and the Capital Market Union. With securitizations, banks can reinforce their role as intermediaries between the real economy and international investors.
- In a time of turmoil, stability of the financial sector is critical. Securitizations allow redistributing risks across market participants, while increasing investing opportunities for national and international investors. As a consequence, banks become safer while improving their lending capacities to the real economy.
- The European economy and its labor market are built on the strength of its small and medium enterprises. SMEs do not, at the moment, engage actively in capital markets, and rely heavily on banking financing. Securitization would allow that the money flows from international investors can reach those who are at the core of our economic activity.

European securitization is and must continue being transparent and understandable for issuers and investors alike. But it is time that we acknowledge their critical role to build the capital markets, especially for a banking-based economy like ours, and we make sure that our legislative framework incentivizes the right usage of this financial instrument.

> *European securitization is and must continue being transparent and understandable for issuers and investors alike.*

There are several areas of the prudential and supervisory treatment of securitizations that should be improved, both for STS and non-STS. Priority should be given to improve the LCR treatment of securitizations and to remove the risk weight floors for originator positions. It is also key that STS with preferential capital treatment should be granted to qualifying synthetics.

The various regulations introduced since the last crisis, such as the banning of re-securitizations, the retention rules, the investor due diligence rules, and the STS criteria, have made securitizations significantly safer, even though European securitizations have a history of very low defaults even during the last crisis. ●

Improving EU securities market transparency and infrastructure

Markus Ferber

MEP, Committee on Economic and Monetary Affairs, European Parliament

A robust market infrastructure for a successful CMU

Since the financial crisis of 2008/2009, Europe's financial markets infrastructure has become more robust and resilient. The excessive market volatility induced by Covid-19 is prove of that. The spike in volatility, trading volume and uncertainty has not led to substantial financial stability problems. On the contrary, EU financial markets have coped well and it is fair to say that the EU's market infrastructure has successfully passed a major stress test.

However, while robustness and resilience are important features of our market infrastructure, they are not all that matters. After all, the key feature of efficient markets from the perspective of most market participants is a price discovery process that is accurate and enables meaningful capital allocation. A prerequisite for an efficient price discovery process is market transparency.

The recast of the markets in financial instruments directive (MiFID II) was meant to specifically address this issue by "turning on the light, without turning off the tap", i.e. improving market transparency without hampering market liquidity. The recast resulted in a substantial revamp of the EU's market structure and improved transparency rules combined with a set of waivers to address certain exceptional circumstances.

About two and a half years after the entry into force of MiFID II, we can draw the first firm conclusions about the effects of the MiFID review. While the overall market infrastructure has become more robust, the results in terms of transparency are mixed. Unfortunately, we have seen that regulated markets, which come with the strictest transparency requirements and the greatest contribution to price discovery, have seen their share of trading decrease.

Instead, systematic internalisers and other less transparent trading venues have gained ground, often because the operators of those trading venues have proven to be quite apt at identifying loopholes to circumvent the rules.

While some of the loopholes might have been in line with the letter of the law, they were certainly not in line with its spirit. This leads to the inevitable question of how to address the still existing problems in the framework of the upcoming MiFID II review and beyond. Arguably, the guiding principle should be that strong in order to facilitate price discovery trading should take place as transparently as possible strong.

That means that the default trading venue for most trades should be regulated markets and not systematic internalisers or dark pools. Such a notion also implies to limit the waiver regime to what is necessary. A reduction of the overall options in terms of waivers as well as revisiting the double volume cap in principle would be logical steps.

Changes to the market structure and transparency rules will only have a very limited effect though as long as enforcement of the rules is not stepped up in a meaningful way. Many of the circumvention attempts that happen in a regulatory "grey zone" could have been prevented with more robust interventions by supervisory authorities. Most of the blame has to be attributed to national competent authorities who have often been too lenient when applying the rules, but ESMA has also failed in its coordination function to apply a stricter approach across the Union.

> *In order to facilitate price discovery trading should take place as transparently as possible.*

Lastly, a consolidated tape is high up on the wish list of many sell-side market participants. The original approach envisioned in MiFID II has not delivered the desired solution, which points at certain complexities in the process of designing a consolidated tape. It is therefore probably best to moderate our ambition and look at what is feasible. A real-time consolidated tape with the widest possible scope is probably not the right starting point for any discussion. An end-of-day record of transactions for a first subset of liquid and transparent financial instruments is probably a more realistic goal.

One thing is clear though: a consolidated tape, no matter its scope, will only work under one condition: consistent and high data quality across all venues. The data obtained must give the full picture, i.e. include all trading venues, and be of high quality as a consolidated tape or tape of record that one cannot trust is essentially worthless. Bumping up data quality to a sufficiently high degree across all venues is therefore an absolute necessity. ●

Ugo Bassi

Director, Financial Markets
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Improving EU securities market transparency and infrastructure in CMU context

The Capital Markets Union (CMU) is a key structural reform programme to remove barriers to investing across borders. Notwithstanding the fact that the Commission has successfully delivered on the CMU Action Plan, capital market integration remains insufficient, and certain fundamental aspects of a functioning single market are still outstanding.

The strength of economic recovery will decisively depend on supportive financial flows and the functioning of capital markets, reinforcing the need for a CMU that supports transparent markets. In addition, as a consequence of Brexit, key market infrastructures outside the EU will increase the risk of dependency of the EU financial stability on non-EU interests and capital markets. This could lead to greater market fragmentation in the EU and loss of liquidity.

Underdeveloped and fragmented capital markets in the EU can be both a cause and consequence of limited benefits that market participants draw from trading, clearing and settling in financial securities. If there is less trading in financial instruments, market infrastructures will not deliver desirable efficiency gains or economies of scale. If settlement processes are subject to inappropriate regulation inefficiencies will persist.

The lack of easily accessible, reliable, understandable and comparable public information is one of the reasons why some companies may struggle to attract investors. An EU Single Access Point (ESAP) for financial information would help improve transparency and thereby help facilitate development of EU capital markets. The setup of the ESAP is still to be decided, but to overcome the obstacle of suboptimal accessibility of information it will need to include a broad scope of information. It will also need to provide easy access for users (both investors and issuers) and ensure that the information is user-friendly, comparable across Member States and both machine and human readable.

An EU consolidated tape (ECT) as a tool for reliable access to consolidated data for all traded assets could also provide benefits to EU capital markets. Together with the single-entry point for company information, this would give investors access to considerably improved information at a pan-European level. The ECT would also foster transparency by rewarding those execution venues that contribute to price forming transaction data. An ECT would require comprehensive coverage, improved quality of data and data standardisation in order to consolidate data in a meaningful manner. The Commission will assess how the ECT should be calibrated as part of the implementation of the CMU Action Plan and of the MIFID II review to be finalised in 2021.

> *The need for a CMU that supports transparent markets.*

Beyond the ECT, the review of MIFID II will provide an opportunity to revisit other market infrastructure topics with the aim of increasing the attractiveness of European capital markets. The Commission will approach these technical aspects in a holistic manner, with a view to ensuring that trading in the Union is transparent and subject to more derogations from transparency where this is justified, while ensuring that EU market participants can trade on markets outside the EU. ●

Gerben Everts

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

Equity and non-equity transparency: the final pieces of the puzzle

In July 2020, ESMA published its final report on the MiFID II review for equity transparency. For non-equity transparency, the final report will be published in September. In this article, I'd like to describe a few of the current problems with equity and non-equity transparency. The measures proposed by ESMA may alleviate to some extent the observed problems with MiFID II transparency.

In the area of equity transparency, the AFM observes the complexity of the waiver structure, increasing market fragmentation due to increasing competition of systematic internalisers (SIs), issues with post-trade data quality and the lack of a consolidated tape. ▶

Waivers for pre-trade transparency can be useful to bring transactions on venue, in particular the Large-in-Scale waiver (LIS). However, the waiver structure is complex yet not easy to improve. The double volume cap (DVC) has very few supporters. It appears over-engineered and not achieving its purpose. We support simplifying the DVC by eliminating the 4% threshold at the level of individual trading venues.

Trading has become more fragmented across venues, with SIs taking a larger part of the volumes. We support policy measures that will further align the level playing field between trading venues and SIs.

We view a real-time post-trade Consolidated Tape Provider (CTP) as important for enhancing transparency and we see the CTP an essential part of promoting the CMU and its necessary acceleration as proposed by the European Commission. It will enable aggregated information from increasingly fragmented markets. While we support the establishment of CTP, we also note some practical constraints which should temper expectations.

MiFID II has not yet delivered on its goals in the non-equity markets and can still be considered work in progress. In our analysis MiFID II's focus on transparency based on liquidity has proven to be counterproductive given the lack of liquidity in the fixed income markets where many instruments are tailor-made and not designed with the intention to be traded on a secondary market.

Market participants argue that MiFID II has merely sought to replicate equity market conventions onto so-called "non-equity" segments and that enforcing transparency on such markets is counterproductive. Instead, it can be argued that sufficiently liquid fixed income markets with sustainable higher levels of transparency can only be achieved by incentivizing standardization of instruments and addressing primary market fundamentals.

Overall, there is still broad support for the original G20 goals of migrating fixed income markets and derivatives towards more transparent and open markets. At this stage, MiFID II can be considered unfinished business and requires action from regulatory authorities to ensure it reaches its goals. Besides the goal for addressing market fundamentals through creating incentives for more standardization, we support improving the level playing field between bilateral and transparent multilateral forms of trading by creating more regulatory certainty. In addition, the right conditions for meaningful transparency can be achieved by focusing on improving data quality through an enhanced focus on liquid instruments, as well as the introduction of a post-trade consolidated tape.

Stephen Berger

Managing Director, Global Head of Government & Regulatory Policy, Citadel

Course corrections to illuminate the EU bond and OTC derivative markets

The European Commission and ESMA have set forward constructive proposals to put the post-trade transparency regime for bonds and OTC derivatives back on its intended course. As ESMA correctly observed in its March 2020 consultation paper: *"Whilst MiFID II/MiFIR aimed … to enhance the efficiency, resilience and integrity of financial markets notably by achieving greater transparency for non-equity instruments, it is unclear that this objective has been achieved."*

Finally shining light on these historically opaque markets will benefit EU investors and further advance the development and integration of EU capital markets. Transparency will also lower the cost of capital, and increase efficiency in the allocation of capital, for both the public and private sector.

The EC and ESMA have identified a number of concrete steps to address the scarcity, quality, timeliness, and accessibility of post-trade transparency data for bonds and OTC derivatives.

First, ESMA has recognized that very few off-venue transactions are subject to post-trade transparency requirements, despite its acknowledgement that *"MiFID II has the explicit objective to increase the level of transparency, including for OTC-transactions."* ESMA has therefore outlined numerous options to make the post-trade transparency framework more comprehensive, and to ensure a level playing field with respect to on-venue and off-venue transactions. The majority of respondents to ESMA's consultation favoured these revised approaches over the status quo.

> *The EC and ESMA have set out a path to fix the post-trade transparency regime for bonds and OTC derivatives.*

Second, the EC and ESMA have both recognized that inconsistent and excessive deferrals undermine post-trade transparency, with ESMA noting *"that a four-week delay for the publication of a transaction provides information to market participants which is of limited use"* and that the *"patchwork of rules applying across the Union"* should be replaced by a single regime.

Indeed, ESMA has wisely laid out multiple options that would ensure that even for larger size transactions, post-trade information would be "published as close to real time as possible with the volume being masked". Experience in the US across corporate bonds, mortgage-backed securities, and OTC derivatives illustrates both the efficacy of, and widespread market support for, transparency regimes that mask the full notional of large size trades but nevertheless limit their deferred publication to no more than 15 minutes.

Third, the EC is exploring the establishment of real-time post-trade consolidated tapes across both equities and non-equities, which would ensure that EU investors can efficiently access and benefit from transparency data. Consolidated tapes should be developed for both bonds and OTC derivatives, and should be comprehensive, require mandatory contribution, disseminate information immediately upon receipt (both freely to the public via websites and via real-time data feeds at a reasonable cost), and feature targeted and limited deferral regimes for larger size block trades.

The MiFID II review process provides a critical opportunity to remedy identified implementation shortcomings that together will put the MiFID II post-trade transparency regime for bond and OTC derivatives back on track. The EC and ESMA should remain committed to adopting the common sense fixes they have identified in their consultations. Collectively, these will improve conditions for investors, strengthen EU financial markets, and more efficiently support the financing of the public and private sector in challenging economic times. ●

Nicholas Bean

Head of Electronic Trading Solutions, Bloomberg

A 'cut & paste' equity CT solution for FI markets may be no solution at all

The MiFID II objective of increasing transparency remains a key measure when considering the success of the legislation. However, a lot of soul searching continues as to why the outcome has not yet lived up to everybody's expectations.

One area of disappointment is the absence of a Consolidated Tape (CT) for either equities or fixed income (FI). Yet, as with the formation of MiFID II itself, many of the questions being asked about their absence seem to be equities orientated, with FI markets appearing to be a second order concern. This is worrying because if we don't learn from past errors, we are destined to repeat them. To avoid this, greater effort must be made to understand how FI markets function so the appropriate value of a FI CT can be determined.

FI transactions are made up of three distinct steps, with equal weighting to the objective, those being i) identification of liquidity, ii) price formation, and iii) execution. Steps i) and ii) are the 'art' of FI trading and, in practical terms, are not largely relevant for equity transactions due to the omnipresence of that information correlated to the commoditised nature of that market and the use of execution protocols suited to highly liquid instruments, e.g. Central Limit Order Books.

Unless FI markets are going to shortly become commoditised in the same fashion as equities (and considering that some market practitioners have been predicting this for several decades but it has yet to come to pass), then an FI transaction will remain a three part process where the identification of liquidity and price formation remain intrinsic to it. Since the inception of FI e-trading, the Request For Quote (RFQ) protocol has been and remains dominant as it accounts for the need of liquidity identification and price formation alongside the final step of execution.

While a CT will not directly change the RFQ experience itself, it may be able to play an additive role in the first two steps of an FI trade by bringing more science to the 'art' of liquidity identification and price formation.

> *A live dog is better than a dead lion.*

A prerequisite for this is data - but which kind? In essence, the most productive type is going to be post-trade, i.e. trade prints, against which market participants can unleash their data scientists, quants, et al - to optimise the three step FI execution process. That leaves us to consider the role of pre-trade data, another emotive issue under MiFID II. While there continues to be healthy debate even within the FI community about the value of pre-trade transparency, there is no debate about the value of post-trade data.

Why not then adhere to the old adage of 'walking before you can run' and save pre-trade discussions for the future so as to not have them hinder the formation of the optimal post-trade solution? Or, as the proverb observes, "a live dog is better than a dead lion" (Ecclesiastes 9:4).

In conclusion, as we head into the MiFID review, it is important to recognise that a functioning CT for FI products is as equally important to the FI market as it is to the equity market. Failure to do so, by in particular employing a 'cut and paste' of an equity solution across to FI, will at the very least result in an ineffective resolution - and at worst will impact the effective operation of our FI capital markets. ●

Ilse Peeters

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Has CSDR delivered on CMU objectives?

As post-trade services providers and financial market infrastructures, Central Securities Depositories (CSDs) are essential in capital markets and therefore also core to the success of the Capital Markets Union (CMU). CSDs contribute to the CMU objectives by continuously enhancing their service offering towards issuers and investors and by implementing the CSD Regulation ("CSDR") which confirms CSDs as the safest place to issue, settle and safekeep securities. CSDR also makes CSDs more competitive as it gives issuers choice of which CSD to use for their securities issuance. Also, the technical development of Target2Securities (T2S) has been accompanied by a comprehensive effort to harmonise market practices across those markets which have migrated to T2S.

For CSDs, in a further step towards more integrated and harmonised EU post-trade processes, there are two main focus points in the coming years. First, the upcoming CSDR review which is foreseen to start shortly. Second, implementation of recommendations for harmonisation which have been put forward by the European Commission's CMU High Level Forum (HLF).

On the one hand, the review of CSDR comes (too) early as not all EU CSDs have been authorised. The review should therefore be targeted to a few key elements that could foster further integration among CSDs. A review of CSDR should be focused on easing passporting and improving supervisory convergence - two topics that have proven less successful in the ongoing CSDR implementation.

On the other hand, the delay that was offered by the authorities for the implementation of the Settlement Discipline Regime ("SDR") should also allow time to reflect on the content of such regime. The COVID -19 crisis may provide a valuable data set to analyse the (theoretical) impact the SDR could have had. As a follow-up of the recent market turmoil, we believe it would be prudent for the Commission and ESMA to carefully assess all implications of the SDR. The surge of settlement volumes combined with business continuity arrangements, may cater for new insights on the impact of measures on settlement efficiency and market liquidity.

> *A review of CSDR should be focused on easing passporting and improving supervisory convergence.*

From a CMU perspective,and in addition to the recommendations of the HLF, we believe renewed attention is required on how the trading, clearing and settlement layers operate cross-border, post implementation of major regulations such as MiFID, EMIR, CSDR, taking into account different dynamics of cash instruments (equities, debt). The Commission could seek evidence on the effectiveness of the open access and interoperability requirements included in MiFID, EMIR and CSDR and the reasons for a potential lack thereof.

A well-targeted CSDR review, combined with further harmonisation as suggested by the HLF will contribute to the CMU objectives and global competitiveness of EU capital markets, supporting the International role of the Euro. ●

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How to address CCP outstanding issues?

Robert Ophèle

Chairman, Autorité des Marchés Financiers (AMF)

The challenging new supervisory framework of CCPs

CCPs supervision is key for the stability of the financial markets, and as such, is considered as a cornerstone within the EU financial regulation. Despite the market volatility and the operational challenges CCPs had to face during the Covid-19 situation, EU CCPs demonstrated their resilience and their choc absorbing function during this crisis; it was all the more welcome than the Nasdaq Clearing episode in 2018 had demonstrated possible weaknesses of CCPs. The recent ESMA stress test has confirmed the robustness of EU 28 CCPs while pointing attention at concentration risks in case of default(s).

The CCP supervisory framework is evolving in the EU, both with the entry into force of EMIR 2.2 and of the accompanying delegated regulation concerning third-country CCPs and with the finalization of the regulation dealing with the resolution of CCPs. They are both supposed to strengthen the resilience of these core market infrastructures.

Let me just highlight how challenging the implementation of these new regulation will be.

EMIR 2.2 reinforces dramatically the responsibilities of ESMA trough the new established ESMA CCP Supervision Committee. The aim is both to foster the convergence of supervisory practices for the EU CCPs, although they remain directly supervised by their national competent authorities, and, on the other hand, to grant ESMA with direct supervisory powers regarding third-country CCPs classified as Tier 2 (CCPs considered as systemically important for the financial stability of the EU), to be exercised in close coordination with their third-country competent authorities. This new set of responsibilities means ESMA will have to find its own way as a credible supervisor of third-country CCPs, although it has neither such role for EU CCPs, nor for EU clearing members or for EU trading platforms.

This to some extent wobbly solution is linked to the almost visceral attachment of member states to a national supervision of market infrastructures whatever their systemic importance and, regarding CCPs it has been confirmed by the recently agreed regulatory framework for resolution. CCP resolution will remain a national matter even if resolution colleges will facilitate adequate coordination.

The EU approaches therefore the end of the transition period of the Brexit in a relatively weak position and the question of whether to grant equivalence to the UK CCPs arises once again.

While it is clear that the ultimate goal should be to ensure the EU has significant market infrastructures for all the financial products issued by EU entities or whichare denominated in an EU currency, in the short term however, in order to avoid any detrimental cliff-edge effect to the EU financial stability, the EU Commission has rightly announced its intention to adopt a time-limited equivalent decision for the UK CCP legal framework. In addition, for the UK CCPs to be able to continue to provide clearing services to EU clearing members or EU trading venues, ESMA shall issue recognition decisions with the related classification as Tier 1 or Tier 2 CCP, in due course.

However, procrastination should stop and the medium term goal should either be clearly and officially endorsed, even if the efficiency of financial markets and the clearing infrastructure may not be fully optimal, or abandoned. In that perspective the stance of the ECB would be key by asserting that it is not prepared to directly or indirectly provide liquidity to third country CCPs. ●

Jochen Metzger

Director General Payments and Settlement Systems, Deutsche Bundesbank

Euro clearing comes home – Time for a change of perspective?

The EU CCP Recovery and Resolution framework has progressed to the final stages of the legislative process and is highly likely to enter into force towards the end of the year. However, a closer look at another EU issue appears more pressing: the EU and the UK are still in the process of negotiating an agreement that sets out a new partnership after the end of the Brexit transition period in December 2020. In absence of an extension of the transition period, a no-deal Brexit has once again become a plausible scenario that euro clearing participants have to prepare for.

After the end of the transition period, UK-based CCPs will become third-country CCPs. This means that a large portion of clearing business relevant to the EU, especially euro clearing business, will take place outside the EU. ▶

Without recognition, these CCPs will not be able to offer certain services to market participants in the EU. Essentially, two things need to happen for these CCPs to be recognised under the EMIR third-country framework. First, the European Commission has to declare the UK's regulatory and supervisory framework equivalent to the corresponding frameworks in the EU. Second, ESMA needs to recognise these CCPs, depending on their systemic relevance for the EU. In such a scenario, ESMA could classify UK CCPs, such as LCH Ltd. and ICE Clear Europe, as Tier 2 CCPs and join the Bank of England in supervising them directly.

The future of EU financial services lies with and within the EU – not outside the EU.

Currently, we can assume that the revised third-country CCP framework under EMIR is fit for purpose to accommodate London-based CCPs, given that EU law is still applicable in the UK. However, it appears unlikely that this will hold in the medium and long term. The UK government has made it clear on several occasions that it intends to diverge from the EU's regulatory and supervisory frameworks in the area of financial services, including those on central clearing. Undercutting EMIR provisions will put the practical co-existence of EU and UK regulation and supervision at risk, perhaps rendering it impossible to follow through. It is thus very wise that the Commission intends to adopt a time-limited equivalence decision, which underscores the possibility of the process being revised should the UK's future regulatory regime substantially diverge from EU law.

Despite the efforts made by lawmakers, it has become apparent that the uncertainty surrounding Brexit and its implications for the EU market is here to stay, and that there are no simple, risk-free solutions. This warrants a clear and simple message: The future of EU financial services lies with and within the EU – not outside the EU. If the market is looking for certainty, it should shift its focus away from the UK. A mid-term strategy would be for market participants to reduce their exposure to London and to explore and develop clearing capacities within the jurisdictional borders of the EU. The EU offers viable alternatives to London-based clearing that have shown promising growth in recent years, in particular with regard to euro clearing. It is time for a radical change of perspective to bring about the certainty the market has been seeking. ●

Verena Ross

Executive Director, European Securities and Markets Authority (ESMA)

Implementation of EMIR 2.2 moving to the next round

The regulatory framework for the recognition and supervision of third country CCPs introduced with EMIR 2.2 has been complemented with the European Commission Delegated Acts in July this year, namely the Delegated Act on the tiering criteria and the Delegated Act on comparable compliance. With the entry into force of these Delegated Acts, ESMA enhanced powers vis-à-vis third country CCPs will be enabled, including the one to determine whether a third country CCP is systemically important for the Union or one of its Member States ("Tier 2 CCP").

This will be a key novelty in the process for the recognition of UK-CCPs, which upon the end of the Brexit transition period, will need to be recognised by ESMA in order to continue to provide their clearing services in the Union. In this context, the Delegated Act on tiering criteria further specified the criteria for such a determination and provided some further predictability to third country CCPs.

ESMA is committed to implement the new regime for the recognition and supervision of Tier 2 CCPs, and so to ensure an even level-playing field between EU CCPs and Tier 2 CCPs.

Over past months, ESMA has been working with all relevant stakeholders in order to ensure a timely decision on the recognition of UK CCPs, upon the adoption of the respective equivalence decision by the Commission, in order to prevent any cliff-edge effect at the end of the Brexit transition period. As

required by EMIR 2.2, over the course of 18 months from the entry into force of the Delegated Acts, ESMA will also review its past decisions on the currently recognised third country CCPs to determine if any of them would meet the criteria for Tier 2 CCPs, and with that be subject to direct supervision of ESMA to ensure their ongoing compliance with EMIR requirements. ▶

In parallel ESMA continues to build up its team in its newly established CCP Directorate to be ready to undertake the new EMIR 2.2 tasks. The Chair and the two Independent Members of the CCP Supervisory Committee that will soon join ESMA will lead the implementation of its new supervisory powers vis-à-vis Tier 2 CCPs.

ESMA is committed to implement the new regime for the recognition and supervision of Tier 2 CCPs, and so to ensure an even level-playing field between EU CCPs and Tier 2 CCPs. ESMA will also ensure that Tier 2 CCPs maintain an adequate level of resilience in line with EMIR requirements to prevent any systemic risk for the Union.

Now looking at the recent experience during the COVID-19 crisis, the existing EMIR framework proved to be effective in ensuring the resilience of EU CCPs throughout the market events and turbulences experienced during unprecedented market conditions related to the crisis. ESMA, together with NCAs and central banks, has closely monitored the performance of EU-CCPs through the CCP colleges. In addition, ESMA published recently its CCP stress test exercise which used stress scenarios which were consistent with the shocks experienced during the COVID-19 outbreak.

Eric Müller

Chief Executive Officer, Eurex Clearing

CCP RR completes the financial stability agenda - but more remains to be done

After more than three and a half years of negotiations, EU policy-makers have finally reached an agreement on a framework for the recovery and resolution of CCPs (CCP RR), completing the final piece of the puzzle to the G20 reforms. Twelve years after the great financial crisis we now have a much more resilient financial system and CCPs have once again proven their key function as financial stability anchors during the COVID-19 pandemic.

By preparing for the worst, the CCP RR framework will further increase the resilience of the private sector and the CCP ecosystem, complementing the existing lines of defense under EMIR. The final deal will request CCPs and Resolution Authorities to draft the recovery and resolution plans establishing swift processes to cover extreme yet plausible scenarios that could lead to the failure of a CCP and to ensure the continuity of clearing of key critical contracts. It gives strong powers to the Resolution Authority to re-establish a matched-book and increases the contributions of the private sector to internalize potential losses. To further limit moral hazard, the Resolution Authority will have the power to recoup public funds in the extreme event they are used to stabilize the financial situation.

Most importantly to our hearts, the final agreement preserves the incentive structure of the CCP, whereby CCPs have been asked to commit a second tranche of Skin in the Game which can be financed by existing CCP capital, and will therefore not shift the loss absorbing responsibility away from clearing members. Finally, the EU framework has developed a comprehensive view of the value of central clearing, by explaining what the costs of letting a CCP fail would be and thereby limiting compensation to cases where our members would be economically worse off according to the No Creditor Worse Off (NCWO) principle. In a nutshell, the long-awaited agreement ensures that all involved stakeholders have a natural interest to do everything they can to mitigate the impact of a crisis on the broader society.

In terms of next steps, CCPs in the EU need to prepare the implementation of the new framework. We are eager to see the details such as for the NCWO counterfactual and the second Skin in the Game which have to be specified by ESMA via Level 2.

The EU is now one of the first jurisdictions with a CCP RR framework to complete the G20 reforms. However, there is still work to be done to strengthen risk management capacities and proper oversight of CCPs. The recently published EMIR 2.2 Delegated Acts on the tiering and comparable compliance of third county CCPs strike the right balance between the imperatives of financial stability and market access in this respect. Now, timely implementation is required to prepare for the end of the transition period for UK CCPs post-Brexit and cater for the risks of having substantial, systemic euro-denominated markets managed in an off-shore centre.

> *There is still work to be done to strengthen risk management capacities and proper oversight of CCPs.*

Moreover, given the sense of urgency around the recent crisis, we have observed a delay of some outstanding G20 reforms such as the Uncleared Margin Rules (UMR), which have still not been fully implemented in the EU. In light of the on-going discussions to grant or extend further exemptions from the clearing obligation, we should be mindful of their cumulative impact and avoid creating loopholes to European clearing requirements and weakening incentives to clear to the detriment of risk management.

The COVID-19 pandemic has illustrated that the financial sector is much stronger than in 2008 and the years of the great financial crisis. The reforms passed have borne their fruits. However, there is no room for complacency in light of a new political and economic reality at global level. It is vital that Europe continues to create an efficient clearing ecosystem that is able to withstand extreme market stress and fosters sustainable economic growth, notably protecting the Euro as key currency and fostering an autonomous and sovereign EU.

Christophe Hemon

Chief Executive Officer,
LCH SA, LCH Group, LSEG

LCH's management of Covid-19 volatility and support to EU recovery

The recent Covid-19 pandemic and the associated market stress had the potential to put immense strain on the financial services sector. The situation was a test of the industry's contingency measures which were quickly deployed across the board. It has been consistently recognised that CCPs have adapted well to the market conditions and were successful in supporting financial stability when it was needed most. In addition, the recent ESMA EU-wide stress-test have demonstrated that CCPs are constantly improving their standards of risk management and resilience.

LCH's risk modelling frameworks incorporated the market moves across cleared asset classes during the recent volatility. Prior to and following these market stresses, CCPs have continued to take proactive measures to prevent an excessive decrease in initial margins falling in calm market conditions. Conversely, CCPs have also acted to prevent procyclical increases in market turmoil. This so called anti-procyclicality is enshrined in the design of LCH's risk models and ensures that margin changes are highly predictable. LCH's prudent approach to margin requirements and anti-procyclicality measures, go above and beyond the EMIR requirements. These practices ensured that the margin call mechanism was highly predictable to our users during volatile markets. For example, risk was predominantly absorbed by existing margin and led to single digit incremental margin increases during the most recent turbulent market conditions.

The recent events have also demonstrated the need to ensure all market participants have unfettered access to the deepest and most diversified pools of liquidity, especially during times of market stress. Access to this liquidity is vital in ensuring well-functioning markets and preserving financial stability.

CCP performance during this recent market stress has shown their resilience. It also provides additional confidence in central counterparties as important financial market infrastructures, supporting the orderly functioning of markets.

The Covid-19 volatility also highlighted some operational issues in the settlement process, predominantly driven by materially higher volumes. Settlement efficiencies were affected due to some general frictions between CSDs/ICSDs and T2S. The increased importance of CSDs demonstrates the importance strengthening of settlement connections that facilitate cross-border settlement between ICSDs and EU CSDs.

While the industry is making steps towards some form of 'normality', we must now place all our efforts in supporting economic recovery in the EU and must utilise all tools available such as EU's CMU initiative and EU recovery package to successfully fulfil our two main objectives – ensuring the orderly functioning of markets and supporting financial stability.

LCH Group and especially LCH S.A. is well placed to support EU recovery efforts, by supporting the EU's expanded role as a bond issuer via the Next Generation EU Fund. This is in addition to LCH's current role clearing EU Government debt and repo for European and international sell-side, and, increasingly, buy-side firms. ●

Toks Oyebode

Executive Director, Regulatory Affairs,
Corporate and Investment Bank,
J.P. Morgan

EU CCP recovery & resolution regulation - A significant milestone

The recent agreement on the EU CCP Recovery and Resolution Regulation marks a significant milestone towards mitigating the systemic risk posed by CCPs and addressing an important unfinished aspect of the post-crisis financial market reforms.

Implementing a robust CCP recovery and resolution regime is critical to enhance financial stability and address moral hazard concerns by better aligning incentives between CCPs on the one hand and clearing members and market participants on the other. The final regulation makes strides on both these fronts, in particular by:

- introducing a second layer of CCP own-funds capital to the default waterfall, known as a "second skin-in-the-game" (SSITG). The SSITG will sit after member assessments, which will further incentivize CCPs to maintain a conservative default fund.

- eliminating procyclical recovery tools such as initial margin haircutting ▶

(IMH). If used, such tools could prove to be detrimental to financial stability by encouraging firms to exit a failing CCP as quickly as possible in order to reduce their exposure.

- capping resolution cash calls at twice the amount of a clearing members' contribution to the default fund. This serves to ensure that such cash calls are measurable, manageable and therefore more reliable. In addition, the regulation requires the resolution authority to consider the impact on financial stability and non-defaulting clearing members before they call for an amount in excess of one time the contribution to the default fund.

Recovery and resolution planning for CCPs is highly complex and in many areas best practice continues to evolve. As such, we welcome the introduction of a review clause to ensure that the EU regulation incorporates the latest thinking. In particular, we believe that the following areas should be revisited:

- While the regulation identifies and aims to address the potential procyclical impacts of resolution cash calls, it does not do the same for recovery cash calls, nor for other potentially procyclical tools such as variation margin gains haircutting (VMGH) and Partial Tear Ups (PTUs). Implementing additional limitations and oversight on use of such tools would make the regime more reliable.
- Provision of compensation should be broader for those who bear losses during recovery and resolution. This is critical to ensure that incentives continue to be aligned throughout the default process.

> *The EU CCP Recovery and Resolution Regulation marks a significant milestone towards mitigating the systemic risk posed by CCPs.*

- Non-default losses (NDLs) should be wholly for the account of the CCP, with right-sized capital to absorb these, as it is the CCP which manages these risks.
- While we welcome the addition of the SSITG, we believe the total amount CCP SITG should be higher and the required amount should be risk-based.

As referenced in the final regulation, the global work plan on CCP resolution is still in progress. It is important these global standards are reflected in the regulation once complete. Specifically, the regulation should incorporate the Financial Stability Board's future guidance on resources for CCP resolution and the treatment of CCP equity in resolution, to ensure that CCP equity is fully loss bearing in the event that a CCP enters resolution.

Derivatives clearing remained robust in spite of record volumes during a period of significant market volatility associated with COVID-19. Nevertheless, observations from this period should inform future policymaking. While it is too early to draw definitive conclusions, among others, the size and frequency of initial margin calls and the setting and application of margin add-ons at CCPs are worthy of additional analysis.

Enhancing the resilience, recoverability and resolvability of CCPs has been a longstanding regulatory policy priority for many in the industry and policy community. Continued attention to these important issues will ensure that the EU remains a thought leader on this topic in future.

V. NEW TECHNOLOGIES AND PAYMENTS

Content

How to support effective digitalisation of EU finance and ensure sufficient technological sovereignty?

Dr. Marcus Pleyer

Deputy Director General, Federal Ministry of Finance, Germany

Europe's Single Digital Financial Market - Picking up speed in rapid waters

It remains difficult to accurately pinpoint how exactly new technologies will affect the European financial markets and its actors. Amid the multitude of possible scenarios, many share the underlying finding that new or rapidly advancing technologies act as a catalyst for the well-known three "D´s" of digitalisation: disaggregation, disintermediation and dematerialisation. On an abstract level, these effects already give a good overview over the major effects of new technologies on value chains and ecosystems in finance. With the help of technologies such as Cloud Computing and Artificial Intelligence, highly specialised business models add new value to specific parts of value chains and offer these elements more effectively or efficiently than incumbent providers with holistic value chains, leading to disaggregation both along the product line and between middle and back office functions and the customer interface.

At the same time, developments such as the Distributed Ledger Technology and related concepts such as smart contracts deployed on decentralized, permissionless blockchains have proven that this technology can not only improve efficiency in capital market processes, but may also question the technical necessity of entity-based financial intermediation.

The same technology is also a driver of demateralisation by enabling the tokenisation of assets. The digital representation of the economic value of and rights to physical assets on distributed ledgers could not only enable investment and trade in new, previously non-fungible or illiquid assets classes, but also promote a more inclusive access for retail investors by facilitating fractional ownership.

The technologies and their application are prone to converge, amplifying their potential effect on the financial market structure. On the other hand, adoption levels vary greatly: while investment in and implementation of machine learning and other AI methods is already relatively widespread, many implementations of DLT technology are still in their early stages and rarely part of operational day-to-day business. The different adoption levels in the industry may actually also be a sign of the readiness of current regulation to cope with the different technologies highlighted here.

> *EU digital sovereignty requires an ambitious approach to key challenges in the EU financial services regulatory framework.*

The transformation of the financial market value chains and ecosystems seems rapid. In particular, the activities of one group of financial market actors can add momentum to this scenario: BigTechs. With their data- and platform-centric business models and the corresponding network and concentration effects, these companies have the potential to substantially transform the financial landscape despite their current primary role as technology providers. Value chains that have been disaggregated by the effects of digitalisation could end up being rebundled in the hands of a few large, non-european companies due to the effects of platform-based business models.

Building on previous work and recognising that the CoViD-19 pandemic highlights the importance of taking up technological innovations in finance, the Commission has been working on two legislative proposals on operational and cyber resilience and on Crypto Assets as well as preparing a Retail Payment and Digital ▶

Finance Strategy. Together with the legislative proposal on combating money laundering and terrorism financing expected for early 2021, the Commission is thus addressing key challenges in ensuring that the EU financial services regulatory framework is fit for the digital age.

In order to ensure an innovative and secure European digital finance union, the German Council Presidency will therefore strive to advance the key priorities in this area as far as possible: providing for a secure and innovative financial market union for tokenised financial services, increasing cyber security and resilience of the European financial market and promoting the Retail Payments Strategy. As regards the Digital Finance Strategy, the focus on an innovation-friendly data-driven and sovereign EU financial sector could give the European Union an early-mover advantage in moving from open banking to open finance. ●

Vilius Šapoka

Minister of Finance, Republic of Lithuania

Digitalisation: the right way forward

Together with the adoption of the EU Fintech action plan in 2018, the European Union has embraced digitalisation and innovation in the financial sector. This improvement was marked by implementing different policies under the Digital Single Market Strategy, Cyber Strategy and the Data Economy. However, this was not enough and the EU took upon itself to create the Digital Finance Strategy. This move is a right way forward as the financial ecosystem is continuously evolving with technologies moving from experimentation to pilot testing and deployment stage and new market players entering the financial sector either directly or through partnership with the incumbent financial institutions. Additionally, the COVID-19 pandemic has emerged as a catalyst for digitalisation as it has shown the importance and the need of digital financial services both for the public and business. The post-COVID-19 finance sector will be more digital than ever before, and Europe will need proper policies that stimulate innovation and help the economy recover back to pre-COVID-19 levels.

In this context, the Digital Finance Strategy should focus on balancing the benefits and risks of digitizing the financial industry. The main goal should be the development of a Digital Single Market. We need to lay the necessary foundation for digital innovation which can lead to a faster, more efficient and better access to financial services for consumers and to help provide finance to the economy in general and the Digital Finance Strategy will play an important role in this development. In this matter, future regulation must be technologically-neutral, without imposing excessive requirements and flexible enough to meet technological challenges of the EU financial sector.

The potential of digitalisation of the EU financial industry and especially of FinTech is in facilitating structural changes in the financial sector, including support for new business models. Accordingly, there is a need for stronger coordination mechanisms to support authorities in supervising innovative cross-border, and potentially cross-sectoral, businesses models and in monitoring effectively the regulatory perimeter to ensure the oversight arrangements remain fit-for-purpose.

Furthermore, there is a need to remove the regulatory fragmentation and to ensure a level playing field between incumbents and new market entrants, both FinTech start-ups and BigTech firms, across the entire EU. For example, BigTech companies are currently pushing into the financial services space, integrating financial services within their digital ecosystems all while changing the established financial order. While these companies are bringing innovation, diversification and efficiency in the provision of financial services, hence, the presence of BigTech firms in financial services also highlights the issue of the appropriate regulatory response, which may be complicated in the case where BigTech firms distribute financial products and services supplied by existing traditional financial institutions.

New financial service providers, who are entering the market, often face less strict regulatory requirements than traditional financial institutions. It is, therefore, crucial to respect the principle of same activities, same risks, and same rules and to strive for a true level playing field to ensure an appropriate and consistent coverage of activities that have implications for financial stability. Removal of potential impediments to the cross-border provision of banking and payment services and facilitation of cross-border access, including via the update of interpretative communications on the cross-border provision of services and further harmonisation of consumer protection, conduct of business and AML/CFT requirements should be among the top priorities of the EU. By tackling fragmentation within Europe, resulting from different approaches the Member States take in adopting the EU directives, as well as divergent supervisory practices, we could achieve the best jurisdiction for financial services in the world. ●

Ugo Bassi

Director, Financial Markets and Acting Director, Horizontal Policies, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Towards a new digital finance strategy for Europe

The future of finance is digital: consumers and businesses have been increasingly accessing financial services digitally, innovative market participants are deploying new technologies, challenging traditional business models. Digital finance has helped citizens and businesses tackle the unprecedented situation created by the COVID 19 pandemic.

If there was still any doubt, it is now clear: digital finance has much to offer. Europe must take advantage of this in its recovery strategy, with digital technologies being key to relaunching and modernising the European economy across sectors and to moving Europe forward as a global digital player. Naturally, users of EU financial services must be protected against the associated risks.

Earlier this year, the Commission set out how to "Shape Europe's Digital Future". In the financial sector, we are building on our previous initiatives as well as on insights obtained from various experts. This includes the 2018 FinTech Action Plan, the 2019 report of the expert group on regulatory obstacles to financial innovation (ROFIEG), the 2020 recommendations of the High Level Forum on Capital Markets Union, and the 2020 SME Strategy for a sustainable and digital Europe.

We also take account of the feedback gathered during the extensive Digital Finance outreach events with stakeholders that we carried out in the first half of this year and the results of our recent public consultation on a new digital finance strategy for Europe.

Our strategic objective is to ensure that the EU financial sector embraces all the opportunities offered by the digital revolution and drives it with innovative European market players in the lead, in order to make the benefits of innovative digital finance available to European consumers and businesses, while ensuring proper mitigation of the associated risks.

Against this background, the Commission intends shortly to propose four priorities to guide the EU's actions for promoting digital transformation of the financial sector during this mandate of the European Parliament and the Commission until 2024:

- First, addressing fragmentation in the Digital Single Market for financial services to give European consumers genuine access to cross-border services and to foster the scaling up of European financial firms.

- Second, ensuring that the EU regulatory framework facilitates digital innovation in the interest of consumers and market efficiency. Accelerating innovation cycles call for regular examination of the EU financial services legislation and supervisory practices to ensure that they remain adapted and relevant in the digital age.

- Third, creating a European financial data space to promote data-driven innovation, building on the European data strategy and open data policy. The EU has led the way in opening up data sharing with respect to payments accounts. Further steps towards enhanced data sharing and openness will encourage the financial sector to embrace data-driven innovation, enabling innovative products for consumers and businesses.

- Fourth, addressing new challenges and risks associated with digital transformation. Digital finance creates new risks, in particular for cybersecurity and data protection. Digital finance also challenges the existing regulatory and supervisory frameworks. In this context, we will pay particular attention to the principle "same risk, same rules, same regulation", not least to safeguard the level playing field between existing financial institutions and new market participants.

> *The Commission will promote the new opportunities of digital finance for consumers.*

Across these four priorities, the Commission will pay particular attention to promote the new opportunities of digital finance for consumers and to protect them wherever necessary. We also commit to continue working closely with our international partners, as the benefits of digital finance are best harnessed if their deployment is based on internationally compatible principles and standards. ●

Valentin Stalf

Chief Executive Officer, N26 GmbH

Mobile Banking: serving consumers best, anytime, anywhere

Digitalisation has changed consumer habits: Remember people looking for phone booths, inserting coins to call their relatives after arrival at their holiday destination? Or purchasing travel maps to find their way in a foreign city? Or using eurocheques to pay abroad? Today, thanks to digital technology, our relatives can follow us real time when we travel and make a video call at quasi zero cost; digital maps guide us to any foreign destination; and when we pay, we use our mobile phones and pay fully digital.

Digital services and increased transparency lead to lower prices

Changes in consumer habits will continue to transform the financial sector over the coming years. The number of bank branches will decrease rapidly, because consumers prefer banking via their smartphones. If they have questions regarding their bank account, AI-supported chat bots will provide answers. For more complex issues, they will video call a financial advisor. Consumers want financial services easily, instantly, and combined with a positive user experience, at lower prices and with greater transparency.

COVID-19 has accelerated these trends. Why wait in a queue at a bank branch in order to transfer or withdraw money, if you can pay online? Why pay with unhygienic banknotes if you can pay contactless with your phone? COVID-19 has brought digital banking in particular to the elder generation who is more digitally savvy than most of us would have thought. Today, bank customers above the age of 65 spend a third more on e-commerce than ever before. Meanwhile, cash withdrawals went down by more than 50% in most countries. In the context of ecosystems, digital banking means that at one point, there will be fewer platforms that advise consumers on all their financial needs. Why do we have to manage different accounts with different banks via different apps, whilst in effect one needs only one app to manage all accounts and payments?

Digital talent requires digital education

What we experience today, is an unbundling of the banking service process with all its tiny, intertwined bits and pieces. What banks used to do as big, intransparent black boxes is now disassembled and re-invented by agile FinTechs, but also by BigTech, so that you can reassemble the process in a transparent, optimized way.

To ensure successful digital transformation we need to ensure training and support of digital talents. Digital education will be one of the key principles in achieving the competitiveness of our market, and future success and can only be achieved with a radical change of our current education scheme and content. Digital transformation will also change processes. Today, client onboarding/KYC, AML and CTF are huge cost blocks for the industry. Results, though, as regards prevention, detection, and prosecution of fraud matters are not satisfactory.

A European-wide comprehensive Digital ID will have the potential to lift KYC and AML efforts to a new level. With the private and the public sector working closely together, AML will become more effective, and more efficient, leading to much better results.

Reduce hurdles and enable cross-border banking for consumers

If we were to invent banking today, it would look different to what we currently experience. The idea of IBANs was to make money transfer easier, faster and cheaper. The reality it that they are not user-friendly, unharmonized across the EU, and there is discrimination of non-domestic IBANs.

As regards Open Banking, our perspective should be what consumers want and need, and not only what is technically possible. Products need to be simple to use: it needs to become easier for consumers to switch bank accounts - also cross-border - or to switch standing orders. How can we make sure that all the data the financial world is generating today is used in a smart way to help people make better financial decisions, also in light of GDPR? Do we want consumers to be financially literate, or do we want companies that know more about the consumer than the consumer knows about himself?

A prerequisite for a true single market are standardised banking products (accounts, mortgages, investment products) across Europe, so that the consumer can make cross-border choices. Non-standardised products, and gold-plating of consumer and data protection rules on national level are the main impediment towards a harmonized Single Market.

At N26, we are putting the EU consumer back into the center again. We are setting the bar for digital innovation, and we rethink existing banking products (e.g. joint accounts, what we call Shared Spaces) and make them simple. The EU should empower citizens to choose freely between the best and most suitable financial products. Enabling a completely frictionless common market for banking services will be key to for a better banking experience of European consumers. ●

Bernd Leukert

Member of the Management Board – Chief Technology, Data and Innovation Officer, Deutsche Bank AG

Delivering a digital future for European Financial Services

The adoption of new technology in the financial sector has moved at a tremendous pace and has the potential to deliver significant benefits to firms, their customers and the wider economy. The pace of innovation in the sector also has the potential to disrupt and destabilise the EU financial system, bringing with it risks for market integrity, consumer trust and economic sovereignty. It is a transformation that will need to be carefully navigated not just by financial services firms, but by regulators as well. The ambition should be nothing less than to deliver a single digital market, with consistent, risk-based rules for all participants.

For Deutsche Bank, digitalisation does not only mean developing new products and services but also requires a fundamental rethink of the way in which products and services are delivered. Our technology strategy has focused on expanding engineering expertise and introducing agile delivery to support a culture of innovation. In July 2020 we announced a strategic partnership with Google Cloud that will accelerate our move to 'native' cloud computing, transform our IT architecture and generate considerable value for clients.

These changes to the way we approach technology allow us to be simpler, safer and more efficient. For example, the bank has used robotic process automation to enhance money laundering checks and partnered with the start-up WorkFusion to transform the way we process documents in our Trust & Agency Services businesses. In addition, technology has allowed us to provide innovative products and services to our clients, digitalising cash management for some of Europe's largest corporates and allowing our institutional clients 24/7 instant mobile access to trade on FX pairs.

The benefits of digitalisation have been made clear in the light of the COVID crisis. We have been able to support the majority of our workforce operating remotely without any significant disruption. We have also been able to adapt quickly to support clients and manage unprecedented lending volumes. These positive effects of the digitalisation of Europe's financial services sector need to be preserved through the post-COVID recovery.

Equally the experience of the pandemic highlights some of the risks that could flow from disruption of the existing financial services ecosystem in Europe. Banks have played a critical role in channeling loans to firms and customers in need, leveraging balance sheets, networks and relationships not easily replicated by start-ups or third country technology providers. The market-making role of large universal banks in the EU has been important in ensuring capital markets have kept functioning.

The challenge for policy makers through the recovery will be to preserve competition and innovation without compromising the integrity of the European financial system. In striking that balance, there are a number of key elements that need to be in place:

Continuous dialogue – Investment in innovation requires legal certainty and this demands open communication channels with regulators and stakeholders – for instance within regulatory sandboxes or innovation hubs.

A level playing field – a consistent approach to the regulation and supervision of the risks inherent in particular activities or services is essential to avoid competitive distortions, the potential for regulatory arbitrage and to secure consumer trust.

> *The ambition should be nothing less than to deliver a single digital market.*

An effective framework for data – standardized data access is essential to understand customer needs and provide the right products and services. An effective data framework would offer individuals practical tools to control their data and how it is used. To support innovation, regulation should focus on governance mechanisms for a data driven economy. Rather than designing regulation narrow pre-defined use cases, the framework should focus on protecting the interests of the individual data subject regardless of the specific use case.

A truly single digital market – the development of a fully harmonized framework for the regulation of digital financial services is perhaps the single most important step to ensure competitiveness of the EU in this space. Even where regulation does not directly pose a barrier to digitalisation, fragmentation due to national gold-plating of rules will reduce the scale benefits of investment in digital solutions and discourage cross border solutions.

Frank Fallon

Vice President Global Financial Services, Amazon Web Services

Digital transformation: cloud's role in building a competitive and secure European Financial Service

As consumer expectations continue to evolve at increasing speed, financial services organizations recognize that they have to move faster and become more efficient than ever before to transform their business and remain competitive in the long-term. At the same time, data is increasingly viewed as an asset, and those firms that can unlock the value of data will have an advantage in the market. Firms need to be able to manage, access, and share their data effectively and securely. Cloud enables financial firms of all sizes to achieve this. By building on the cloud, firms of all sizes, from Fintechs to G-SIFIs, benefit in three key ways: extracting new insights from traditional and alternative financial data; creating the scalability and agility to respond to market and business changes in real-time; and reducing the time and resources needed to manage and maintain technology infrastructure. All this while operating with the highest security standards available that are required in the financial services industry.

Data-led insights, enabled by the cloud, are providing firms with the ability to make business-critical decisions concerning customer segmentation and personalization, market positioning, product pricing, risk, security, compliance, and surveillance. Financial organisations are increasingly looking to artificial intelligence (AI) and machine learning (ML) in the cloud to bring greater efficiency to existing processes and to extract deeper value from data. Further, by moving to the cloud, firms can focus their efforts on innovating and addressing customer challenges.

From continuously and quickly developing, testing, and deploying new applications with a robust and deep set of technological capabilities available at their fingertips to rapidly scaling on global infrastructure, the cloud provides them with more control over their technology decisions and provides the ability to scale up or down depending on their needs.

Organisations no longer need to make large upfront capital investments to build and maintain infrastructure because the cloud provides elastic, reliable and secure IT resources on demand over the internet with pay as you go pricing. Firms can provision exactly the right type and size of resources needed, deploying as many resources as they need when they need them and only paying for what they use, all while benefiting from a level of security trusted by governments for their most sensitive data. At AWS, we use the same secure hardware and software to build and operate each of our regions (geographical locations), so all of our customers benefit from the only commercial cloud that has had its service offerings and associated supply chain vetted and accepted as secure enough for top-secret workloads. This is backed by a deep set of cloud security tools, with more than two hundred security, compliance, and governance services and key features. By using resilient and secure cloud infrastructure that has been built to compensate for major operational disruptions, we are confident well-architected cloud environments reduce risk in the financial system compared to legacy on-premises technology.

> *Firms need to be able to manage, access, and share their data effectively and securely. Cloud enables financial firms of all sizes to achieve this.*

As financial institutions reap the economic benefits from digitalization, cybersecurity becomes a critical priority. As President Von der Leyen noted: “Cybersecurity and digitalization are two sides of the same coin [...] for the competitiveness of European companies, we have to have stringent security requirements and a unified European approach”. In this context, the development of a pan-European set of rules on cybersecurity and digital resilience is an opportunity to raise the bar on these critical aspects of an increasingly digitalized financial services sector. For such a framework to be effective, it should prioritize what is important in terms of security and resiliency and use this to proportionately protect financial organizations. Further, given the rapid level of technological innovation, the framework should remain principles-based in order to handle dynamic complexities.

The emerging regulatory framework should have at its core the dual objectives on enabling European financial institutions and consumers to reap the potential of digital transformation, and mitigating the new risks digital finance might bring. It should ensure that financial firms have full access to all the technologies that will be the foundation of the sector's competitiveness, like cloud and machine learning and should neither prescribe nor prevent the use of particular technologies, while ensuring that regulatory objectives continue to be satisfied. This imperative in a context of long-term low interest rates, low returns and facing the post-COVID recovery. At AWS, we remain committed to work with customers and regulators alike to provide the most secure and reliable technology environment for the European financial services sector that enables innovation on behalf of customers. ●

Leena Mörttinen

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

Effective digitalization of financial services requires a comprehensive approach to systemic risk

Digitalization of financial services continues to benefit the economy through provision of competitively priced innovative services to customers. Covid-19 has shown that digital services can also contribute to resilience of societies in times of crisis. However, the digitalization also brings new risks.

The reliance on digital infrastructure coupled with collection and processing of masses of highly sensitive data through complex value chains with multiple service providers, high speed of innovation and growing pressures to reduce costs create new vulnerabilities and risks on the level of the societies.

There is a growing awareness that these risks need to be properly managed by the financial institutions and their service providers. Requirements for risk management should be further enhanced in the legislation and supervisors should have adequate powers to enforce them. In addition, attention should be given on how to deal with the systemic nature of these risks as operational incidents involving financial services can quickly hamper normal functioning of the society.

Financial markets are strongly interlinked with other critical sectors such as telecommunications and energy networks. Preparing for large scale incidents requires more than financial buffers. Contingency arrangements and redundancy capacities need to be in place, supported by a "whole-of-government-and-society" approach, taking into account also considera-tions of national security.

The "Digital Operational Resilience Act" currently prepared by the Commission provides a good starting point to deal with risks brought about by digitalization. However, the following areas should also be covered to provide a comprehensive approach to address also the systemic nature of the risks:

Legislative framework should provide for a clear and unquestionable obligation for cooperation and immediate infor-mation exchange between all relevant EU and national authorities: financial supervisors, central banks, cyber and other security authorities and government ministries. Provisions on professional secrecy or proprietary information should not impede on the information flow.

Operational incidents have a local impact and may threaten national security, which is why they require action by the relevant national authorities. This implies that these authorities need to have adequate influence on both incident preven-tion and incident handling. National authorities also need to have powers to deal directly with third party service provid-ers (TPPs).

In addition to legislative action the Commission should further non-legislative actions to bolster the operational prepared-ness in the financial sector. These actions could involve joint exercises, operational "playbooks", secure collaboration tools and investments in reinforcements of critical infrastructures and European redundancy capacities. Financial sector should be fully integrated into existing EU cross-sectoral crisis management arrangements. These actions should be re-flected also in the Digital Financial Services Strategy/Fintech Action Plan currently being prepared by the Commission.

> *Attention should be given on how to deal with the systemic nature of these risks as operational incidents involving financial services can quickly hamper normal functioning of the society.*

In many Member States the core financial services have been designated as critical functions and financial infrastructure is considered as part of national arrangements on Critical Infrastructure Protection. However, such designation has not been made at the EU context. Consequently, the EU legislative framework on Critical Infrastructure Protection, which is currently under review, should be amended to include also financial services as discrepancies in definitions may lead into lack of cooperation and information sharing.

Common cross-sectoral EU framework should be complimentary to the existing regulation in financial services. It would contribute to better understanding of interdependencies between differ-ent critical functions and services, including financial services, the changing security environment and emerging risks, in both the physical and in the cyber domains. ●

Michael McGrath

Assistant Secretary, Financial Services Division, Department of Finance, Ireland

Encouraging innovation alongside fostering digital inclusion and protection

Technological developments and changes in the area of financial services have continued to grow at pace and sophistication since the Global Financial Crisis. The growth in fintech reflects a trend where companies with the latest technology tend to be better able to service customers and, in some cases, smaller companies may be more agile than current incumbents.

The entry of new fintech firms, supported by changes in European legislation such as PSD II, have provided greater flexibility and ease for consumers. As the digitalisation of financial services continues to grow at pace, we must continue to question if we have the appropriate legislative and regulatory frameworks in place for such entities.

Our goal as policy makers must be to ensure that our frameworks enable firms to harness opportunities, while providing better services for their consumers and users. Our frameworks, while being robust, must allow for start-ups to have a chance to grow and develop. We must avoid rules or frameworks that stifle innovation. Otherwise we will never see the development of European Fintech firms competing globally or truly develop the Capital Markets Union that we all want. This flexibility must be balanced by ensuring that we have the appropriate protections in place for consumers such as potential mis-selling of products, misuse of personal data, liquidity or cyber risks.

We must strive to ensure that we don't create regulatory gaps as this is important due to the cross border nature of digital finance. To maintain confidence in European Single Market and the benefits of the provision of financial services across the Union, the ability for policy makers to react quickly to developments in this area is critical to maintain this confidence.

In Ireland our competent authority has introduced an Innovation Hub that allows for fintech firms to engage with the regulator outside of existing formal regulator / firm engagement processes. This enables an open and activate engagement with start-up fintech firms.

This provides an important route for those firms to understand how to navigate the regulatory landscape and also provides our Regulator with important intelligence on developments and innovation in the sector. We see this approach as an important tool to ensure that we have the correct balance in having a supervisory regime that does not stifle innovation, while being able to react quickly if required to protect consumers.

While it is important that we assist the development of the digitalisation of Europe's financial system, we must also ensure it does not result in disadvantaging certain parts of our population, such as the elderly or the less well off. The need to provide digital inclusion for all of our citizens is as important as improving financial literacy. Both of these associated goals can help us deliver on the objectives of CMU as envisaged in the recent High Level Forum Report.

> *Fostering digital innovation while protecting consumers & securing digital inclusion for all is key.*

To conclude, the digitalisation of the financial sector will continue to accelerate over the coming years. Fostering digital innovation while protecting consumers and securing digital inclusion for all is key. We also must be mindful of the need to have appropriate mechanisms so that our fintech firms are able to finance themselves.

We must be able to support European fintech firms as they move through their different growth phases, from start-ups to global players. Therefore, we must have the flexible regulatory frameworks in conjunction with a deeper and more developed European capital market that provides the necessary financing for our companies to grow and compete globally. ●

Is the EU policy approach on cloud and data up to the digital challenges?

Prof. Dr. Joachim Wuermeling

Member of the Executive Board, Deutsche Bundesbank

Reaping the benefits of going digital without compromising on stability

Cloud computing is a key technology in the digitalisation of the financial industry, promising a boost in computing capacities and software capabilities. As banking supervisors, we want to help smooth the digitalisation process so that the financial sector can reap the full benefits of new technologies. We're open-minded about cloud computing and other technologies. At the same time, driven by our mandate for ensuring financial stability, we will not lose sight of the risks associated with digital transformation.

Benefits of cloud technology

Cloud services open up a wealth of benefits and innovative potential, not least because they enable banks to tap into huge computing capacities and state-of-the-art software capabilities. Cloud usage can also boost the take-up of fresh technologies like big data analytics and artificial intelligence, especially among small and medium-sized banks. Moreover, cloud service providers can better equip banks to fend off certain types of cybercrime.

Challenges

Needless to say, where there is light, there is also shadow. Cloud technologies introduce risks that require proper management – all the more so when they are deployed in risk-relevant areas such as credit checks, capital planning and money laundering prevention.

At the individual-bank level, IT and cyber risks are typical challenges, of course. But when clouds come into play, there is also the matter of outsourcing risk because cloud services are often provided by third parties. One risk is the weak negotiating position and limited control that banks might have vis-à-vis large, internationally active cloud providers. Then there is the risk of vendor lock-in, which might materialise if a bank cannot easily switch between providers due to technical barriers, prohibitively high switching costs or contractual issues.

There's a golden rule that (prospective) outsourcers to cloud providers need to follow: you can't outsource responsibility. A bank might transfer some of its IT processes to an experienced IT service provider in an outsourcing arrangement, but it can't offload the responsibility. That's why every bank has a duty to monitor and control the risks arising from the outsourcing relationship.

Way forward

Without losing sight of the risks, I regard supervisors as enablers of digitalisation in the banking sector. We will naturally remain within the scope of our supervisory mandate, which provides for technology and market neutrality.

Clear and regular communication of our expectations is crucial. Last year, European supervisors communicated their expectations regarding risk management at banks, in the shape of the revised EBA Guidelines on outsourcing arrangements. These guidelines are an essential step to ensure planning security, and we are currently working on their national implementation.

Furthermore, we encourage banks to make better use of instruments already embedded in the supervisory framework. Joint reviews (pooled audits) of cloud providers are one way in which banks' internal audit units can gain high-quality insights into the interface between bank and third-party services. This can help them assess a cloud service provider's risk management and the internal controls it has put in place more effectively and efficiently.

Without losing sight of the risks, I regard supervisors as enablers of digitalisation in the banking sector.

Of course, supervisors may have to access and check third-party cloud service providers, too. EBA guidelines already stress the importance of having suitable clauses in outsourcing contracts, and we will examine their quality and effectiveness closely.

Further steps are being taken to forge an effective European oversight framework for monitoring the activities of critical third-party providers. In March, the European Commission launched a public consultation on a digital operational resilience framework for financial services, and it will build on this consultation when conducting its ongoing initiative to develop a cross-sectoral financial services act on operational and cyber resilience. We also welcome the European Commission's initiative to set up an EU Cloud Rulebook including standard contractual clauses for cloud use in the financial sector.

Looking ahead, supervisors will continue to strive for close European and global coordination in this field. We are guided by the goal of enabling banks to reap the full benefits of going digital without compromising on financial stability.

Joachim Wuest

Head of Financial Services,
Google Cloud Germany

European banks accelerate digital transformation with cloud adoption

Financial services institutions face continued pressures in the race for business transformation. This has never been more apparent than now during the COVID-19 pandemic which made consumers shift to digital banking channels at an unprecedented rate, whilst capital markets firms are dealing with extreme volatility. Cloud technology presents significant opportunities to help financial institutions standardise in multi-cloud or hybrid cloud environments, streamline tasks related to internal risk assessment, compliance and governance, improve visibility through the use of machine learning and data analytics, and minimise complexity with modern collaboration tools.

We see three key areas where cloud technology can help transform the financial services industry for the future:

1. Cloud can help reimagine customer relationships using data and artificial intelligence (AI);
2. Cloud can transform and modernise the use and management of data with the help of machine learning (ML) addressing one of the key challenges faced by financial services institutions;
3. Cloud can help drive operational improvements within core systems.

Whilst financial institutions in Europe were relatively slow to adopt public cloud at first, we are seeing an accelerated trend toward cloud across the Eurozone aimed to redefine and innovate banking services at large. Our recent announcement with Deutsche Bank to form a long-term global partnership to drive a fundamental transformation of banking and enable co-innovation between the two companies to create the next generation of technology-based financial products is a strong example of this type of strategic approach to cloud. This tendency can largely be attributed to the growing understanding of cloud security capabilities, and trust in the industry.

Trust, security and sovereignty

Financial services is an industry that is based on trust, and security and privacy are absolutely critical.
At Google Cloud, we provide a number of technological advances to support our customer privacy and security controls to achieve various strategic autonomy and sovereignty requirements:

- Data Locality Controls are available for various services enabling customers to have sole control on the storage location of all copies of their data including backups;
- Confidential Computing of VMs allows to encrypt customer data also during processing;
- External Key Management enables data encryption keys hosting offsite and air gapped from Google;
- Access Transparency, Access Approval and Key Access Justifications tools enable customers to understand why access for their data is being requested and deny access to their data.

Embracing open standards and multi-cloud approach

We also understand customer and regulator concerns over potential market concentration and systemic risk. We agree it is critical to ensure that proper risk mitigations are in place. Google has a deep commitment to open source, reflected in our contributions to projects like Kubernetes, which has been originally developed by Google, then open-sourced and is now the industry standard in portability and interoperability in the cloud. Another example is TensorFlow, our state-of-the-art AI and ML technology, which we open-sourced to allow the broader, global community of researchers to innovate.

We support openness and the ability for financial firms to freely choose which services and providers will best meet their needs, without being locked into a single vendor. That's why we introduced our cloud-native platform called Anthos that runs in a data center, in one cloud or in multiple clouds to give firms the freedom of choice and workload portability. For example, if a bank is running Kubernetes or open source containerisation, they can use Anthos to support workloads across any cloud, including through local providers in Europe.

We believe in open source technology and an open cloud, and work to support and enable our customers' choice. ●

Christopher P. Buttigieg

Chief Officer Supervision,
Malta Financial Services Authority

Cloud computing and adapting Financial Supervision to the digital era

Cloud computing is a facilitator for enterprise business transformation and has the potential of significantly changing the way financial services are offered to clients. Leaders in financial services and practitioners are progressively acknowledging that cloud computing can facilitate the: [a] storage of data and applications; [b] access of advanced software applications via the internet; and [c] application of advanced analytics for better and more integrated insights.

The paradigm shift in the conduct of financial services through FinTech brings about new risks and challenges, which also require a change to our approach to financial supervision.

This article briefly outlines: [a] the policy and regulatory work being carried out by the European Commission to create a framework for the better use of cloud computing in Europe; [b] the operational and systemic risks which emerge from outsourcing to the cloud service providers ('CSP'); and [c] how these risks are being dealt with by financial supervisors at European level. ▶

▶ The Commission is currently working on projects, which will further reap the benefits from cloud computing at European level. Specifically, the establishment of a European federation of cloud infrastructures and services, a European marketplace for cloud services, and a governance framework that includes an EU cloud rulebook. Largely driven by the Digital Single Market, these projects entail: [a] the free flow of non-personal data; [b] data portability; [c] cybersecurity; [d] data protection in the cloud; [e] standardised cloud service level agreements; [f] cloud use by the financial services sector as pre-empted within the FinTech Action Plan 2018; and [g] a European mapping of data flows.

Outsourcing to CPSs gives rise to governance and oversight challenges, for example the dynamics of the management's oversight and control of data, which is a critical function for every organisation, which must be adapted to the cloud environment. It also brings new dimensions of operational risk, particularly cyber security risk, and possible concentration risk, which must be monitored by prudential supervisors to ensure that these are properly mitigated. In addition, discussions are on-going on the possible systemic risks brought about from outsourcing to the CSPs, above all if financial services firms rely on a handful of dominant CSPs, the failure of which could have a meaningful impact on such firms.

In the field of prudential supervision, the European Banking Authority ('EBA') and the European Insurance and Occupational Pensions Authority ('EIOPA') have both issued guidelines specifically dealing with outsourcing to CSPs. The European Securities and Markets Authority ('ESMA') is also consulting on a set of guidelines in this area. The guidelines, which converge on substance and address cloud outsourcing from a multidisciplinary perspective, are being implemented at national level and monitored by national financial supervisors.

More generally, FinTech presents challenges that are shaping the art and craft of financial supervision, including the methodologies and processes, which today incorporate: [a] data driven solutions and analytics for supervision; and [b] technology whereby supervision is partly carried out on a real time basis.

> *Europe is strategically going forward in closing outstanding gaps, maximising the potential of the cloud, and mitigating substantial risks.*

Europe is strategically going forward in closing outstanding gaps, maximising the potential of the cloud, and mitigating substantial risks. Nonetheless, the fast-moving pace of emerging technologies is increasingly posing challenges to financial supervision, which has to continue keeping abreast and adapting to the emerging new technologies. Ensuring that we are able to supervise the industry is not enough. As outlined in this short article, benefiting from the opportunities which this presents by adopting technology to make supervisory processes more efficient thereby, allowing financial supervisors to optimise resources, and be more effective in achieving supervisory objectives, is equally important. ●

Gabriel Bernardino

Chairman, European Insurance and Occupational Pensions Authority (EIOPA)

Cloud services: challenges and opportunities for the insurance sector

Cloud computing technology is seen as key enabler of agility and data analytics allowing firms to get quick access to new business models and technologies such as Artificial Intelligence and Machine Learning. Given that data processing and data analytics have historically been at the very core of the business of insurance undertakings, the relevance of cloud computing for the sector is no surprise.

Based on EIOPA's thematic review on the use of Big Data Analytics in motor and health insurance, in 2018 cloud computing services were already used by 33% of insurance undertakings, with a further 32% saying they would be moving to the cloud over the next 3 years (i.e. by 2021).

> *Digital finance is an important driver of Europe's financial services.*

At the European Insurance and Occupational Pensions Authority (EIOPA), our view is that we should be able to strike a balance between enhancing financial innovation and ensuring consumer protection and financial stability.

This is also true for cloud services, which are becoming common place in Europe's financial sector. Today, cloud outsourcing services have become more standardised, allowing services to be provided to a larger number of different customers in a highly automated manner and on a larger scale. ▶

▶ However, although services can offer the insurance sector the advantages of economies of scale, flexibility, operational efficiencies and cost-effectiveness, they also raise challenges. This includes issues related to operational resilience, data protection and location, security issues and concentration risk; large suppliers of cloud services can become a single point of failure when many undertakings rely on them.

Understanding how new technologies and business models drive new risks and opportunities is crucial, as is insurance regulation that is fit for purpose.

Earlier this year, EIOPA issued guidelines for cloud outsourcing with a view to providing clarification and transparency to users of cloud services, to reduce the risk of possible regulatory arbitrage. The guidelines also foster supervisory convergence regarding the expectations and processes applicable in relation to cloud outsourcing.

The guidelines were developed following a public consultation with stakeholders. They are principle-based and cover a number of key areas, such as the pre-outsourcing analysis, covering risk and materiality assessments of outsourcing arrangements and contract clause requirements.

In the area of governance, the guidelines cover documentation requirements, including notification, to supervisory authorities. The guidelines also address the management of access and audit rights, the security of data and systems, sub-outsourcing, monitoring and oversight, and exit strategies.

Looking ahead, and taking into consideration the upcoming Digital Finance Strategy of the European Commission, EIOPA will consider issuing further guidance on outsourcing in other activities / areas of the insurance value chain, with the aim to clarify supervisor expectations in this area, improve the governance of such processes and provide transparency to the market, without lowering standards.

Digital finance is an important driver of Europe's financial services. However, innovation cannot be at the detriment of consumers, nor can it call into doubt the security and resilience of Europe's insurance industry. EIOPA will therefore continue to work with a range of stakeholders to further the European digital agenda and create a Europe fit for a digital age. ●

Tsvetelina Penkova

MEP, Committee on the Internal Market and Consumer Protection, European Parliament

Europe's approach on cloud and data in a post-Covid world

The use of cloud services has proven to be largely beneficial not only for the financial sector but for all economic actors as well as for the consumers in their everyday life. Agile data storage, faster processing, scaling up of operations and cost optimisation are only a few of the benefits that the cloud provides. In order to take full advantage of the technology and to maintain a high level of privacy and security, both financial institutions and cloud service providers in Europe are subject to multiple regulations, some of which have become world standards, like the GDPR.

But beyond the existing (and forthcoming) regulations, it is important to properly implement those that are already in place and to define clear responsibilities in the contractual arrangements between the cloud providers and the financial institutions.

The realisation of the huge potential of the data economy has spurred a number of initiatives in Europe, which aim to boost innovation and technology, starting with the Digital Single Market Strategy and coming to the new European Strategy for Data.

Data sharing requirements, common sectorial data spaces, including for financial services, federalisation of cloud services (like for instance GAIA-X, the newly created Franco-German cloud consortium) are all relevant workstreams evolving in the EU. However, in order for these to work we need incentives for data sharing, interoperability of data systems and clear competition rules, while always accounting of the principle of global convergence.

Another important aspect of cloud is security. Some argue that the cloud provides higher security than in-house infrastructures. While this is true in many cases, it is important that we nurture a robust security practices with the participation of all interested stakeholders, CSPs and users alike. The Cybersecurity Act and the soon-to-be revised NIS Directive are a good basis to achieve this goal and now we await the first cybersecurity certification scheme for cloud services, which is being developed by ENISA.

> *We need incentives for data sharing, interoperability of data systems and clear competition rules.*

Finally, for our data economy to flourish, we also need adequate resources. The current pandemic situation has imposed additional budgetary challenges for Europe, but we call on the members states to be more ambitious in the upcoming MFF negotiations and remain dedicated to fostering a commensurate Digital agenda for Europe. ●

Patricia Plas

Director of AXA Group Public Affairs - AXA Group

Is the EU policy on Cloud and Data up to the digital challenges?

Since 2016, the European Union (EU) has taken steps to develop a regulatory framework on data with the GDPR, the EU Cybersecurity Act, and the Regulation on the free flow of non-personal data, among others. Against this background, the Commission now aims to make of Europe a trusted digital leader. However, will the new Digital Strategy be adequate to change EU's image of that of a regulatory superpower to an innovation powerhouse? Does this approach have the potential to expand worldwide? How to ensure that EU calls for technological sovereignty do not result in a protectionist approach?

The EU is taking a more assertive approach to digital challenges to differentiate itself on the global stage by reflecting about digital sovereignty, as a mean of promoting Europe's leadership and strategic autonomy. This translates into ambitions to develop data governance rules and sovereign digital infrastructures.

A data governance framework facilitating data collection, processing and sharing should enable the EU to further translate its values and principles into the digital domain and share globally its experience in data protection. Nevertheless, to design a comprehensive digital approach, these key considerations must be balanced with competitive stakes so that EU stakeholders can take full economic advantage of the data economy. For instance, the creation of common data spaces dedicated to financial services or health, should help EU actors to benefit from the raw material of the digital economy that is non-personal data. However, some grey areas regarding the exact scope of these initiatives (e.g. the types of data involved, modalities of access, security safeguards) may act as a brake to a supportive contribution.

Moreover, there is no question that Europe lags far behind Chinese and US firms on several technological and industrial capacities fronts. To date, the EU focus has often been on data protection and security matters but going forward, ramping up capacities of the EU tech industry would be beneficial. One angle would be to boost some competitive edge, among which leveraging industrial data and taking advantage of a more decentralized digital ecosystem, with the rise of the Internet of Things, 5G and edge computing. In this sense the EU aims to develop a secure cloud infrastructure. However, while a European actor could indeed diversify the cloud market and bring the flow and storage of data under greater European control, it is unlikely that it would be able to compete with other cloud providers on the whole supply chain, in the short term.

> *How to enable the EU to further translate its values and principles into the digital domain.*

These ambitions demonstrate that the geography of the cloud matters to the EU. More globally, the reflection on the need for sovereign digital technologies has gained momentum in the past few years. Some EU companies operating globally, and non-European observers are concerned that this approach could result into protectionist measures. Therefore, while Europe's ability to act independently in the digital world should be encouraged to avoid overreliance on non-EU firms and to feed into recovery effort from the covid-19 crisis, it is critical that the EU remains open for businesses operating with foreign technologies as well as for foreign participation in the EU digital market. ●

Will AI be a game changer in the financial sector and under what conditions

Bruno Scaroni

Group Strategy & Business Accelerator Director, Assicurazioni Generali S.p.A.

Assicurazioni Generali's AI Journey

Despite some years during which the insurance sector started to scout Artificial Intelligence solutions (AI), looking for big high tech and insurtech startup proposals, only in the last couple of years have we observed a more structured and selective adoption. According to rigorous process analysis and business cases, Generali is leading this journey by progressively integrating selected technical levers in daily business operations. AI has been mainly leveraged to accelerate internal procedures, support data analysis, reinforce and enhance existing channels for customers and distributors.

Several AI levers have been identified and embedded in AG's business processes, with Chatbot and Voicebot representing the most significant early successes. In addition, AI tools have been adopted to manage automated document analyses and management, image analytics with computer vision techniques, data analysis to support cybersecurity propositions.

We are aware that in a large and international group like Generali, only a broad adoption can bring AI at scale: specific programs are active in analyzing, measuring, and driving adoption. We have identified selected cases where the digital levers for automation, advanced analytics, and AI (three strongly interconnected areas) must be used at scale: as a reference for such combined solutions we are automating the entire document management process (i.e., email and document exchange during UW processes, document analysis during claim handling, claim image processing, automatic email processing, and dispatching).

In the coming years, AI usage will most likely expand to embrace other day-to-day business activities in traditional areas (like Finance or HR) and act as a crucial driver for process redesign: for example, software platforms will give suggestions to operators on how to respond to an email, how to classify information or will automatically send an alert if a claim related image is a suspected or a manipulated one.

We expect insurance companies to leverage AI more in the future, focusing on customer engagement and enhancing their customer journeys. Insurers that will leverage AI to anticipate customer needs (i.e. suggest better prevention and extended coverage for specific events or periods) and to introduce new services (i.e. virtual assistants, automatic savings) will surely gain a significant and lasting competitive advantage. ●

Chris Bartz

Chief Executive Officer & Co-Founder, Elinvar

Machine Learning will not replace the advisor, rather significantly enhance them

Machine Learning is a powerful tool – however, it's the combination with human capabilities which unleashes its maximum potential.

As of now, real AI that passes the Turing test does not exist. Currently this term regularly refers to Machine Learning (ML) instead: Classic algorithms, trained with data. ML allows identifying significant information from large data sets, recognizing patterns, and finding relevant solutions by objective criteria. ML is a key technology with potential: As per a study by IDG, 71 percent of ML projects bring an economic benefit within 3 months.

According to German Bitkom though, only 6 % of companies use so-called AI today: Mostly in marketing or payments; very rarely for advanced applications. Particularly in the financial services sector, due to lack of proper conditions, this is unlikely to change soon.

Where and how can ML create additional value?

The focus and quality demanded by clients are certain to keep growing: Clients ask for perfect individualization based on information and data they share. This can only be attained by a combination of high-quality ML processes and human capabilities. ML alone is not sufficient for maximum individualization – but it significantly improves the chances of getting there. ▶

"If AI is the new electricity, the fuel that powers these plants is data," says Oren Etzioni, CEO of the Allen Institute for AI. For companies to benefit from ML at scale, they must create suitable conditions: End-to-end digitalized infrastructure that allows accessing and analyzing all substantial data.

The currently widespread on-premise structures of data silos, disjoint systems and divergent formats without standardization or sufficient processing power, make the application of ML virtually impossible. A cloud-based infrastructure, covering the entire value chain and ensuring high data quality, addresses all these problems at once. Cooperating with regulated fintech can speed up the replacement of legacy IT.

High-quality ML can then be used to deliver automated, uniform processes or pre-identify the top five out of 500 possible results. Evaluating large data streams in real time provides decision support in previously unattained quality.

The human capabilities for advice and trust, emotional and social intelligence stay the decisive USP

Regardless of how effective ML will be, to maximize individual customer value, financial services do need – and will always need – humans. In complex tasks such as wealth management for a family unit, every single member, their emotional and professional requirements are of utmost relevance to find the perfect solution.

Does the solution proposed by ML really fit? Given the current emotional state, the immediate reaction, the history of the client? Considerations a non-human algorithm is unable to integrate for the foreseeable future, if ever.

There is no absolute objective truth with regard to financial decisions. Advisors with intuition and experience have to decide in the face-to-face personal contact, if the theoretically best decision is also factually best.

The model for success clearly lies in the ideal combination of data-driven resources and human decision-making power. If real AI ever manages to elicit the authentic trust that can arise between humans today, it might take over. Until then, human mental power and empathy will remain indispensable. ●

Dominique Laboureix

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

Artificial Intelligence: a new frontier for the financial sector?

When the ACPR published its first report on Artificial Intelligence (AI) in the financial sector (December 2018), one element clearly stood out: half of the R&D projects already included the use of AI). Facilitating the work of employees, managing relationships with customers, monitoring or pricing risks, enhancing fraud or anti-money laundering prevention, AI potentially applies to a wide range of activities. The industry appears to be on the brink of a set of innovations that will profoundly transform it. The same holds true for the supervisors themselves.

Envisaging AI as a "new frontier" may therefore make sense. To reach a new frontier means questioning past organizational habits but also accepting that not all promises will be fulfilled as and when expected. However, the journey is worth it. Supervisory authorities are facing an additional challenge here: to foster and monitor the adequate regulatory and governance environment so that the journey can be made in safe conditions with regard to financial stability.

The first condition for wider adoption is to overcome overly innovation-averse mindsets, as institutions might be prone to prolonging the life of legacy systems - and methods! A cultural shift is however taking place year after year, thanks to the increasing reliance on data scientists or hybrid business/data profiles. This may help the market meet the current challenge of transitioning AI to production.

Technical constraints inherent to AI should also be addressed: reproducibility of machine learning models (ML) is not often built into their design, and their robustness needs to be carefully monitored. AI systems would also greatly benefit from the lessons learned in software engineering, for streamlining development, reliably delivering products and managing third-party risk.

A key lever for the implementation of AI in high-stake processes (for instance, financial transaction monitoring) is access to adequate training data. One recent European initiative aims to shape common data spaces wherein data from public and private bodies can be used safely and fairly, while another one considers guaranteeing supervisors' access to supervised entities' data.

Against this background, regulation does not appear as a significant obstacle. In fact, regulating too early such a changing area carries the risk of being irrelevant or creating undue hurdles. The same holds true for alternative options like voluntary "quality labelling".

However, the market needs guidance on how sector-specific regulation applies to AI-driven processes. Explainable AI (XAI) is thus in the interest both of the financial institution which builds it and of the supervisory body which audits it.

A recent discussion paper issued by the ACPR last June casts explainability as a fundamental pillar on which other AI design principles such as fairness, performance or stability should rely: not only does it distinguish AI the most from traditional algorithms, it is also – when adopted for internal control or external audit – a keystone of responsible AI. XAI is therefore central to the reflection conducted by the ACPR along with other supervisory authorities and the financial sector on how to build, monitor and audit AI. ●

Key success factors for delivering an effective and viable retail payments area

Burkhard Balz

Member of the Executive Board, Deutsche Bundesbank

European payments market at a crossroads

Technological innovations, regulatory adjustments and the increasing digitalisation of daily life have permanently altered the payments landscape in Europe, and will continue to shape it in future. The COVID-19 pandemic is fueling the ongoing technological shift transforming society, making daily life – including payments – much more digital than before. Payment behaviour in the post-coronavirus age will not completely return to what it was before the pandemic.

Technical capabilities for initiating and processing payments digitally have evolved at a rapid pace over the past few years. Playing an increasingly central role for trade in goods and services, smartphones have been a catalyst for the new business models developed and rolled out by a growing number of providers. These enterprises are capitalising on the use of data analytics, new means of accessing payment accounts and the introduction of instant payments.

Fintech and BigTech companies have attracted particular attention in this regard. These developments are putting traditional structures and existing economic principles in the payments sphere to the test. While these new developments generate efficiency gains and create a richer user experience, they also result in a tendency to operate increasingly within individual ecosystems. This could potentially lead to certain online platforms dominating the market, including where payments are concerned.

The structural change shaping European payment systems also poses new challenges for central banks, supervisory bodies and legislators. As it is, the majority of card, mobile and online payments made by Europeans already rely on technology platforms operated by global providers and based on international card schemes. In Europe, payment solutions have traditionally evolved along national borders, while global players have tended to think and act internationally.

This – in addition to increasing globalisation and growing use of the internet – has given them an initial edge in Europe, too. If an even larger share of payment transactions shifts to international providers and value and process chains span across national borders, there may be repercussions for supervisory mandates as well as implications under competition and data protection law. It remains to be seen how the decision of the European Court of Justice on the Privacy Shield will affect the European payments market.

While systems coped very well under the circumstances, the COVID-19 pandemic has emphasised how important it is for the EU to safeguard the uninterrupted functioning of essential infrastructures and the continuous provision of crucial services. Payment systems and services count among these. Reliance on non-European providers alone could jeopardise European sovereignty.

The challenge for European payment service providers is to create effective pan-European payment solutions to rival those offered by their global competitors. In response, a number of major banks, 16 so far, have proposed the European Payments Initiative (EPI), which is supported by public authorities and national central banks. This initiative could enable consumers to pay in a uniform, convenient, safe and efficient manner throughout the whole of Europe, covering both online and offline channels. Instant payments, the new service allowing bank transfers all over Europe within seconds, would form an integral part of this set-up.

> *The challenge is to create effective pan-European payment solutions to rival those offered by their global competitors.*

Even as banks focus on recovering from the repercussions of the COVID-19 pandemic, work should continue on pan-European payment solutions. EPI could be the decisive cornerstone for the future of the European retail payments market and is thoroughly in keeping with the political agenda in Europe.

The European Commission has made a European retail payment strategy a priority and the German Presidency of the EU is putting digitalisation high on its agenda. European private stakeholders should make the most of this momentum to pave the way for European omni-channel payment solutions that foster European sovereignty and competitiveness while fulfilling the needs of consumers and businesses. ●

Nathalie Aufauvre

General Director Financial Stability and Operations, Banque de France

The EU retail payments market must address new challenges to stay in the race

Retail payments have significantly evolved for the past ten years in Europe thanks to a favourable competitive market which stimulated innovations. The most significant evolution is their increased digitalization. European actors have made retail payments a digital activity and now offer state-of-the-art technologies. While addressing public demand and preserving consumers' choices, they set up safe online payments services, P2P payments through mobile apps or contactless payments. The COVID19 crisis also catalysed the shift to digitalized and contactless payments, inducing new payments habits that will certainly last. Meanwhile, more and more merchants try to make payment steps invisible, as illustrated by the planed disappearance of cashiers in some stores.

However, this digital evolution also sheds light on the challenges the European payment ecosystem is facing. First, despite the key achievement of SEPA, the European payment sector is still highly fragmented. Each country either has its own card scheme or rely on non-European schemes, while many banking communities have launched their own mobile payment solution with a purely domestic scope. While a significant wave of mergers has occurred in the payment industry in the US, it has only started recently in Europe. This fragmentation means a reduced profitability in a sector relying on mass effects. On the contrary, international technology companies, with a large and global customer base, benefit from network effects and can prove very competitive especially thanks to activities combined to payments (marketplaces, behavioural analysis). In addition, imperfections of the European retail payments market could strengthen this risk of marginalization of its incumbent stakeholders: the absence of an independent pan-European solution for daily payments (online or in shops), the still expensive costs of retail payment for merchants and the delayed enhancement of security for online payments expected from PSD2.

EU retail payments players still have their destiny in hand to build tomorrow's Europe of payments, as illustrated by the European Payment Initiative (EPI): a major project that will strengthen our autonomy in vital area, but which existence is conditional to a strong commitment of the concerned banking communities.

That said, they are not on their own: Central banks can and will play a key role to energize the retail payments market as permitted by their mandate. Following their oversight mission, they ensure that retail payments remain safe, functional and accessible. As catalysts, they lay the ground for a constructive cooperation between all the stakeholders. Finally, as payment operators of key market infrastructures, they have the responsibility to contribute directly to innovation, in cooperation with the private sector, in order to improve the financial system. Ensuring pan-European reachability for instant payments, experimenting wholesale MDBC or facilitating cross-border payments to reduce their cost and complexity, are in this vein.

For central bankers, their goal is not to disintermediate or to compete with the private sector but to facilitate, together with the EU market, the emergence of new tools and solutions simplifying operations for the benefit of European citizens and companies. ●

Maria Velentza

Director of Financial Services, Directorate-General for Competition, European Commission

Promoting innovative digital finance to European consumers and businesses

Digitisation is transforming the financial sector at a very rapid pace: consumers and businesses are increasingly accessing financial services digitally, market participants are deploying new technologies and business models are constantly changing. Digitisation is challenging the very structure of the financial system. The Covid-19 pandemic has further reinforced the shift to digital/contactless payments and has confirmed the vital importance of having safe and convenient payments for remote or face-to-face transactions.

In order to enhance the opportunities brought by digitisation, the EU financial sector has to adapt to the changing nature of innovation and embrace the digital revolution. With innovative EU firms in the lead, the benefits of innovative digital finance should be made available to European consumers and businesses. Moreover, pan-EU payment solutions, provided under fair competition ▶

terms, can reinforce the economic, monetary and technological sovereignty of the EU, enhance its role as a global player and contribute to financial stability.

Meanwhile, data is becoming more important for companies to compete. For security and privacy reasons as well as broader financial stability concerns, there has traditionally been little data sharing in the financial sector. The rise of FinTechs and the recent entry of Big Techs in financial services have demonstrated the potential for innovation in the financial sector; at the same time, data ownership and portability as well as interoperability of platforms will be key in determining the degree of competition in finance.

The time has come to strike a balance between security, financial stability and fair competition. Competition policy not only recognises the importance of access to data to compete, but also ensures that a level playing field is maintained, that competition takes place on the merits, and that the benefits of innovation reach consumers. Regulatory action and traditional enforcement tools work in tandem to serve these goals.

> *Digitisation is challenging the very structure of the financial system.*

In this sense, one of the priorities of the EU Commission has been to put in place a European financial data space to promote the use of digital data analytics in the context of open data policy. The EU has led the way and gathered invaluable experience in opening up data sharing with respect to payments accounts with important legislative initiatives such as the revised Payment Services Directive (PSD2). More generally, PSD2 aims to open up the market to new business models and represents a first step in the direction of a more open, collaborative and competitive EU financial sector. The EU is now ready to take further steps towards more data sharing and openness, for the benefit of consumers, businesses and public policy objectives such as the Green Deal.

Before taking such steps, regulators and policy makers will need to carefully consider the significant political and regulatory challenges that need to be addressed, such as:

- further adapting regulatory and supervisory financial services frameworks to new technologies and business models while mitigating possible new risks (e.g. cyber risk and new dependencies or third-party risks);
- promoting a well-regulated data-driven financial sector, while ensuring a level playing field; and
- ensuring innovative firms can scale up the Single Market, in particular thanks to enhanced supervisory convergence.

Sonja Scott

Country Manager Germany, American Express

Achieving an effective EU retail payments area

A long-held ambition of the EU, the creation of a truly effective retail payments area would be a major achievement, and it is at last in sight. If built on a stronger competitive foundation, it would undoubtedly help provide European consumers, businesses and merchants with greater choice.

The EU has tried many recipes to achieve its objective of a single market for EU retail payments, but to date hasn't yet found the perfect mix of ingredients. Not least, the achievement of this goal has been stymied by inadequate competition in the payments' ecosystem in the EU.

American Express have long held that, with more competition comes better services and better prices. Fundamentally we believe consumers, businesses and merchants deserve more choice. We support all efforts that are focussed on encouraging real competition to the dominant schemes – whether from fintechs, European-led initiatives or alternative models.

Indeed, addressing this issue was a central aim of the Interchange Fee Regulation (IFR). However, data from the Commission's own recent Report on the IFR shows that the market share of the dominant four-party schemes has either held the same or even increased since 2015. This has come at the expense of national schemes and alternative players, and has so far done little to advance a single retail payments area.

Still, one potential game-changer came only a few weeks ago, when the European Commission, the ECB and number of national governments publicly supported the European Payments Initiative (EPI), a new initiative by 16 European banks from 5 countries which aims at developing an EU interbank scheme based on instant payments. American Express welcomes this development. We believe that such a pan-European scheme would help to achieve one of the bloc's major policy objectives: to increase competition in the payments market, providing both consumers and merchants with greater choice in how they pay.

> *Consumers, businesses and merchants deserve more choice. We support efforts that are focussed on encouraging real competition to the dominant schemes.*

We would, however, underscore that – in a world where consumers want to shop globally – the EPI project must introduce true global interoperability, that it should be underpinned by a regulatory framework that ensures the proper economic incentives are guaranteed, and that the final product is as secure, convenient and fast as existing card payments. Failing that, it is unlikely to get the consumers' or political support and traction it needs.

Equally important, especially given the fast pace of change, we call on EU policymakers to support other initiatives in the sector that would help bring real challenge to the existing dominant players. Chief among them is doubling down on initial efforts to support Open Banking, by moving toward "Open Finance," and ensuring a truly open data economy.

Taken together, these options paint a pathway for the creation of a truly effective EU retail payments area, built on strong grounds of competition and innovation. Without them, and without a clear policy to tackle dominance in the market, these efforts may well be in vain. ●

Antony Cahill

Managing Director, Europe Regions, VISA

Open finance: the next frontier in FinTech and payments

COVID-19 has accelerated the shift to digital payments, in particular contactless payments. Notwithstanding this change in consumer behavior, more than a third of retail payment transactions in Europe are still in cash. The last five months have shown a clear appetite for consumers and businesses to embrace a world of digital payments and furthermore highlights the opportunity to increase digital payments through ongoing innovation and competition.

Open finance has and will continue to play a critical role for continued and sustained growth in this critical enabler of commerce as both innovators and regulators strive to place consumers increasingly in control of their money and financial data. New players continue to enter the market and established providers are responding accordingly with greater pace and improved services. This situation is steadily transforming the landscape in terms of players, features and price, ultimately providing consumers more choices than ever imagined. The revised Payment Services Directive (PSD2), through a focus on open access and standards, has placed Europe at the leading edge of that change.

The PSD2 regulation is designed to enable businesses to innovate in an unfettered and consistent way across the single market and overall it has been remarkably successful in achieving this aim. In a world of PSD2, companies can (with appropriate customer consent) combine their information with multiple external data sources to provide innovative and valuable customer products and services. The regulation has empowered consumers and allowed them to benefit from the best the world has to offer.

Open finance has the potential to lead to the convergence of digital payment rails ultimately leading to a real-time payment capability across all types of transaction. At the same time, Europeans will continue to have the highest expectations in relation to security, reliability, control and protection.

As Visa, we have responded by progressively opening up our ecosystem to allow participants including new (EU) Fin Techs to easily and quickly access the capabilities in our network while maintaining the highest possible standards of resilience, integrity and security. For example, our expertise in the secure authentication of sellers and buyers, and fraud prevention measures will be more important than ever in an instant payments context.

When we think about the future of payments, we should stay grounded in what consumers and businesses really need and how to manage risks in a digital environment.

In the payments world, not all transactions are the same, buying a new car or holiday is very different to buying a cup of coffee. What matters more to the consumer or business in the moment of payment is therefore very much contextual – for some it may be protection and security for others loyalty or invoice information. However, immediacy and simplicity may at times be the key attributes valued above all else.

The rapid expansion in the number and diversity of participants in the payments ecosystem has created new risks for consumers. It is important to set minimum operational safety and soundness standards, data -and cyber security standards for all payment ecosystem operators.

> *When we think about the future of payments, we should stay grounded in what consumers and businesses really need and how to manage risks in a digital environment.*

It is important for the future European Retail Payment Strategy to remain principle-based as the European payment market continues to undergo a rapid transformation. Such an approach will both encourage and enable payment participants to continue innovating and delivering for consumers and businesses.

The EU should determine specific outcome-based objectives for payment service providers such as fraud levels, security parameters, levels of market access and service delivery, but also give payment networks and companies the flexibility to deliver on these objectives.

This approach should allow Europe to stay ahead of payment innovation, while expanding the opportunities for competition, growth and innovation - which drives the best results for consumers. This will be ever more important as we move towards open finance. ●

Massimiliano Alvisini

Chief Executive Officer Europe,
Western Union

Fostering financial inclusion in the new normal

Western Union is a leader in cross-border, cross-currency money movement and payments; our customers can transfer money from one part of the world to another in seconds, transacting digitally or in cash at a retail location, or choosing cash, account or electronic wallet pay-out.

Offering all these options enables financial inclusion, but also risks misuse by bad actors—which is why Western Union invests so heavily in compliance, and why policy objectives targeting illicit money movement must account for the wide cultural and economic variability of today's global consumers.

Many of our customers are global migrants. We continuously work with different communities to deliver payment services for their unique cultural, economic and technology enabled circumstances. In that vein, we welcome the European Commission's work on an EU Retail Payments Roadmap, within the wider context of the current G20 and CMPI initiatives, at the centre of which is financial inclusion.

Financial inclusion is intrinsically linked to two things: price and technology. It's important to note that costs associated with cash transactions are significantly higher than costs related to account-based transactions, whether electronic wallets, bank accounts or cards. Besides the cost of physically distributing currency, our pricing must account for the channels through which funds move, as well as regulatory and infrastructure costs.

Western Union constantly drives technology aimed at financial inclusion. Real-time payments, for example, increase financial inclusion by improving the efficiency of financial systems; we have dramatically increased our real-time payments services. We also have increasingly digitalised our retail service, so many customers can start a transaction on our app and complete it in person at an agent location. But even as digital options increase, the majority of principal we move is still paid out in cash at retail.

The remittance sector is often deemed high risk for financial crimes; this fails to recognise the robust risk mitigation that the industry in general, and Western Union in particular, has put in place. Anti-Money Laundering compliance forms our single largest cost. We invested $1bn+ between 2015-2019 in people, processes, and technology, including predictive analytics and machine learning. We live on the bleeding edge of developments in AML/CFT, both in Europe and globally.

Our belief that the policy objectives of AML and financial inclusion must align does not entail compromises on AML. Some suggestions:

- AML rules should recognise the risk mitigation already in place. AML compliance is not a box ticking exercise; companies should be encouraged to adopt a risk-based approach, with the most resources allocated to those cases posing the most risk.
- There should be clear AML data privacy rules. AML enforcement works best where information flows both among and between the public and private sectors.
- Regulators should help reduce unnecessary compliance costs, most notably by streamlining reporting standards across the EU. This also facilitates information exchange and the use of AI and other technologies.
- Critically, we need EU-wide recognised e-ID and online KYC solutions. A universal on-boarding solution would truly offer customers the benefit of a Single Market in payment services, as well as introduce competition and drive down fees. There is no better way to foster financial inclusion. ●

Does the EU need to build its own payment system?

Denis Beau

First Deputy Governor,
Banque de France

The future of European payments is being built now

Over the past decade, regulatory developments promoting competition between payment service providers have combined with strong impetus from technological innovation to redraw the payments landscape. Consequently, new participants are arriving on the scene, innovative technologies are spreading, and more payment services are becoming available.

By accelerating the digitization of economies, the COVID19 pandemic has amplified these trends in multiple ways. More and more consumers are turning to cashless payments, namely by using debit or credit cards but also smartphones, even at bakeries.

Against this background, and alongside its monetary policy and financial stability functions, the Eurosystem is also tasked with keeping means of payment efficient and safe in the euro area, while making sure innovative and user-friendly solutions are available. Today however, the majority of card, mobile and online payments made by European citizens and companies relies on technology platforms operated by global providers and international card schemes. The ongoing changes in payment behaviour stemming from digitalisation will further amplify this development, resulting in numerous challenges for public authorities and central banks.

With the pandemic, it becomes more obvious that the EU needs to safeguard the uninterrupted functioning of essential financial market infrastructures – such as payment systems – and the continuous supply of crucial services.

The predominant reliance on non-European payment service providers could threaten European sovereignty on that matter. Moreover, BigTechs are continuously gaining market shares and become increasingly dominant by offering a comprehensive range of financial services to a global customer base. As a result, consumers have more limited alternatives and might end up tied to proprietary solutions. Meanwhile, banks face the risk of being disintermediated by losing their direct links to their own customers.

Consequently, sixteen major European banks have recently put forward the European Payment Initiative (EPI). This project could first enable consumers to pay in a uniform, convenient, safe and efficient manner throughout the whole Europe, comprising all different online and offline channels.

In a second stage, consumers could use it globally as well, thus reducing their reliance on non-European payment service actors. Such a reorganisation of the European payments landscape undoubtedly will require significant investments, whereas resources are becoming scarce. Nonetheless, this initiative may rely on existing infrastructures such as domestic card schemes and digital solutions, which already serve a broad range of users and enjoy significant market shares despite their limited national reach. Besides, instant payments should form an integral part of this future set-up. EPI could be a nucleus to pool European interests and to regain autonomy, while being open to other remaining players from national markets.

For a successful implementation, all significant stakeholders from the supply side as well as both payers and payees need to join in. In addition, European authorities and central banks are willing to support this promising initiative within the reach of their mandates, including by ensuring a sufficient degree of regulatory predictability.

> *The current juncture is a unique opportunity to build an integrated European payments market.*

Another important concern for European sovereignty is the control over individual payment data, which are the cornerstone of successful business models in the field of financial services. The recent decision of the Court of Justice of the European Union on the Privacy Shield illustrates that there has been a growing understanding of this issue in the past few years.

However, all European stakeholders – whether consumers, market players or public authorities – face the risk of not being able to maintain proper control on such data, because the latter are usually processed on servers located outside of the EU. As a mitigation measure, the existing regulatory framework – mostly defined by the GDPR – could be completed by introducing a location policy for sensitive payment information.

The current juncture is a unique opportunity to build an integrated European payments market. Let us make the best use of this momentum. ●

Martin Merlin

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

A retail payments strategy for the EU

Digitalisation and the emergence of new technologies has transformed the payments landscape over the years, more recently bringing innovative players and services to the market. Over the last decade, EU legislation on retail payments has facilitated this trend and paved the way for an increasingly competitive market.

However, European consumers and companies are not fully benefitting from this transformation, as faster, more innovative payment solutions remain largely domestic or are not yet available or accessible on a large and European scale. Whilst the second Payment Services Directive has enabled innovative solutions such as payments initiation services or account information services, open banking is still in its infancy. Despite progress achieved under the Single Euro Payments Area, the European retail payments market remains fragmented, with no European solution emerging for point-of-sale and online payments, and the potential of instant payments remains largely untapped. On the other hand, global tech companies play an increasing role on the European payments scene, thanks in particular to their huge client-base, and vast access to data. However, they bring a set of new challenges, in particular in terms of data privacy, security, consumer protection, economic and financial autonomy and even potentially monetary sovereignty.

The digitalisation process and the emergence of innovative players and FinTechs is also contributing to a more diversified offer for cross-border payments between the EU and other jurisdictions, in a global context where cross-border payments are generally more complex, slow, opaque, inconvenient and costly than domestic ones. However, many challenges remain. One of those challenges is data protection, in particular owing to the different levels of protection offered by national regimes. In this regard, a recent CJEU ruling[1] determines that, in order for apayment service provider (as the controller) to transfer data to a third country, it will have to be satisfied that the requirements of a third country's domestic laws are essentially equivalent to those required under EU law, and do not result in limitations to the right of protection of personal data. As this requirement could apply to any data transfer outside EEA borders, even when transactions are carried-out in Europe, it could have a tangible impact on the EU market. Taking into account the potential risks involved in the transfer of data outside Europe, it is crucial that the EU retail payments market becomes less dependent on the processing of data for payment purposes outside of EU borders.

> *As digital payments are key for the EU's digital economy, a Retail Payments Strategy is needed.*

In recent years, Europe has made important progress towards a true banking union and has launched an ambitious agenda for creating a Capital Markets Union; it needs now to have the same level of ambition for the retail payments market.

As payments are vital to the economy and digital payments are crucial for the digital transformation in Europe, their strategic importance justifies the need to adopt a Retail Payments Strategy. ●

1. Schrems II (Case C-311/18 - Data Protection Commissioner v Facebook Ireland Ltd and Maximillian Schrems)

Dr. Joachim Schmalzl

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

The future of payments in Europe

Today's European payment landscape is highly fragmented. Payment solutions are developed around national ecosystems with little or no acceptance across other European markets. This domestic-first approach to payments and the absence of a pan-European solution able to compete with global payment solution providers for the European market, has left the floor to an oligopoly of Big Techs and international payments service provides. Additionally, while some European countries have developed domestic payment systems (e.g. girocard in Germany), others rely on international card systems (ICS) for their national, European and international transactions.

With the uptick in the usage of digital payment methods resulting from ▶

▶ the ongoing COVID-19 crisis, the existing dominant market players are in a favorable position to further strengthen their position across Europe. In addition, the current market situation also provides challenges through limiting competition in the payments space. Importantly, European cross-border retail payments are currently only feasible through ICS, leaving many European consumers and merchants with no viable alternatives for domestic or cross border transactions across Europe. As a negative consequence of this constellation and the resulting limited competition, international service providers have been able to increase their fees unilaterally and significantly without risking their market position.

It is important to note that Payments constitute a primary element of the customer's day-to-day banking experience, without which, the whole banking relationship and the valuable data associated with it would no longer be in the hands of the customer's bank. Questions around custodianship of customer data have been in the focus for some time now. New regulations (such as PSD2) meant to accelerate innovation by allowing third parties access to customer information have further allowed the Big Tech companies to successfully penetrate the payments landscape by offering a more streamlined user experience while adding a disintermediation layer between banks and their customers.

> *The current European payment landscape provides for limited competition at the European level and presents challenges to the long-term prospects of the European payments and banking industries.*

In conclusion, the current European payment landscape provides for limited competition at the European level and presents challenges to the long-term prospects of the European payments and banking industries. As a result, Europe is in need of a pan-European payment solution, able to compete with global Big Tech and International Card Schemes while providing tangible benefits to the European market by offering a seamless, competitive, and unified payment solution for the whole of Europe and available to all European consumers. In order to address these challenges, the German Savings Banks (Sparkassen-Finanzgruppe) together with a group of European banks from five EU countries (Belgium, France, Germany, Spain, and the Netherlands) announced their participation in the European Payments Initiative (EPI).

The initiative aims to replace the fragmented domestic solutions of participating European countries with pan-European payment solutions (including in-store, online, cash withdrawal and P2P) available to consumers and merchants across Europe. EPI aims to provide a new means for payments to European consumers and merchants in all types of transactions. ●

Regis Folbaum

Head of Payments & Data, La Banque Postale

Moving towards a European card system

OFAC, Tik-Tok, Alibaba, WeChat Pay, Libra... What do these 5 have in common? They are some of the symbols that reveal the lack of sovereignty in Europe in general and in payments in particular, an issue that we need to tackle rather sooner than later.

20 years after the creation of the euro, more than 10 years after the implementation of SEPA (Single Euro Payments Area), payments have become a strategic challenge for Europe and are now construed as a true component of its economic sovereignty. Yet, the Europe of payments is still ahead of us. Due to the fragmentation of national card schemes, even the strongest European operators offer services that only work within individual member states. While we witness the rise of US, China and even-BigTech-led payment schemes, EU still lags behind and does not have a unified European card scheme. Crypto-currencies and stablecoins cannot be the only solution for retail and cross-border European payments.

A SEPA for cards is now critical and implies that we go beyond connectivity and interoperability barriers to set common standards. Cards, still the most used electronic payment, account for around 52% of all non-cash transactions in the EU. Consumers embrace its benefits in terms of convenience, speed, safety and security. The fast-changing realm of instant payments, disrupted by new technology companies may offer an opportunity to achieve a single space for European cards, which ultimately would benefit both cardholders and merchants.

> *Now that EPI is open for business, founding members welcome the joining of new banks / PSPs to build a Europe's unified and innovative payment system...*

The European payments market is already dominated by non-European players, and we must also take in account the growing role of non-European digital companies - whether American or Chinese - offering payment solutions. This raises a sovereignty issue not only for payment infrastructures but also for the conservation, use and confidentiality of citizens' data. ▶

▶ Last but not least, there is also a strong demand from merchants, who want to do away with barriers, solutions and local standards. A single EU standard could meet these expectations while lowering prices for merchants. Now, with EPI as an end to end payments solution that will cover all major retail use cases in Europe and compete with best-in-class solutions, we will have a truly European and competitive alternative. This private-led solution, involving strongly regulated actors (among which La Banque Postale) and leveraging SCT Inst, will allow a progressive advance towards a unified European payment system.

The set-up of EPI lies on three key factors:

- the stability of the cards' business model and a viable business model for the SCT Inst-based transactions given the significant investments required for the build, the migration to and the run of a new infrastructure;
- a stabilized regulatory environment; and
- a momentum of other communities willing to join EPI.

All of the above imply continuous support of public authorities, especially the European Commission, the European Central Bank and National Central Banks. Now that EPI is open for business, the founding members welcome the joining of new banks or PSPs to build this challenging but exciting adventure to provide Europe and its citizens with a unified and innovative payment system.

La Banque Postale, as a major player with a large retail customers base, strongly supports this pan-European initiative. ●

Stéphanie Yon-Courtin

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

From castles to citadels: building the EU retail payment system

The past decade has seen radical changes in the EU retail payment landscape, with new entrants fostering competition, and consumers empowered to start a dialogue with payment providers on the services they need and the charges they pay. Still impregnable castles could soon be replaced with a diverse landscape of citadels, with the potential to strengthen our sovereignty in building a strong network of payment services in Europe, for European consumers, respecting European rules.

Once seen as a siege against incumbent payment providers, the introduction of more open competition in the retail payment space with the second Payment Services Directive (PSD2) could set useful precedents for open finance, and beyond financial services in the upcoming Digital Services Act. Further opening of the retail payment markets will be the logical next step, provided that reciprocal access to financial data ensures a level playing field across providers, based on the 'same business, same rules' principle. We must act to prevent BigTechs from becoming the new seigneurs imposing their laws on EU citizens.

Access to worldwide services, such as card schemes, is largely in the hands of global, non-European actors, with questionable consequences on Europe's sovereignty, in particular on the independence of our foreign policy decisions. The use of ad-hoc services for consumer-to-consumer transfers or currency conversion, offered through mobile apps by innovative actors, often European, is still very dependent on word of mouth and therefore linked to national, regional and even local preferences.

A truly European approach to retail payments will bridge these apparent contradictions, and allow us to move from a small number of fiefdoms to a network of citadels anchored in Europe, with a strong influence on the global payment landscape.

The end of the Wirecard sandcastle shows that we should not be complacent in building European payment providers. Pan-European sandboxes will be useful to foster innovative and competitive European leaders in retail payment, if and only if all relevant supervisors are involved under the joint steer of the ESAs, and with sufficient safeguards to prevent potential threats to financial stability, and to market integrity, transparency and efficiency.

> *As we are watching the house of Wirecard fall, a new supervision for EU payments is an urgent need.*

As we are watching the house of Wirecard fall, a new supervision for EU payments is an urgent need, ensuring that dots are connected across all related areas including financial reporting, financial innovation, audit, Anti-Money Laundering and Countering Terrorism Financing.

Adequate governance of this new kind of European cooperation will be key: supervisory authorities should be confident in sharing sensitive information and in challenging each other, and by independent voices empowered to protect the interests of European payment users as a whole, away from national sensitivities.

Much like Medieval Italian and German communes have created the foundations for the vibrant European economy of the following centuries, we now need to build a European network of payments providers, acting as together citadels to challenge the stronghold of the few global castles constraining the current EU retail payment landscape. ●

Burkhard Balz

Member of the Executive Board, Deutsche Bundesbank

Payment rails as an essential European infrastructure

Digitalisation has changed payments profoundly. Since the beginning of the 2000s, online payment situations have become increasingly widespread, inflating the need for card, online and mobile-based cashless payment services. The COVID-19 pandemic has accelerated this trend even further, with cashless payment services in demand for both the increasing volume of e-commerce and even in face-to-face transactions.

This ongoing digitalisation is characterised by platform ecosystems dividing up the markets for physical goods and services between themselves. Payments are to be integrated into these platforms as an additional element, yet one that does not attract too much user attention as it should not interrupt the customer journey. The most successful platform ecosystems are offered by BigTechs from the United States and China. From their point of view, a seamless integration of payments is crucial, but it is only a complement to their core business.

This distinguishes them from traditional payment service providers, such as banks. For banks, payments are part of their core services for which they expect to be paid, at least by the payee. In BigTech ecosystems, the business model is very often based on the usage of big data. Therefore, they strive for perfect integration of payments into their platform ecosystem and start to develop their own payment services.

In this changing environment, the offerings of payment service providers in the euro area are in danger of falling short of the needs of payers and payees. This is not only due to their purely fee-based structure, but also due to the often limited reach of online services on a national scale. Against this background, regulators and central banks in the EU are endeavouring to support payment service providers in developing a system for cashless payments that works online as well as face to face. It should run on European payment rails. One new European payment scheme that can be used as a proper rail-like basis is the SEPA Instant Payment scheme.

In this context, it is quite challenging for an individual market player, such as a bank, to develop long-lasting business models. This is because payment services are a network product that traditionally works as a cooperative service provided by a group of suppliers taking into account the interests of both sides of demand: the payer and the payee. With ongoing digitalisation, the market model – with payers, payees and payment service providers as separate institutions – is supposed to be of minor importance. The trend towards platform-type offerings of goods and services has induced a need for large-scale services which fit into these kinds of eco-system.

> *It is also up to the private sector to have an understanding of the need to invest in the LT development of European payment solutions based on EU infrastructure.*

To manage this big challenge in time, it is up to the regulator to set an adequate legal framework to enable payment service providers in Europe to build up European-based payment services on European-based rails. It is up to the private sector to pick-up these patterns. It is also up to the private sector to have an understanding of the need to invest in the long-term development of European payment solutions based on European infrastructure. Otherwise, the payment industry – with its underlying infrastructures – may no longer be a field for European players. ●

VI. ESG AND SUSTAINABLE INVESTMENT

Content

Have the prospects of global and EU ESG policies changed with the Covid crisis?

Ambroise Fayolle

Vice President, European Investment Bank (EIB)

Covid recovery and green transition are no zero-sum game

Economic recovery from the COVID-19 slump should not be seen as a zero-sum game. The urgent need to bring life back to our economies should not come at the expense of our climate and environmental ambitions – those two objectives should reinforce each other.

After all, climate investment always carries with it additional benefits. Automated, electric cars, for example, cut greenhouse gas emissions, but they also reduce accidents from driver error, decrease noise pollution and improve air quality. We should direct our massive stimulus packages towards investments that reorient our economies toward climate and environmental action, at the same time as they boost jobs and growth.

We must ensure that stimulus packages keep the world on track to meet the Paris Agreement targets. We must protect the environment, help the most vulnerable countries around the world and ensure that business has a sustainable future everywhere. Failure to do so will have severe long-term consequences for our societies.

The European Investment Bank Group's role as the EU climate bank is to stimulate a green recovery. We have long lead the way for climate action. Last year, we stepped up our climate ambitions by committing to:

- end the financing of unabated fossil fuel-based energy generation
- align all financing activities with the Paris Agreement by the end of 2020
- dedicate at least 50% of our annual financing to climate action and environmental sustainability by 2025
- catalyse €1 trillion of climate action and environmental sustainability investment in the next decade.

We know we can do this. Only a few months ago, the amounts necessary to finance climate change seemed so great that many doubted the money could ever be found. Yet the COVID-19 stimulus packages are larger still. And the result will be jobs. According to a report backed by the Global Commission on the Economy and Climate[1], a partnership of seven developed and developing countries, low-carbon growth could offer economic benefits of $26 trillion by 2030.

The European Investment Bank has a strong foundation in green and sustainable financing. Since we pioneered the world's first Climate Awareness Bond, we have issued close to €29 billion of green bonds. In 2018, we issued our first sustainability bond to support projects that back social and environmental investment. Coronavirus has not slowed us down. Even since the lockdowns started in March, we have issued well over €4 billion of these thematic bonds, exceeding the entire volume of 2019.

Just as we were already central to this shift towards green financing, we have also recognised that it is good for jobs. We are sure the green transition can contribute to economic recovery from COVID-19 by creating more jobs, building new and fast-growing industries and promoting greater competitiveness. Again, even before COVID-19 struck, we were on this path. The EIB Group is an important partner in the Just Transition Mechanism to support those who may be adversely affected by a structural shift away from carbon-intensive activities. That commitment remains strong. And when the EU bank makes a commitment, it has significant impact. Since 2012, we have provided about €170 billion of finance to support over €600 billion of investment in projects that reduce greenhouse gas emissions and help companies—from the smallest start-ups to international conglomerates—adapt to the impacts of climate change.

Ours is a global commitment, not just to climate action, but also to innovative strategies that open up new markets to environmental investment. Two years ago, we committed $100 million to the Green Bond Cornerstone Fund, which is expected to significantly increase the growth of green bonds in emerging markets. Last year, we invested €60 million in the Amundi European Green Credit Continuum Fund, which aims to broaden the credit spectrum of green bonds and loans beyond its previous focus on large investment grade issuers. COVID-19 has shown us what is truly important in our lives, as each of us has to make some sacrifices to protect those most vulnerable to the disease. Let us carry that solidarity with us as we confront the great challenge of climate change. ●

1. https://newclimateeconomy.report

Sirpa Pietikäinen

MEP, Committee on Economic and Monetary Affairs, European Parliament

Sustainable finance is the answer for Covid-19 recovery

260 billion euros are needed annually in the EU by the end of this decade in order to reach climate and energy targets. A common misconception is that this will require drastic additional investments. On the contrary, tools, resources and money already exists. Total assets under management in Europe in 2019 were estimated at 23 trillion euros. The global assets under management are around 90 trillion dollars.

Corona recovery measures in the EU and Member States reached 3 trillion euros within just a few months, even before the planned Recovery Package and Commission's proposal for Recovery Instrument, Next Generation EU. In this perspective, the annual 260 billion seems rather achievable. Moreover, sustainable transition makes financial and economic sense.

The Global Commission on the Economy and Climate estimated that climate action stands a chance to deliver over 26 trillion dollars in economic benefits. The return on investment in carbon neutral and circular technologies and infrastructure is estimated to be multifold, over 7 trillion dollars by 2030.

It is becoming clear that sustainability risks have a financial impact on assets. By 2100, expected financial losses could amount to over 4 trillion dollars in present value terms, according to a study conducted by Economist Intelligence Unit in 2015. A 6°C scenario could put 13.8 trillion dollars at risk, threatening 15 percent of global assets under management, and therefore posing a risk to the financial system as a whole. Recent studies hint that the systemic risk might put in risk a third of the financial markets.

In order to integrate sustainability risks and impact within investment decisions, or for authorities to decide on large-scale projects or public procurement tenders, there is a need for a robust toolbox to assess risks and to measure impact. All public money spent should follow the EU taxonomy classification in order to create effective coherence between public and private resources. Zero-euro should be used supporting fossil economy and environmentally harmful activities. This means the full respect of Do Know Significant Harm principle and gearing at least 50 % of investments to climate and environment transition.

The newly adopted EU Taxonomy is a revolutionary step towards correcting the way financial sector and the real economy can price in environmental externalities. The sign-off of the landmark regulation in June puts the EU in the forefront of global sustainable finance agenda, both in public and private sectors. Greening the financial sector is becoming an urgency in order to make investment decisions that affect generations to come.

We need comparable sustainability data based on robust standards built on harmonized sustainability indicators that measure key aspects of sustainability of an economic activity, using a common methodology. Relevance of each indicator varies from one industry and sector to another, the core environmental calculation system should consist of measuring key aspects of production, consumption and resource efficiency: use of resources, water consumption, direct and indirect land use, emissions including CO_2 emissions, production and treatment of waste, and the impact of an activity on biodiversity.

> *EU Recovery Plan and the next Sustainable Finance Strategy are the opportunity to speed up the necessary transition into a sustainable economy.*

The next step in Sustainable Finance strategy should be the development of integrated reporting and accounting standards that equip different stakeholders, from corporates planning investments in the real economy to financial intermediaries making investment decisions or managing assets on behalf of asset owners, to end investors, public authorities and the civil society, with tools to make informed decisions regarding where money is spent.

It is our duty to ensure that these recovery trillions are spent sustainably in the long term. No euro should be spent on unsustainable economic activity or businesses. Otherwise we will be leaving to future generations both public and climate debt. For this we need the tools for assessing the environmental impact of an investment and public spending more than was thinkable when the EU taxonomy was proposed. EU Recovery Plan and the next Sustainable Finance Strategy are the opportunity to speed up the necessary transition into a sustainable economy. Covid-19 and the recovery financing can be a virtue in the vice. Circular economy and sustainable finance – a match made in heaven.

Verena Ross

Executive Director, European Securities and Markets Authority (ESMA)

Enhancing sustainable finance through better disclosures

Sustainable finance remains a strong priority for ESMA as also highlighted in our recent Strategy on Sustainable Finance[1]. Under the political direction of travel set by the co-legislators, ESMA and national securities regulators look at this important issue with their mandates to prevent threats to financial stability and ensure investor protection in mind. This mandate is very relevant for the adjustment of financial markets to the risks arising from climate change and the associated transition to a more sustainable financial system.

In parallel, financial markets are at a point of change, as investor preferences shift towards financial products that incorporate Environmental, Social and Governance (ESG) factors. This trend has become clear in European equity and bond markets. Since the beginning of 2019, ESG equity funds domiciled in the EU attracted net inflows of €54 billion, compared to outflows of €128 billion for other equity funds.[2] The growth of the European private-sector green bond market also far outpaced that of the broader corporate bond market, but the supply of such bonds still falls short of current investor demand.

At this critical juncture, transparency is key. The EU Disclosure Regulation sets out relevant requirements for a broad range of financial market participants, financial advisers and financial products, often supplementing existing sectoral rules for these actors and products. The aim of this regulation is to strengthen protection for end-investors and improve disclosures to them.

ESMA is working with EBA and EIOPA to create Technical Standards under this Regulation on which it has recently launched a public consultation that closed on 1st September. In the Consultation Paper[3], the proposed requirements can be broadly divided into two themes:

- Principal adverse impact reporting at entity level: these are disclosures of principal adverse impacts of investment decisions on sustainability factors – including detailed indicators for environmental and social impacts; and

- Pre-contractual, website and periodic product disclosure: applicable to products with either environmental or social characteristics (“light green”) or with sustainable investment objectives (“dark green”).

In addition, the recently published EU Taxonomy Regulation has added many new empowerments in the Disclosure Regulation, including on the “do not significantly harm” principle and on product-related taxonomy disclosures.

However, investment firms are only a part of the ESG disclosure spectrum. As ESG investing becomes more popular, we need to ensure that market participants are provided with relevant and reliable disclosure also by non-financial companies, to enable comparisons across different companies and sectors. It is also important to ensure that disclosure requirements are consistent across the whole investment chain, covering both investment firms and the companies they invest in.

ESMA has consistently called for better corporate ESG disclosures, most recently in our response[4] to the European Commission’s consultation on reviewing the Non-Financial Reporting Directive (NFRD). There are currently multiple disclosure frameworks, and ESMA considers that a consolidation is required, which should also take full account of the need for connectivity between non-financial and financial reporting. The medium-term goal should be a single set of international standards, as this will be most helpful for companies as well as investors given the global nature of both financial markets and sustainability challenges. In the short term, ESMA acknowledges that standardisation is needed at European level to meet the immediate investor demand for more useful company disclosures. ESMA therefore welcomes the European Commission’s initiative to start looking at European standards for company disclosure and encourages the Commission, in parallel, to continue pursuing the international track to pave the way for one global disclosure standard for companies. ESMA stands ready to assist these European efforts by undertaking any standard-setting work in this important field. ●

1. https://www.esma.europa.eu/press-news/esma-news/esma-sets-out-its-strategy-sustainable-finance
2. Morningstar data and ESMA calculations
3. https://www.esma.europa.eu/sites/default/files/jc_2020_16_-_joint_consultation_paper_on_esg_disclosures.pdf
4. https://www.esma.europa.eu/sites/default/files/library/esma32-334-245_response_to_ec_consultation_on_revision_of_nfrd.pdf

John Berrigan

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

Sustainable finance is the key to a sustainable future

The EU Action Plan on Financing Sustainable Growth is a priority of the Commission's Capital Markets Union (CMU) Action Plan, and one of the key steps in implementing the Paris Agreement and the EU's Agenda for sustainable development. The sustainable finance strategy will also play a key role in the recovery from the economic fallout of the COVID-19 outbreak. We must bounce back from this pandemic and use the opportunity to redesign parts of our economies. Our sustainable finance work is integral to the EU Green Deal and Next Generation EU. Our sustainable finance taxonomy is what will guide investments under Next Generation EU into an environmentally sustainable recovery.

The sustainable economy transition requires significant investment across all sectors. Reaching the EU's current 2030 climate and environmental policy goals would already require additional investments of approximately €470 billion a year by 2030. Private investment is key. The EU budget and Member State public spending can provide some of this massive investment, but not all. Only the private sector can provide the scale. This is why we need laws to unlock that private investment and for the financial sector to channel it effectively. The Commission will lead the global work in this area and help sustainability-conscious investors choose suitable projects and companies.

We have already made great progress on our key: the Taxonomy Regulation establishes the first legislative framework that defines what environmentally sustainable economic activity is. Two new categories of EU climate benchmarks were created and ESG disclosure requirements for benchmarks proposed. The Disclosure Regulation was adopted in spring 2019. It requires financial market participants and advisers to provide sustainability disclosures to end-investors. This list is not exhaustive. We are picking up successes as we move forward step by step.

The EU is leading the way in this field. Given the challenges and the enormous investment needed worldwide, global financial markets have a greater role to play. This is why, in October 2019, the EU, together with Argentina, Canada, Chile, China, India, Kenya, and Morocco launched the International Platform on Sustainable Finance. In 2020, Indonesia, New Zealand, Norway, Singapore, and Switzerland joined the group. It is heartening that the Platform continues to grow. It now unites 45% of the world's GDP and 50% of the world's population. Not a bad start.

To speed up efforts to reform the financial system, and to ensure that sustainability remains a permanent feature of EU policies, the Commission is setting up a new platform on sustainable finance that will begin its work in 2020. As a central forum for discussion, the platform will bring together private sector experts, market participants and public bodies.

> *Our work on sustainable finance is an integral part of the EU Green Deal and Next Generation EU.*

By the end of 2020, we will present a renewed strategy on sustainable finance that shifts focus to the real economy and corporates, as well as to public authorities and citizens - to give everyone the necessary tools to transition from brown to green. We will amend the Non-financial reporting directive to improve companies' climate and environmental data disclosure to better inform investors about the sustainability of their investments. We will strengthen companies' disclosure of sustainability-related information, the Eco-label for sustainable financial products, and incorporate sustainability in prudential requirements and the provision of financial advice. Citizens and retail investors can play a major role to finance the transition with the right tools. We will provide those tools.

The digitalisation of the EU financial system offers excellent opportunities in this sense. Financial incentives and new forms of private-public cooperation will be imagined and implemented. Climate and environmental risk management will be improved by integrating them into the EU prudential framework and assessing the suitability of the existing capital requirements for green and brown assets. It also means examining how the financial system can help increase resilience to climate and environmental risks, in particular when it comes to physical risks and damage arising from natural catastrophes.

We have come a long way, and we are moving ahead confidently. Sustainable finance is the key to a sustainable future, and we are wasting no time in building exactly that for generations of Europeans to come, as well as for those of the rest of the world.

Daniel Hanna

Global Head, Sustainable Finance, Standard Chartered

From sustainable finance to finance being sustainable

Covid-19 has had profound health, human, economic and financial impacts. It has also accelerated the focus on sustainable finance and the desire for a green recovery. Up to 90% of high net worth investors are now interested in sustainable investing, according to the results of our recent Sustainable Investing Review (https://av.sc.com/corp-en/content/docs/Sustainable-Investing-Review-2020.pdf), with 42% considering investing up to 15% of their funds in sustainable investments over the next three years. In March, during the height of concerns regarding the pandemic, we saw a record inflow from corporate clients into our UN Sustainable Development Goal money market deposit product. This trend is not unique to Standard Chartered's clients. Over 90% of sustainable indexes outperformed traditional indexes during the pandemic-led market downturn in Q1 2020 and many of those indexes continued to outperform during the rebound that followed. Exchange-traded funds focused on companies with above-average grades for ESG practices attracted more than USD10 billion in the first four months of 2020, more than all of 2019 combined.

The public sector has also given greater focus to sustainable objectives due to the pandemic. Globally, the Covid recovery package stands at over USD10 trillion. We believe it is vital that public money serves environmental as well as social and economic outcomes. The European Commission has taken encouraging and ambitious steps to integrate environmental principles into its recovery package. Helpfully, we are also seeing some emerging markets, the fastest growing source of new carbon emissions, adopt a similar focus on ESG. Malaysia announced a stimulus plan that includes USD2.9 billion for rooftop solar panels and LED street lighting.

The Philippines Central Bank approved a Sustainable Finance Framework to support the renewable energy transition in the wake of the pandemic. The African Union Commission and the International Renewable Energy Agency will collaborate to advance renewable energy to bolster the continent's response to the pandemic.

Progress is being made. But much more is needed. Our Opportunity2030 report (https://av.sc.com/corp-en/content/docs/Standard-Chartered-Opportunity-2030.pdf) highlighted the USD10 trillion private sector investment required for just 3 of the UN's Sustainable Development Goals – clean water and sanitation (SDG 6), clean energy (SDG 7) and sustainable infrastructure (SDG 9) – across 15 countries in Asia and Africa. While real economy investment is required, the finance sector needs to do more to mainstream ESG-led decision making to support a sustainable recovery and a low carbon transition. Our Sustainable Investing Review found that the most significant barriers to further sustainable investment are lack of information and standards.

More effort is required to increase, improve and harmonise data and disclosures from all sectors of the economy, in particular from emerging markets which are the most at risk from climate change but also represent the biggest sustainable investment opportunities. Information is improving thanks to initiatives such as the Task Force on Climate-related Financial Disclosures. However, the quality and consistency of broader sustainability data is often poor, non-comparable and inconsistently disclosed. In addition, sustainability metrics, models and methodologies need to be harmonised and made more transparent in order to inform investment outcomes and drive capital allocation to where it is needed most.

> *The Covid pandemic presents a unique opportunity to shape a green recovery and the future of finance.*

Finally, we need to ensure international alignment to harness the power of global markets, financial innovation and to facilitate cross-border investment flows, specifically into emerging markets. These efforts need to be underpinned by the global adoption of definitions of sustainable economic activities, to give confidence to investors and to prevent "sustainability-washing". The latter has taken on a new level of importance as the market considers developing Covid-recovery instruments. The EU taxonomy marks a step forward and we hope to see regulatory convergence between markets. More work is needed, however, to develop science-based transition pathways covering all sectors and regions. These are not new challenges. What is new is that the Covid pandemic presents a unique opportunity to shape a green recovery and the future of finance.

Natalie Westerbarkey

Head of EU Public Policy, Fidelity International

Covid crisis accelerates shift towards sustainable capitalism and new economic order

The global COVID-19 pandemic crisis has clearly accelerated the shift to incorporate environmental, social and governance (ESG) criteria into investment processes by asset managers. Data from Fidelity's proprietary ESG rating tool launched in 2019 shows that corporates with robust ESG ratings have suffered less financial loss on average and outperformed those with poorer ones. The correlation of ESG factors with financial performance is also increasingly evident in data published by international providers.

As a result, sustainable capitalism is on the rise and investors have a growing financial interest in embedding ESG factors into their portfolios, as the maximisation of shareholder returns at any cost no longer leads to the desired financial output. Such insight is not new; corporates with robust governance have traditionally been considered better long-term investment targets. The same applies for corporates with a strong track record on social issues, such as labour and human rights, and on mitigating their environmental impact. Ignoring these areas, we know, can result in corporate failure which ultimately destroys financial returns.

The newer aspects are the increasing investor awareness of the global interrelation between the E, S and G factors and a greater understanding of just how swift and decisive the impact of these factors on financial returns can be.

The adoption of new EU and global ESG policy frameworks provide greater clarity for investors, corporates and consumers on a common approach of what exactly constitutes sustainable finance. Hence, new ESG policies represent indispensable guidance for international finance. International finance, however, encompasses both private and public sector investments. Therefore, it is crucial that public sector actors also apply ESG standards when investing in corporates, especially where companies benefit from the large Covid-19 recovery packages provided by the EU and member states. Otherwise, it would create an unlevel ESG-playing field between private and public sector players resulting in weaker corporate and economic resilience to future shocks.

Citizens should be given the opportunity to benefit financially from this shift towards more sustainable sectors and participate in the economic recovery. This can be achieved in form of retail equitization programmes, for example, through the existing European Investment Bank's EFSI projects - the European Fund for Strategic Investment. Investor education and public awareness are key components for this initiative to succeed. The financial sector as an intermediary has an important role to play too. Fidelity recommends promoting such projects and their investment opportunity as part of the CMU, the EU's Capital Markets Union initiative. One major goal of this framework is shifting finance of start-ups, small-medium size enterprises (SMEs) and large corporates from bank to non-bank funding. However, investor capital needs to be channelled from deposits into equitization opportunities in a way that enables broad participation in future economic growth, while also ensuring investors understand the potential risks.

> *New ESG policies represent indispensable guidance for international finance.*

Given its strong governance and EU-budget guarantee, the EIB EFSI could be one such channel. The EU's European Investment Project Portal and Advisory Hub could also be used to focus on financing projects that contribute to the European Green Deal, as the High Level Forum report proposed in June 2020. Most importantly, any equitization opportunities need to be easy to understand, relatively low risk and visible to institutional and retail investors - especially those concerned about low and negative interest rates, who are seeking an improvement on their existing returns.

Time is of the essence. Setting up a European centralised information repository of EU listed companies - including transparency on their ESG data - should be a priority to make these investment projects accessible to investors quickly. This could build on the historic momentum of the EU Recovery Fund deal agreed by EU leaders in June, which aims to be operational from 1 January 2021.

Taken together, these initiatives will help economies, companies and investors chart a more sustainable course out of the Covid-19 crisis towards a new economic order, using the UN's Social Development Goals as blueprint for the 2020s decade. In this new era, only those corporates with a robust sustainable agenda across E, S and G will be able to attract significant investor capital and deliver long-term financial outperformance. ●

Ann Prendergast

Managing Director, Head of State Street Global Advisors Ireland (SSGA)

ESG: a matter of value, not values

As a result of the Covid-19 pandemic, the world has dramatically changed: it is clear that industry must take a more holistic approach to ESG, as we remain engulfed by a pandemic, the effects of which will continue to pose profound social, political and economic challenges around the globe for years to come. Some argue that the COVID-19 crisis will be a catalyst for climate action, given that the speed with which events unraveled during the pandemic could bear similar resemblance to the effects of climate change. The question is then how fast we will see the repricing of assets and changes in the economy as a result of this action.

The crisis also underscores the importance of social issues, intensifying social and economic inequities where certain demographics are more vulnerable to the virus and economic shutdown. COVID-19 has escalated ESG issues, making them demonstrably integral to corporate resiliency. As fiduciaries of our clients' assets, State Street has a duty to act in their best interests and, increasingly, this includes consideration of ESG factors relevant to the performance of investee companies. Addressing material ESG issues is essential to a company's long-term performance – a matter of value, not values.

From an investor perspective, it is important to distinguish between "values-driven investing", i.e. strategies aligned with an investor's own ESG preferences that prioritise environmental or social impact over returns, and "value-driven" investing, which incorporates material ESG factors alongside other traditional financial metrics while still seeking to maximise returns (known as ESG integration). There is a growing body of research demonstrating the value of ESG integration in investment strategies: stronger cash flows, lower borrowing costs and higher valuations are common features of companies focused on managing material sustainability risks.

ESG issues have been growing in significance for some time, as structural shifts in economies and business models driven by technology are elevating the value companies derive from intangible assets, such as brand value and employee engagement. Traditional financial accounting is becoming less complete for investment decision-making, as knowledge-based companies leverage technology and talent as major sources of competitive advantage rather than the tangible assets of old-style manufacturing. It is hard to argue that investors should ignore companies' governance or their exposure to non-linear risks, such as climate change.

Now Covid-19 reinforces our view that social characteristics are a proxy for resilience. Our research illustrates that the stocks of companies with strong ESG characteristics – such as good employee safety practices, effective supply chains and agile operations able to repurpose products to meet new market needs – suffered lower declines during the March equity sell-off than the shares of competitors with comparatively weaker ESG characteristics. This indicates that ESG integration can be an effective means for promoting a long-term investment focus on value creation.

COVID-19 reinforces our view that social characteristics are a proxy for resilience.

The public and private sector responses to the crisis serve as a timely reminder of how policymakers and financial market participants can collaborate to address critical challenges. With ESG, and sustainability more broadly, firmly at the heart of the EU's economic recovery, grey areas between material and non-material ESG issues must be resolved, to further facilitate the development of better metrics, methodologies and reporting standards. This cannot be fully achieved without greater international coordination, including leveraging the work of the Sustainability Accounting Standards Board and the global Task Force on Climate-related Financial Disclosures. Researchers are already making progress on ways to help investors better measure the financial impact of intangible ESG value drivers, such as human capital development. Improving the quality, consistency and comparability of ESG information is in everyone's interest and will clarify the relationship to financial materiality.

In an uncertain world in which ESG matters more, not less, to strong corporate resilience and sustainable performance, promoting material ESG considerations in investment decision-making is good for the long-term interests of all our clients.

NEXT EUROFI EVENTS

The Eurofi High Level Seminar
14, 15 & 16 April 2021
Lisbon - **Portugal**

The Eurofi Financial Forum
September 2021
Slovenia

The Eurofi High Level Seminar
April 2022
France

Will tackling climate risk still be a major priority post-Covid?

Sylvie Goulard

Second Deputy Governor,
Banque de France

Climate change as a source of challenges for the Eurosystem's monetary policy

Climate change is a legitimate and serious source of concern for central banks in their role of defining and conducting monetary policy.
Indeed, climate change will affect monetary policy in two ways. On the one hand, most economic variables that are critical for the diagnosis underpinning monetary policy objectives and decisions, such as production, productivity and prices, will be affected by climate change, because of more frequent and more intense extreme weather events and gradual warming and because of the adverse outcomes caused by the transition to a low carbon economy. On the other hand, the transmission mechanism of monetary policy itself is vulnerable to climate change because of the latter's potential negative reverberation on the functioning of financial markets and the strength of financial institutions' balance sheets.

> *The Eurosystem, confronted with such climate-related challenges, intends to address them candidly.*

Against this backdrop, central banks face a threefold challenge. First, climate shocks can be non-linear, making the evolution of climate-related risks difficult to predict and a significant source of uncertainty, which will make it more challenging than today for central banks to evaluate their own policy space. Then, the question for them is the following: how to assess thoroughly the implications of such uncertainty for the design of their monetary policy? With respect to inflation targeting, this may include parameters that are critical for central banks' credibility, such as the nature of the policy target, its level, or the horizon over which this target should be met. Second, central banks need to beef up rapidly their analytical capabilities to be able to factor in climate-related shocks in their models and assessments. Third, central banks should look thoroughly at the implications of climate change for their monetary policy operational framework.

That includes the eligibility, mobilization rules and the valuation of the collateral they accept in their credit operations to the extent that these assets carry climate-related financial risks, which are not properly factored in by financial markets. From a broader perspective, central banks also need to determine if and how they could play a catalytic role and foster collateral and financing practices in the financial system that are aligned with meeting the Paris Agreement 1.5°C objective. Acting as a catalyst does not necessarily mean changing the mandate of the central bank. Rather, it would imply to factor in, when this is feasible and relevant, climate-related considerations in the design of monetary policy operations.

The Eurosystem, confronted with such climate-related challenges, intends to address them candidly. Accordingly, the monetary policy implications of climate change are one of the main workstreams of its on-going strategy review, which is due to conclude in the course of 2021. ●

Keiichiro Nakamura

Chief Executive Officer, SMBCE, Managing Executive Officer, Head of EMEA Division, SMBC & SMFG, SMBC Europe

Encouraging sustainability – managing risk

Most environmental scientists now agree that climate change represents significant risks to society. Increased temperatures are causing the loss of glaciers and rising sea levels as well as extreme weather events such as droughts, storms and heatwaves. In Japan, heavy rains, floods and landslides have become more frequent and data from the Japan Meteorological Agency shows that the 10 years from 2010 to 2019 extreme rainfall events with precipitation of more than 400 mm per day -- the level likely to cause landslides or floods -- rose 170% compared with 10 years from 1976 to 1985. The possible relationship between the problem and climate change is pointed out.

Even a 1.5 degree C rise in temperatures above pre-industrial levels may bring catastrophic change. A managed

transition to a sustainable, decarbonised future is essential and many are now urging policy makers and authorities to take immediate action. This requires a coordinated set of ambitious policy responses, backed up by regulations that are clear, consistent and broadly applied.

Such policies and regulations must seek both to encourage the move to sustainability and to force economic actors to manage the risks of climate change.

The approach of the EU Taxonomy regulation, broadly speaking, is to encourage the transition towards sustainability. It will drive the necessary change by creating a unified system for determining whether an economic activity or investment qualifies as environmentally sustainable. This introduces consistent criteria for labelling a product as "green", which will be used by Member States and financial market participants respectively in the labelling and marketing of financial products.

> *...as providers of credit and liquidity banks must be agents for change.*

Certain national regulators have focused on risk management. In the UK the PRA and FCA have encouraged regulated firms to manage climate change risk by requiring their Boards and senior management to focus on their risk management systems and controls and have co-chaired the Climate Financial Risk Forum, which has recently published guidance to advance the sector's responses to the financial risks from climate change. This covers:

- Risk management – to enable better decision-making and resilience building;
- Scenario analysis – to assist in understanding and responding to future risks;
- Disclosures – to improve transparency and help stakeholders assess the future value of assets;
- Innovation – to encourage new services and products enabling a firm to respond to climate change and contribute towards a decarbonised economy.
- The PRA has now consulted on plans for its 2021 Biennial Exploratory Scenario, which will be a bottom up stress test of the resilience of the UK's largest banks to climate change risks, further informing the UK's early-stage but comprehensive set of tools for assessing and mitigating climate change risks.

Banks are subject to the risks of climate change but as providers of credit and liquidity banks must be agents for change as well. The financial sector must encourage sustainability and at the same time manage its own risks. As ever, the winners will be those firms that respond best to the opportunities and obligations presented in the years to come.

Bernhard Langer

Chief Investment Officer, Invesco

Investing for sustainability- turning an art form into a science

Sustainability and responsibility in investments are on everyone's lips, with climate change and environmental protection enjoying high attention. The 2015 Paris Agreement marked a significant step as governments acknowledged that actions are required to mitigate global warming and the impact of climate change. While historically the assessment of ESG risks was considering more of an art form than a science, the increasing availability of quantitative data allows for controlling portfolio exposures towards sustainability risks both in dedicated ESG investment strategies as well as conventional ones.

> *Invesco Quantitative Strategies is convinced that a prudent risk management should include forward-looking environmental risks.*

While ESG is clearly a multi-dimensional problem, certain aspects are clearly salient drivers: the aggregated ESG score as well as the carbon footprint of a portfolio. Managing the latter leads to the limitation of two types of risks at the same time: the contribution of the portfolio to global warming as well as the risk of global warming to the portfolio. In a recent study, we compared a portfolio with explicit carbon management to another one lacking this dimension.

The carbon-controlled portfolio aligned to the 2-degree Paris target, whereas the

naïve portfolio aligned to 3.95-degree global warming scenario. Furthermore, the financial transition risk in a 1.5-degree scenario could be dramatically reduced from a portfolio impact of -5.1% to -3.4%.

Developing climate scenario analysis is a high priority for the financial industry and financial regulators in order to be able to measure forward-looking climate risks. The results are promising but the models are only as good as the data and assumptions that underpin them, where more work is likely to be needed. Ensuring access to reliable and comparable sustainability data is therefore essential to further these developments. Beyond climate, there is increasing evidence that other environmental and sustainability risks are likely to be equally relevant, both for the planet and for investors.

The coronavirus pandemic has served to highlight the issue of biodiversity and deforestation, as well as social risks. While investor awareness of these issues is increasing, we still have some way to go before the quantification of these risks reaches the same level of sophistication as for climate risks. Invesco Quantitative Strategies is convinced that a prudent risk management should include forward-looking environmental risks. We have developed a toolset to explicitly control the carbon emissions of a portfolio without sacrificing return expectations. Those techniques play a crucial role in supporting the Net Zero goal from a financial perspective. We expect that over time, this will evolve to cover other environmental and sustainability risks as the scientific evidence increases.

Burkhard Eckes

EMEA Banking & Capital Markets Leader, PricewaterhouseCoopers GmbH

Sustainable Finance/ESG – Further progress to be made in "S" and "G"

The EU had committed itself in 2015 at the Paris Climate Summit to achieving various climate targets by 2030, embarked on an intensified course in spring 2018 with the publication of the Sustainable Finance Action Plan and then proposed a further strengthening of its efforts with the Green Deal. Europe is thus currently very consistently and purposefully oriented and the question arises as to whether this goal, which can ultimately be described as a strategy, can be achieved and whether further measures are required.

On the regulatory side, the Sustainable Finance Action Plan is initially unilateral in its approach to financial services institutions. The idea here is fundamentally correct. After all, if triple-digit billions are to be invested in environmental protection measures every year, regulation can be used to persuade the financing institutions to steer the funds in the right sustainable direction as early as the financing stage. In order to decide which investments are sustainable, uniform criteria are needed, which are successively developed by the taxonomies.

In addition, the financing institutions also need data from the investing companies in order to be able to apply the taxonomy. It will therefore also be necessary to persuade companies in the real economy to publish this data. And it will not be enough to focus only on the large companies. Many small and medium-sized banks in particular do not finance large companies at all, but at the same time they have to comply with the requirements of the Financial Services Action Plan.

The Action Plan initially focused on climate risks, even though the terms "S" for social and "G" for governance are already used in the other regulations published in 2019/20. The Covid-19 crisis in particular, but also recent business scandals, show that, in addition to "climate", progress must also be made very quickly in the areas of "social" and "governance".

Therefore, taxonomies need to be developed in these areas as well. And here, too, the second step will be to find out how financiers can obtain data for these areas. Especially for financial institutions the requirements regarding Sustainable Finance/ESG will have a huge impact on business strategy, client approach and segmentation, products/services and prices, production/provision and operating model but also on risk management, finance and capital.

> *It will become a huge challenge for Financial Institutions to collect datas from investing companies they need to be able to apply the taxonomy.*

Ultimately, Europe seems to be developing very quickly and strongly in this environment. In America and Asia there are currently no comparable consistent developments to be seen. However, one continent cannot act alone on global financial and goods markets in the long term. We must therefore try to roll out the good European approach globally. Otherwise a potentially positive competitive factor for companies and institutions in Europe will quickly turn into a disadvantage.

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PUBLIC AND PRIVATE SECTOR VIEWS

Sustainability disclosures

Ugo Bassi

Director Financial, Markets and Acting Director, Horizontal Policies, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Sustainability-related disclosures by financial entities and revision of NFRD

The urgency of the challenges arising from climate change and environmental degradation require strong action and increased efforts from all actors. In order to mobilise end-investors, we need to make it easier to identify whether and how financial entities and financial products are ambitious in terms sustainability. One cornerstone in the EU Sustainable Finance strategy is the Regulation on sustainability-related disclosures in the financial services sector (Reg. 2019/2088).

This Regulation, although *prima facie* a disclosure framework, has considerable behavioural effects: Many financial entities will have disclosed their due diligence policies on the integration of principal adverse impacts on sustainability caused by their investment decisions (i.e. the negative externalities). In order to reduce greenwashing and ensure credibility of financial products that pursue sustainable investments or promote environmental or social characteristics, any sustainability-related claim by a financial product must be well justified.

The Co-legislators agreed on an ambitious timeframe for the Regulation: most of its provisions apply as of March 2021. By then several regulatory technical standards must be jointly developed by EIOPA, ESMA and EBA. The finalisation of the regulatory technical standards faces several challenges. Whilst pioneering sustainability disclosures, the standards should ensure the overall regulatory neutrality and cross-sectoral standardisation so that end-investors can compare relevant information across borders, financial sectors and financial products. In addition, the Commission is adapting provisions on fiduciary duties and suitability test in UCITS, AIFMD, Solvency II, MiFID II and IDD rules.

The Commission also intends to put forward a proposal to revise the Non-Financial Reporting Directive (NFRD) in early 2021, which governs the disclosure of non-financial information from companies towards investors and other stakeholders.

Good disclosure of non-financial information is critical to the Sustainable Finance strategy as financial market participants need comparable and reliable non-financial information to be able to understand the risks and impacts of their investments.

There is considerable evidence that information currently reported under the NFRD is not sufficiently comparable and relevant information is not reported at all, also because of the discretion that companies have in deciding what information to report.

The revision will need to strike the right balance between materiality (information that is relevant to the circumstances of a company, that is necessary for understanding its social or environmental impacts or the risks that it faces) and standardisation (users of information need reporting to be comparable between companies and that companies report all relevant information) and find a way of combining European and global approaches. In the meantime, the European Financial Reporting Advisory Group was mandated to launch preparatory works on potential European non-financial reporting standards, including mapping of existing non-financial reporting standard-setting initiatives. ●

Frank Pierschel

Chief Sustainable Finance Officer and Head of International Banking Supervision, Federal Financial Supervisory Authority, Germany (BaFin)

Data do make the difference

With the adoption of the EU action plan on sustainable finance in March 2018, the issue of data needs has rapidly gained attention amongst legislators, financial regulators, domestically and worldwide. Sustainability disclosures are essential to meet the objective of the Paris Agreement targeting a carbon neutral economy by 2050. Rescuing our human life on earth will mark the biggest structural challenge since the industrial revolution in the 19th century. In order to achieve this goal, it is not just capital to be allocated. It is also information, education and a de-ideologised assessment of the risks ahead to us.

Now, the financial industry is put into a delicate sandwich position. Sandwich between political and social goals on one side and the needed real economy's structural change on the flipside. Financial industry is obliged to disclose information about their approaches on integration of sustainability risks into their business strategies.

It has to report on the integration of sustainability risks, on the consideration of adverse sustainability impacts, on sustainable investment objectives, ▶

▶ as well as on the promotion of environmental or social characteristics, in investment decision-making and in advisory processes. Harmonised requirements for financial companies and their products will ensure a certain standard of investor and consumer protection and will help to mitigate the risk of greenwashing.

Hence, we are faced with three key challenges: First, to fulfil its role in sustainable finance, the financial industry needs information from non-financial industries. Therefore, non-financial reporting must be enhanced. Secondly, as long as we are bound by the obstacle of limited ESG data availability, data must be pooled and publicly available to level the playing field. I plead for a publicly funded data pool of raw data. Thirdly, we need to find the right balance of information. Foremost, data must be comparable and transparent.

> *Financial and non-financial disclosures are key to bridge the financial industry's data needs to fulfil their elevated tasks in sustainable finance and the key responsibility of the real economy to make this planet great again.*

Disclosures should be simple, clear, concise and not misleading. Information overload that would ultimately confuse an investor must not happen. As well as we need to ensure that disclosures are not overly burdensome for the industry. It is of paramount importance that we may not lose track of continuing to apply the principle of "supervision with a sense of proportion" almost good practice in the roll-out of previous comprehensive frameworks.

So, the biggest challenge is creating proportionality in a field that could not be wider by now. That is why the taxonomy will extraordinary support streamlining all efforts towards well informed but not too punishing ESG disclosures.

The better all players are informed, the clearer business strategies, risk management practices and ESG cultural behaviours can be drawn, either, in the financial and in the non-financial industries. BaFin requires, for instance, a strategic assessment of sustainability risks and has issued a "Guidance Notice on Dealing with Sustainability Risks" which serves as a compendium of proportional good practice principles to be applied. However, such risk management practices just get into life when necessary data is available. ●

Jacek Jastrzębski

Chair of the Board, Polish Financial Supervision Authority

Moving towards a greater understanding of sustainability

The EU plans for the green transition envisage a major role of ESG disclosures by financial and non-financial institutions, which are the core of the Regulation on sustainability-related disclosures, Taxonomy Regulation and NFRD revision.

The urge for the enhanced disclosures regime and for the green activities taxonomy is understandable. It is true also from the Polish market's perspective that the lack of standardised disclosures is a significant obstacle to ESG consideration in business activity. A comprehensive framework is very much needed to serve as a means of harmonisation for the benefit of the single sustainable market. In particular, the essential feature of Taxonomy is that – considering the company's capex as well as turnover and opex, if relevant – it could give investors a flavour of where the company is going and how and when it would become Taxonomy-aligned. This is important especially for those EU markets where, like in Poland, many activities will not become subject to Taxonomy right away.

> *A dialogue between all stakeholders should be endorsed to the extent possible.*

Disclosures should be directed in such a way to support the market's transformation towards sustainability, but idea for a 'brown' taxonomy should not be a subject of legislative attention at current early stage of ESG standards introduction. We do not want to achieve stranded assets by legislation and this is the greatest danger

that the 'brown' taxonomy carries along. Moreover, there is the fact that industries which are the least green now give employment to thousands of people. This directly relates to the 'S' part of ESG and cannot be ignored.

Entry into force of dedicated laws and revisions will not mark a finish line ▶

for the work on ESG disclosures nor other sustainability-related issues. Disclosures alone are only one element of ESG information flow as a whole. We expect that Polish financial institutions will be keen to use the services of professional data providers – rather than to build their internal capacity in this regard. This means that such providers will play a crucial role in ESG landscape and no doubt they cannot operate unsupervised.

This supervision has to be designed in such a way to allow for the development of local ESG data providers which in practice should mean sharing competence between the EU and MS. This entails in turn great efforts to be made to achieve supervisory convergence as ESG and Taxonomy supervision would be placed on EU and local levels at the same time.

Nevertheless, localisation of ESG issues is indispensable to the extent possible as we wish to achieve a transformation on every level of existing value chains. To that end, we might need to think about the structure of the market in advance – localisation of supervision and data provision are good things to start with.

The right path to take then is to encourage openness to different perspectives and dialogue between all stakeholders. This will bring a common understanding and will contribute to safeguarding the effectiveness of our efforts towards sustainability transformation. Moreover, a constant dialogue is crucial to understand local perspectives and to streamline supervisory convergence.

The above issues were highlighted in the response of the KNF to the EC consultation regarding SF Strategy in July 2020.

Sebastien Raspiller

Director, Treasury, Ministry of Economy and Finance and the Recovery Plan, France

Transparency on ESG risks is now a democratic requirement

In 2020, sustainability disclosures are still the main tool to change investors' behaviors and corporate's strategies towards a more sustainable model. This is why French legislation has moved very early on towards increased transparency regarding ESG risks and the integration of ESG factors into investors' strategies. However, one must remain lucid about the current quality of this information and its real impact on economic behaviors. Transparency is useful in a precise framework where the relevance, quality and comparability of information are guaranteed. Confidence in and access to this information is another key factor of success. We should not seek transparency for the sake of transparency, the information must be substantial.

The wide dissemination of data on sustainability risks and strategies is useful for all actors in the economy. It enables companies to know more about themselves and to deepen their understanding of the issues at stake in their sectors. It enables investors to better manage their risks and to meet the rising expectations of savers in this area. Lastly, it enables public decision-makers to adapt regulation to collective issues as effectively as possible. Transparency is a form of collective cooperation. Transparency on ESG risks must therefore be considered as a democratic requirement.

Looking now at the concrete implications of these principles and objectives for financial regulation. France has been very active in promoting TCFD and we continue to support these recommendations. We are also still committed to the success of the One Planet Summit and the works led by the NGFS. Work at the G20 level has nevertheless come to a halt due to the international context.

We can of course only regret this, but we must now assume that the immediate future of this regulation is European. The most immediate challenge comes with the revision of the non-financial reporting directive, hopefully in 2021. We believe the revision of the NFRD should make a certain number of indicators and computing methods mandatory and contain sectoral requirements while taking into account the size of the company. It should also lead to more "connectivity" between financial and non-financial information.

Finally, a high level of standardization of indicators should not prevent companies from making individualized comments. ESG information should therefore be structured according to three levels: a universal level that makes it possible to find out how a company stands in relation to the economy as a whole and to determine an absolute level of performance and risks, a sectoral level that makes it possible to compare companies with the same level of constraint, and an individual level that allows each company to develop and value its own approach.

> *ESG information should be structured according to three levels - universal, sectoral, individual.*

We are also very keen that the work on the dematerialization of non-financial data should start simultaneously. Our wish is to see the rapid emergence of a European open data base (preferably operated by a private player). We are confident that access to the data will enable the development of risk management and non-financial performance analyses that we so desperately need to transform our system. In this regard, the involvement of financial actors will be crucial to drive these improvements.

Tobias Bücheler

Head of Regulatory Affairs, Allianz SE

Alignment and relevance of sustainability disclosures is key for its success

The EU's ambition to become the first climate neutral bloc in the world by 2050 calls for massive capital flows into sustainable investments. The financial sector has an important role to support the aspiring EU sustainability agenda in financing a broad transformation towards a low-carbon future. However, to channel investments towards sustainable assets effectively and assess sustainability risks correctly, reliable information by investee companies is needed.

In addition, upcoming EU legislation like the Taxonomy Regulation and the Sustainable Finance Disclosure Regulation can only be fulfilled if more and better non-financial information is available. At this stage, there is a strong need to align the different pieces of disclosure regulations and corresponding implementation timelines to avoid compliance challenges and liability risks for financial service providers, as well as confusion for customers and investors. The revision of the Non-Financial Reporting Directive (NFRD) provides a great opportunity to align EU legislation and improve the availability, quality and comparability of sustainability data.

In the context of the NFRD review, companies should be mandated to disclose straightforward climate-related KPIs - based on greenhouse gas emissions - which inform on core business transformation and allow for global scaling and application in global portfolios. This should include forward-looking statements and targets as well as sector-specific KPIs for key sectors, starting with high-exposure sectors. The disclosure of such climate pathways would greatly support the mainstreaming of sustainable finance towards a low-carbon economy while facilitating engagement activities between investors and companies.

The fact that climate risks are particularly acute calls for immediate and effective action with respect to transparency and comparability of environmental data. Nonetheless, other sustainability factors apart from climate aspects are equally important and hence the opportunity to improve and align non-financial disclosure in their regard as well should not be missed.

Moreover, amendments to the NFRD should focus on a high degree of integration and connectivity between non-financial and financial reporting as both types of information are required to evaluate a company's development, performance and position.

While the ongoing EU initiatives on non-financial disclosure are an important step to address the increasing need for sustainability data, a high degree of data comparability can only be achieved via international standardization. The EU should hence avoid further fragmentation and push for a maximum degree of international alignment regarding non-financial reporting.

We strongly support the EU Commission's ambition regarding climate neutrality and believe that the EU is well-positioned to take a global leading role in this regard. Reporting requirements are a critical enabler for this and the chance to develop a consistent and well aligned framework must therefore not be missed. ●

Takanori Sazaki

Regional Executive for Europe, Middle East and Africa, Mitsubishi UFJ Financial Group

Strengthening the road to decarbonisation

An increasing number of governments and individual companies globally are announcing their ambitions to commit to a net zero world. And while it is very important for all stakeholders to state their ambition, it is even more important to understand how governments, corporations and other significant stakeholders are going to achieve these ambitions. These individual roads to decarbonisation are commonly referred to as the transitional pathways.

We will need a whole economy transition in which each stakeholder is playing an important part. Net zero will not be achieved in a niece. In order to understand what the overall transitional pathway will look like, we need to rely on consistent and comprehensive data. Not only will this data help to understand whether we are on track, it will also help financial institutions and central banks assess the risks related to this pathway, while at the same time seize opportunities to enhance and potentially even accelerate the transition.

Climate risk and resilience should become a core part of financial decision making and comprehensive disclosure will enable financial institutions to appropriately adjust their strategies and build risk management capabilities. ▶

▶ The first voluntary climate related disclosure standards suitable for a broad range of companies were published in by the Task Force for Climate Related Disclosures (TCFD) back in 2017. TCFD membership support has increased exponentially to approximately 1100 organisations representing USD 140 trillion in balance sheet. 285 of the total number of TCFD supporters are public and private Japanese organisations, bringing Japan to the top of the TCFD league table.

The TCFD standards have matured over time and companies have steadily increased their disclosures in each of the four key climate risk areas covering Governance, Strategy, Risk Management and Metrics. In the EU, we are expecting the TCFD standards to become mandatory standards through the revised non-financial disclosure regulation and other jurisdictions may follow.

The Japanese financial system, including our institution as the current chair of the Japanese Bankers Association, welcomes and has continuously supported a number of globally coordinated initiatives which have developed since the first voluntary guidelines were published in 2017 to further enhance sustainability related disclosures, such as the work of the Network for Greening the Financial System (NGFS), whose mandate is to enhance the role of the financial system to manage risks and to mobilize capital for green and low-carbon investments, the work of UNEP-FI to develop methodologies for assessing physical and transition risks related to climate change, specifically focussing on carbon intensive sectors, and the recently established BCBS high level Task Force on Climate-related Financial Risks (TFCR), which is tasked with the impact of climate change on global financial stability.

It is essential to ensure that the voluntary TCFD standards are indeed appropriate and complete, before adopting them into regional legal frameworks and using them to design policy, supervisory and regulatory standards. These climate related disclosures will only strengthen the role of the financial system in the world's path to net zero, if they are used in a consistent manner by both public and private organisations and that they remain globally aligned. ●

Ingrid Holmes

Head of Policy and Advocacy, Federated Hermes International

EU sustainability disclosures: Non-Financial Reporting Directive reform is key

Investors incorporating sustainability or ESG data into investment decisions will be looking for (ideally) consistent and comparable sustainability-related information. This is difficult to come by. This is partly because the disclosure landscape today is crowded with a range of different voluntary regimes aiming to tackle a range of environmental and social challenges, and to an extent governance challenges (although these are increasingly addressed through corporate governance codes), through greater transparency. Their focus lies along a spectrum from the more obviously and immediately financially material (e.g. SASB) to the more medium term financially material and, largely, more currently public policy-focused disclosures (e.g. SDGs). While this happened for the best of intentions it creates a confusing reporting landscape for companies, which must identify the most relevant frameworks for them. It also creates a lack of comparability in the information reported to users. As such there is a clear value case to be made for streamlining disclosure regimes to bring efficiency to the system overall through cutting costs of disclosure – and, as part of that process, to ensure that disclosures are made in a decision-useful way for their intended audience, which includes investors.

'Audiences' or 'users' of sustainability disclosures will, in the main, be interested in the specifics of how companies are identifying, assessing and managing sustainability-related financial risks and over what timescale in order to better understand the risk versus reward profile of the firm and better inform their own decision-making. For this reason, preparers should keep front of mind the need to ensure disclosures are decision-useful to the different users of those disclosures. This means they should focus on what is material for the respective audiences of disclosure, which sometimes may not align with what the preparer themselves might consider material.

Consolidating the currently patchwork approach to voluntary versus legal reporting requirements will help with the standardisation of corporate reporting and so is, overall, welcome. However, for a sustainable/responsible investor this can never be a substitute for looking in detail at the information provided and the inputs and assumptions that underpin it. There is already a lot of data available (especially from large caps); the challenge now is for investment managers to contextualise it, for it to be reported in a more coherent fashion and for it to be essentially integrated into financial reporting - both narrative and numbers. Being or becoming a sustainable company is always a work in progress that static reporting cannot capture - and so it is important to look at trends as well as numbers.

Attempts at streamlining the current plethora of sustainability disclosures regime it is not without risks, however. In simplifying the complexity inherent in the sustainability agenda, straightforward but misleading reporting may result. In addition, while EU leadership on standardising reporting is to be commended, setting new EU standards does potentially risk a significant divergence between EU and non-EU markets, which is a concern given US companies, for example, account for around 50% of the investable universe. ●

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About EUROFI

The European think tank dedicated to financial services

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

Our objectives

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

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

Our approach

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

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

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

Our organisation and membership

Eurofi works on a membership basis and comprises a diverse range of more than 65 European and international firms, covering all sectors of the financial services industry and all steps of the value chain: banks, insurance companies, asset managers, stock exchanges, market infrastructures, service providers... The members support the activities of Eurofi both financially and in terms of content.

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

Our events and meetings

Eurofi organizes annually two major international events (the High Level Seminar in April and the Financial Forum in September) for open and in-depth discussions about the latest developments in financial regulation and the possible implications of on-going macro-economic and industry trends. These events assemble a wide range of private sector representatives, EU and international public decision makers and representatives of the civil society.

More than 900 participants on average have attended these events over the last few years, with a balanced representation between the public and private sectors. All European countries are represented as well as several other G20 countries (US, Japan...) and international organisations. The logistics of these events are handled by Virginie Denis and her team. These events take place just before the informal meetings of the Ministers of Finance of the EU (Ecofin) in the country of the EU Council Presidency. Eurofi has also organized similar events in parallel with G20 Presidency meetings.

In addition, Eurofi organizes on an ad hoc basis some meetings and workshops on specific topics depending on the regulatory agenda.

Our research activities and publications

Eurofi conducts extensive research on the main topics on the European and global regulatory agenda, recent macro-economic and monetary developments affecting the financial sector and significant industry trends (technology, sustainable finance...). Three main documents are published every 6 months on the occasion of the annual events, as well as a number of research notes on key topics such as the Banking Union, the Capital Markets Union, the EMU, vulnerabilities in the financial sector, sustainable finance.... These documents are widely distributed in the market and to the public sector and are also publicly available on our website www.eurofi.net :

- Regulatory update: background notes and policy papers on the latest developments in financial regulation
- Views Magazine: over 190 contributions on current regulatory topics and trends from a wide and diversified group of European and international public and private sector representatives
- Summary of discussions: report providing a detailed and structured account of the different views expressed by public and private sector representatives during the sessions of the conference on on-going trends, regulatory initiatives underway and how to improve the functioning of the EU financial market.

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