SUMMARY

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Summary

Views Magazine

Regulatory Update

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EDITORIAL

The Eurofi Financial Forum 2020 took place in Berlin in a hybrid format on the eve of the informal Ecofin meeting.

More than 180 speakers from the EU public authorities and the financial industry participated in the 30 sessions of this Forum, which were followed by more than 500 participants.

The challenges and conditions for relaunching growth in the Covid context and the main regulatory and supervisory developments in the financial sector at the European and global levels were discussed during this Forum, as well as major on-going trends such as digitalisation and the development of sustainable finance.

In the following pages you will find the summaries of all the panel discussions that took place during this international Forum and the transcripts of the speeches and exchanges of views.

We hope you enjoy reading this report which provides a detailed account of the views expressed by the public and private sector representatives who took part in this event on the economic and financial stability challenges that the EU is facing and the policy priorities for the EU financial sector going forward.

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SESSION SUMMARIES

POST-COVID CHALLENGES AND PRIORITIES

Conditions for relaunching investment and growth in the EU in the post-Covid context

1. The EU faces an investment and growth weakness

An official opened by stating that long term and productive investment are essential for economic growth. However, corporate, infrastructure, energy and R&D investments 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 the US, China and Japan over the past two decades. The COVID-19 pandemic and the global lockdown have induced a sharp slump in the world's economies. The pandemic is destroying capital, including human capital; it is causing businesses to invest less, given the uncertainty, and has led to much higher private savings, which is reducing overall economic demand. Moreover, higher public debt can have a negative impact on growth in the long-term.

In May, the European Commission calculated that, in a relatively optimistic scenario, corporate Europe would lose €720 billion by the end of the year. One quarter of all European companies with more than 20 employees would exhaust their working capital and run out of cash by then, even while benefiting from wage subsidies. This will have repercussions on growth. This very hot topic lies behind much of the thinking about the German presidency.

1.1 Low productivity growth, weak demand expectations and regulatory uncertainty

A policy maker stated that investment developments in the decade since the global financial crisis have been disappointing, in pace and quantity. The reasons are essentially threefold: low productivity growth, weak demand expectations and policy uncertainty.

When thinking about levels of investment, it is better to reflect more on the barriers, rather than having a specific number in mind. The main barrier is the low allocative efficiency of corporate investment. In Europe it is not oriented towards the most productive areas or efficient markets. This is holding back rates of returns, many of which can be attributed to inefficiencies and blockages in product, labour and other markets. This inhibits the reallocation of resources from less to more productive sources and is also linked to the unfinished agenda of the banking and capital markets union (CMU).

Regulatory uncertainty is another factor which explains the EU investment weakness. There have been some changes to not only the regulatory frameworks, but the tax framework for supporting green investments, for example. The quicker a medium term investment framework can be provided, the more investments there will be in this area.

Europe has also performed particularly poorly in artificial intelligence and other innovative sectors for several reasons: Pricing intangibles is extremely challenging; these investments are also held back by the lack of developments in banking union and CMU. Often, investments in these areas are complementary to investments in other assets, such as human capital, and technological infrastructure. If conditions in any one of those areas are lacking, it can hold back more cutting edge technologies. This is where the Recovery and Resilience Facility (RRF)[1], by supporting public investment in years to come, can play a particular role. Unfortunately, in large parts of the European and domestic markets, opportunistic power is inhibiting the capacity of rival companies to grow.

A market expert stressed two points about the situation just before COVID. First, like most advanced economies, Europe had suffered from longer downfall trends in productivity and growth alongside an increase in their share of older people. This long fall in productivity is due to a maturing of the old capitalist cycle.

1.2 Overly fragmented banking and financial markets in Europe

Lack of investment in the EU is probably due to a number of weaknesses, in the view of a market expert. Among them is that important savings are largely invested abroad. Although the euro zone has a large surplus of savings over investment, European companies do not benefit from them, largely due to the failure of CMU. There is a real paradox: the euro zone's savings surpluses do not contribute to investment in Europe.

Second, banks in Europe, which are a key component of the financial markets, are in a weaker position compared to their American competitors. Banks continue to make too little profit in Europe compared to the US. The banking sector in Europe is too fragmented, not concentrated enough and oversized. EU banks still have to absorb a significant amount of non performing loans due to the economic downturn. In addition, they do not benefit, as in the US, from a securitisation system that would help the intermediation of banks, insurance and pension funds to transfer sound risks to the market. Thus, some weaknesses have accumulated in Europe compared to the US, which has fewer rigidities and has recovered its growth.

An industry participant added that complicated access to risk capital and start-up funding, plus the fragmented financial markets, unfinished banking union and high dependence on bank lending could be reasons why low interest rates and accommodative monetary policies have not kick-started investments.

1.3 Lasting very low interest rates have developed a preference for liquidity over productive investment

A public representative evaluates how, in the last 10 years, the European economy was in a real liquidity trap and did not do enough to solve it. Lasting very low interest rates developed a preference for liquidity over productive investment. This has to be recognised. Germany's position on the current fiscal

1 The Recovery and Resilience Facility (RRF) constitutes the core of Next Generation EU (NGEU). For NGEU, the European Commission has been authorised to raise up to €750 billion on the capital markets on behalf of the European Union. The funds can be used to provide loans of up to €360 billion and grants of up to €390 billion. These will be disbursed up to the end of 2026 and repaid by 31 December 2058 at the latest. The entire loan portfolio and 80% of the grants will be assigned to the RRF. The remaining part of NGEU will mainly be used to reinforce EU-wide spending programmes under the MFF.

rules was correct; unfortunately, more could not be invested, because of the Stability and Growth Pact. Individual national fiscal policies over the last year have not been evaluated without analysing the fiscal policy of the eurozone as a whole. Maybe the necessity for a common European answer would have improved the level of investment in Europe. Analysis of this situation is particularly relevant now, following the European Council summit in July, the Commission's proposal and the position of the European Parliament, all of which are working together to deliver a fiscal answer to Europe's current crisis.

An industry representative agreed on the presence of this liquidity trap for the last 10 years. The question is what banks can add. A company will not change an investment decision if the loan is a few basis points cheaper. Relaunching investments needs fiscal policy, whether through financial incentives, implementing structural reforms or defragmenting financial markets and finalising CMU. The COVID-19 crisis has shown what governments and fiscal policy are able to achieve in unprecedented times.

1.4 Demographics and low investor confidence issues

Uncertainty and low investor confidence are given by an industry representative as other reasons why companies are not investing even when they possess the financial means. Structural factors, such as ageing societies, fragmented financial markets, EU break-up risks and the lack of a common fiscal policy seem to weigh on future returns from investment. With economic prospects often higher in other parts of the world, Europe has become less attractive for both domestic and foreign investors. Demographics are related. They make potential growth in the eurozone extremely low and, in the view of market economists, explain why companies have been focusing on other geographic areas.

Adding to what was said earlier about inefficiencies, this industry participant characterised the last decade as one of austerity measures. Looking at investments in AI and other high tech areas, a combination of public and private investment can be seen in the US and China, creating incentives for the private sector. This has been much less the case in Europe, which has somehow missed the train with these sectors.

1.5 National public banks also have their share of responsibility

A public finance representative believed that European growth is lower than it has been for the last half century. There is a role for public institutions in changing this. Keynes said: 'When facts change, I change my mind.' The public institutions did not change their minds, not only about COVID, but the crisis of 2008. The financial sector's profits have to be better allocated to produce growth that is so desperately needed.

Having addressed the structural features and demographics, the conversation began to look forward towards institutional and public policy priorities. A great bulk of responsibility remains in the national sphere, in an official's view. National support for the euro area altogether amounts to roughly €3.5 trillion. European support is roughly half of that and rescue packages are €1.3 trillion, so there is a massive need to implement domestic structural reforms and ensure the sustainability of public finances after the pandemic, as prerequisites to relaunching sustainable growth. Given challenges affecting future growth - demographics, lasting very low interest rates, collapse of world trade, weak profitability of the EU banking sector, high level of public debt in many member states – all European countries should prioritise strengthening productivity and competitiveness in the future, while promoting a green and digital economy.

2. Making Europe's response to the pandemic a success

Another official reported that Europe responded quickly to the pandemic with several policy measures designed to help the most affected countries. At the beginning of April, euro area finance ministers agreed on three safety nets worth a total of €540 billion. Each of these has a different purpose: the ESM's pandemic crisis support helps countries to cover direct and indirect healthcare costs; the Commission's SURE programme is for workers; and the new guarantee fund of the EIB can be used to finance corporate investments. At the same time, monetary policy measures by the ECB have stabilised financial markets. In July, the €750 billion Next Generation EU recovery plan of the European Commission was adopted. It is now crucial to agree on the recovery package with the Parliament and begin distribution of the funds.

2.1 The fiscal deal agreed in July by the EU Council and national responses to the COVID crisis were a significant step forward

An official earlier summarised how public action has been quick and solid, both on the national and the European sides. As well as dealing with some sudden challenges, a public decision maker described how regulatory obligations were loosened so that banks could continue providing credits and member states could support the industry. National governments also came up with support plans quickly. The first phase was to stabilise, not letting companies go into insolvency or lay off large numbers of workers because of liquidity shortages. That quick action meant money was made available rapidly.

The second phase was to provide money at the national and European level to invest in the future and stabilise economic development. The official explained how the German presidency is trying to put the heads of states' agreements from July into action. Following that painfully agreed compromise, the Commission is going to the market, for the first time ever, to raise money to be spent via the EU budget.

2.2 The EU Parliament welcomed the EU agreement on the Recovery and Resilience Facility (RFF) but deplored some shortcomings in the Multiannual Financial Framework agreement

A public representative congratulated the German Government on their excellent work in reaching agreement at the European Council. Now they need to deliver the legislative proposals that will put this package in place by the beginning of next year. The RRF is currently being negotiated in the European Parliament, which wants the same responsibility to evaluate and control the Commission as the Council itself.

The Multiannual Financial Framework (MFF) agreement was very difficult and community funds will be less than expected over the next few years. The Parliament will look for the possibility to review this, which is difficult when there is less money on the table. It needs a clearer commitment about the resources required to repay the debt that the Commission will use in the next few months to eliminate any uncertainty about policies in the 2028-34 period. This requires a strong position on the development of new European own resources that does not increase the tax burden but addresses fraud and tax avoidance. There are some further conversations to be had on the overall governance of the RRF before agreement of the Parliament with the Council, represented by the German presidency.

2.3 Making the Recovery and Resilience Facility a reality

2.3.1 Spending EU money wisely and quickly

A policy maker sees the immediate next step as converting the political agreement of July into actual legal reality. This requires not only the German presidency, but member states and the European Parliament, to get the deal over the line, so that money can start to flow. Before then, the Commission is engaging with member states on the design of their RRF plans. The scale of this challenge is huge.

RRF calls upon member states to come forward with a detailed plan covering both reforms and investments. Higher levels of public investment need to be combined with framework reforms to make sure that they are allocated to the right sectors. There will always be a risk that resources are channelled to corporates or sectors that are not the most productive and do not take account of the genuine structural changes and impacts emerging from this crisis. Emphasis has been placed on the digital and green components of member states' investment plans to help reduce investments flowing to incumbents or sectors that are poorly placed for the future of the European economy.

The RRF is designed to be bottom up, with member states taking ownership. The hope is that they take the broader European dimension into account, as they can only deliver their full benefits if they are part of a common European package.

2.3.2 Boosting EU investment and productivity for sustainable development, energy transformation and digital areas is essential from a geopolitical perspective

In the view of a market expert, this is a transitional period for the RRF, in which the economy should be stabilised. The problems will come afterwards. There are enormous challenges from the strength of Europe's competitors; in the market expert's opinion, China is already planning for 2030 or 2040, so Europe must act quickly if it wants to maintain its role in global competition. Some of this region's weaknesses have already been covered but could be summarised as a lack of investment in disruptive innovations – digital, hydrogen, artificial intelligence and health. The region lacks the infrastructure to improve productivity and must concentrate on these technological challenges alongside a strong industrial policy with such a strategic orientation. Investing in these disruptive technologies will ensure the correct pooling of resources.

The expert added that 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. Moreover, addressing technological challenges requires a European industrial policy and an EU strategy for technology funding. In this respect, a holistic industrial policy marrying finance, research, industry, competition, trade, existing local eco systems and education is vital and urgent

2.3.3 Helping economies to become more competitive

An official related how the 'own resources' decision legally allows the Commission to go to the market and raise a certain amount of money. It also regulates repayment over a longer period, whereas the RRF sets out how to spend that money. Each member state needs to file a comprehensive reform package before it can access this money to ensure that it is channelled to the right areas. Helping economies to stabilise is fine, but this is helping economies to become more competitive and to build the foundations for future growth, avoiding the same liquidity trap of the last 10 years. It will ensure a V shaped recovery.

2.3.4 Defining the appropriate governance

Turning to governance, an official described how what is first needed is for the Commission to draw up guidelines that will form the conditions by which member states can create the programmes to access European money. This should show how to implement climate and digital targets, and how to achieve the mixture of investment and reform required. The second imperative is to get the governance right, so that decisions can be taken quickly. When it comes to disbursing the money, the milestones have to be clear cut too. Another recommendation is for the member states to talk to people in the market – stakeholders, smaller companies and young firms – about what is needed from the reforms. Those discussions then need to be integrated into their plans.

2.4 Public finance plays a key role provided restrictive measures on public funding are alleviated

A public finance representative explained how national promotional banks (NPBs), as countercyclical actors, have an active role to play in financing the EU economies. Long-term investment projects need a system that uses NPBs or public finance as support. They are enablers to relaunch investment, as they trigger a high leverage effect, and they are prepared and ready to act. In this context, it is essential that they should continue to benefit from the active support of InvestEU. Hence the agreement reached in July, when InvestEU went from €38 billion to €23 billion, caused some disappointment. The public finance representative believed that this July EU agreement sent some contradictory and risky signals. Europe was not made by grants over the last 70 years. Among expected clarifications, restrictive measures on public funding should be alleviated by generalising and simplifying the possibility of mixing European subsidies and investment with public capital.

2.5 Implementing domestic structural reforms and ensuring the sustainability of public finances after the pandemic are prerequisites to relaunching sustainable growth

A policy maker noted that many speakers praised the MFF plan as exceptional, but one central obstacle remains: the past shows that money alone does not ensure recovery; what really matters is reform. The direction of the reform needed is clearly twin – green and digital. Other reforms are horizontal to the functioning of the economy, such as in public administration and governance, but reform is not easy.

Hence the recent creation at the EU Commission of two new DGs, DEFIS and REFORM, and a Secretary General with the role of coordinating these efforts. Likewise, the technical support instrument of the EU Commission was increased by about 40% in the negotiation of 17 21 July. The lifecycle of any investments must also be kept in mind; it is not only a point in time that matters. The policy maker compared this instrument to the ESM, which enters the financial markets to acquire money under privileged conditions. Technical support does the same, not on the financial markets, but on the knowledge markets. This money is then passed to the beneficiaries of over 1,000 technical support projects across the member states. Ownership is essential and projects must be constructed from the bottom up, if these countries are to realise the reforms they envisage. There is perhaps little contradiction between the ownership of member states and Union priorities. After all, the latter are decided by representatives of the people of Europe. An official (Strauch) also praises this instrument as one of the most successful projects of the Commission.

Another official reminded participants how a number of interventions suggested that European economies had not taken full advantage of the last 10 years. Some had not fully recovered from the financial crisis and their public finances were not in the best condition before the Covid crisis. Thus, member states do not have the same budgetary resources to deal with the crisis and this increases the risk of economic fragmentation between countries. The sustainability of public finances will continue to be a concern in the years ahead. Member states need to implement the structural reforms now that will improve the business climate and increase potential growth.

The RRF cannot have a permanent role in the eyes of a market expert. It shifts the burden largely to the states to reduce their current unproductive expenses and increase their infrastructure investments. This will help the industrial policy of the European community to prepare for the big challenges of the future, such as the security of its maritime borders, defence and immigration. Member states must adapt and invest in strategic new sectors, improve the size of their start-ups and adapt competition policy to avoid more examples of predators picking up the best technology firms.

2.6 Completing the Banking Union and implementing the Capital Market Union are urgent priorities to ensure an effective funding of EU economies

An expert stated that achieving Banking Union and CMU is no longer a theoretical wish; it has to be taken seriously, with securitisation and an enforcement of institutional investor capabilities to channel savings. An industry representative recommends better cross-border capital flows between EU countries to facilitate the development of equity instruments that will help Europe to compete globally. In comparison with the US, there is a greater role for venture capital and start-up financing in Europe, which will be essential in ensuring recovery.

A public representative stated that the problem with the current orientation of the new RRF is that it may have missed the real bottlenecks in the European market, which are a lack of a real CMU and, ultimately, financial fragmentation. These cannot be solved through national structural reforms only. Ultimately, European policies are needed, but Parliament will deliver. These efforts have to be accompanied by thinking on a European level with revisions of Basel that take into account the impacts of the current crisis, particularly the development of zombie companies. This work is essential so that all the other efforts will succeed, an official stressed. A policy maker agreed and advised interested parties to consult the CMU report of the High Level Forum, which covers many of the issues discussed by the panel.

A public finance representative added that priority must also be given to the functioning of the economy by encouraging both debt and capital financing. This requires an easing of prudential measures which, in the current situation, risk leading to the financial embolism experienced in 2008. It will also be necessary to introduce incentives, such as financing the deferral of debt repayment in favour of riskier investments, either because they are long term or will contribute to the general interest by being focussed on areas such as hospitals, affordable housing or education. An official had talked about a spike in bank lending because companies had needed bridge loans during the COVID crisis, but not in all European countries. In others, bank lending had stagnated, reported the industry representative because guarantees came directly from the state or EIB instead. Regulations might be amended a little, but the way forward is more CMU and open access to venture capital. ■

Is the EU response to the Covid 19 economic crisis fit for purpose?

1. Europe's response to the pandemic is a significant step forward Europe responded quickly and appropriately to the pandemic with several measures designed to help the most affected countries

1.1 A major achievement

With the Coronavirus Response Investment Initiative (CRII) the European Commission aimed to mobilise around €50 billion for crisis repair. Ventilators and medical equipment were supplied in Spain, innovative syringes in Belgium, telemedicine in northern Italy, small and medium enterprises in Greece, tele schooling in Poland, and masks, ventilators and small and medium enterprise jobs everywhere.

An official considered that a common response from the European Union to the crisis has been achieved, which started with the immediate measures of activating the general escape clause, the exceptional framework concerning state aid, CRII and the extension of the solidarity funds taken in March and the April decisions by the Eurogroup for the €540 billion programme. A temporary solidarity Instrument (SURE) has been established to support protecting workers and jobs in the current crisis. The EIB will create a pan-European guarantee fund of €25 billion to support up to €200 billion of EU businesses, in particular SMEs, throughout the crisis. The ESM has also provided pandemic crisis support, in the form of precautionary credit lines. The only requirement to access the credit line being that euro area member states requesting support commit to use this credit line to support domestic financing of direct and indirect healthcare, cure and prevention related costs due to the COVID-19 crisis.

In July, the European Council agreed on a Recovery and Resilience instrument and a new Multiannual Financial Framework (MFF) for the period 2021-2027, with an overall package worth €1.8 trillion. Trilateral discussions started as quickly as possible.

A policymaker commented that common borrowing to scale up the common budget to an unprecedented dimension to finance a green, digital and balanced recovery has never occurred before in the history of the EU. The Recovery and Resilience Facility (RRF) comprises €312.5 billion in grants and up to €360 billion in loans to support public investments and reforms. The Commission has established a new Directorate General, DG Reform that will support member states to implement such structural reforms.

1.2 Europe reacted swiftly and appropriately to the pandemic

A public representative emphasized that the European Parliament was very pleased to see the responsiveness of European institutions. All the draft reports related to the Next Generation EU Plan have been prepared by the ECON Committee. Amendments are being tabled, which will soon move to compromises. The plan is to vote everything in the Committee by October. The biggest one, the RRF, should go to the plenary in early November. It is vital that the ratification process of member states should start as soon as possible.

An official stated that all institutions have learned the lessons of what occurred in the Global Financial Crisis (2008). The rapidity of the reaction is extremely important. There is confidence that the EU agreement will be finalised with the European Parliament and the Council of the EU by the end of the year so that everything can start in January. Support for the economy is needed, both in the very short term and in the long term. There will be new challenges on how to use this money effectively and to ensure that it is well spent. Each country in Europe is in dialogue with the Commission to ensure that it is well used. The green dimension is fundamental.

An International Financial Institution (IFI) representative commented that they are impressed by the size and the speed of the package, especially compared to what the EU tried to achieve in 2008 to 2010. The sense of emergency responsibility has been there, and the employment and investment priorities are clear.

An industry representative pointed out that the handling of the first wave was a quick and appropriate answer to something extraordinary. European and national public authorities and central banks deserve credit for providing answers, which have dramatically limited the damage, particularly in the financial sector. A second phase will be a massive shock. More long-term structural growth needs to be rebuilt, which this package will contribute to. In itself, it will probably not be enough, but at least it is a significant and very structural element.

1.3 A common answer viewed positively by the markets

Another industry representative is of the view that the package is larger than the market expected. The EU has been much more coordinated in its response to the pandemic, having learned in the aftermath of the Global Financial Crisis (GFC) that much coordination is vital. The package is large enough that it makes a difference economically. Europe is leading the way globally, whether it is on digital or green, which are the right priorities to focus on.

1.4 Implementing the EU recovery agreement quickly is essential

An IFI representative commented that what has been very striking is the speediness in decision making. The speediness of delivery is very important, as well as the instruments being workable by the private sector and smartly linked to reforms.

An industry representative considered the capacity to implement this EU recovery plan quickly crucial. Banks have worked very efficiently with national authorities and governments. It is important to contribute to finding more structural solutions to help, as well as limiting the destruction of production capacities. Money is needed, with a different split between equity and debt. Europe needs to have a financial system, which would be able to accompany structural growth and fund productive investments.

2. Much remains to be done

2.1 Avoiding a self-congratulatory feeling

An industry representative warned against the emerging self-congratulatory feeling about having managed the first wave of the crisis. The virus is going to be with the world for a long period of time, and Europe needs to look at whether it will have the resilience and the dynamics to manage this long-lasting crisis. Europe has managed the first wave of the crisis despite its complexity rather than because of it. Meanwhile, some projects have been put on the backburner for a few months or quarters, such as the Banking Union (BU) and the Capital Markets Union

(CMU) with appropriate involvement of international players. Other issues like structural domestic reforms have been on the backburner for years or decades.

Europe needs to refocus on reforms and more agile and dynamic structures are needed in decision making within the EU. Some EU countries that had many buffers in their systems coped well early on with the crisis but it is important to re-establish more sustainable structures in almost every dimension of the EU; first and foremost this would involve the BU and the CMU. This crisis is a great opportunity because the Recovery and Resilience Facility is a sizeable fund. However, Europe has reacted in an instinct to finance projects through debt, rather than admitting that if there are European tasks and expenditure then Europe needs to design revenues (own resources) for the European level in order not to rely on the debt only, as it has always done in the past.

2.2 Fiscal risk in the monetary union has not been addressed by the EU fiscal agreement

An official considered Austria as one of the countries that has been more critical and difficult in the process but agrees that the response taken is the correct one. Austria is still sceptical because there are some problems in the medium term that the markets have not yet priced in. Pouring lots of liquidity into the market by mutualising debt but not strengthening fiscal rules cannot be repeated.

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. Some member states are now in a particularly weak position to address the economic fallout, and differentiation according to country risk has re-emerged. There will be huge political problems if the EU member states do not do their homework.

An IFI representative stated that the lessons of 2010 need to be drawn on, to use the market condition and the action of the ECB to avoid excessively quick fiscal tightening at this stage. At some point this will require the Stability and Growth Pact (SGP) to be back in the equation, otherwise the very disruptive opposition between frugals and spenders will come back in the coming months and years.

An official noted that for a number of countries the EU recovery plan is a huge amount of money. It needs to be used as leverage for reform. Discussion is needed on the fiscal strategy and fiscal consolidation. State aid is a short-term challenge. The Commission reacted very quickly, adjusting its state aid framework to facilitate liquidity support for companies through banks and balance sheets. That needs to be phased out and to move into 2021, because there is a temporary state aid framework until the end of 2020. Traditional issues such as the CMU and the BU need to be brought back into the discussion, as the impact of the crisis on the financial sector will be very important and there will be some scars.

2.3 Finding agreement on increasing the EU's own resources will be challenging

2.3.1 New own resources to repay EU Borrowing

An official hoped the informal Ecofin taking place in Berlin would be used to start the debate on the conclusion of the July EU summit on own resources and to strengthen the own resources of the European Union. A dedicated session would take place at the informal Ecofin that would cover the question of the specific own resources that were named, such as the European Emissions Trading System (ETS), the Carbon Border Adjustment (CBA), new plastic levy, digital tax, and the Financial Transaction Tax (FTT).

An expert asked a public representative how they see the own resources discussion in the European Parliament, and whether it would be supportive of those ideas. The public representative stated that the European Parliament has been supporting this for a very long time. Another concern was that the significant effort currently being put into the recovery fund might have a negative effect in the long term on the budget and MFF. That is, if additional, genuinely new own resources are not found to ensure that in the future there is the room to pay for both debt and to support the European programmes that the EU would like to continue to support.

2.3.2 The introduction of new own resources will be a medium to long-term project

An expert noted that a number of proposals have been put forward for the own resource package, such as border adjustment tax, plastics tax, and even a financial transactions tax. It will be very difficult to agree. An official agreed. The concept of unanimity will make it difficult to achieve agreement, but the plastics duty was unanimously agreed. That was a first step, and there was agreement to discuss others. The Carbon Border Adjustment Tax could be a very important shift towards pricing in some of the negative externalities seen.

An official considered that this debate has been with the EU for a very long time. There is now a new incentive, which is that the debt will have to be repaid; it will be much better to find new resources to do that. The discussions in the informal Ecofin are eagerly awaited. It is unlikely the 27 would have an agreement on enhanced cooperation. ETS makes a great deal of sense because it is completely consistent with the green agenda.

An official had no illusions about the difficulty of that debate and expected that the issue of repaying the debt for the next generation EU will give the debate on own resources a new push. The biggest surprise at the leaders' conclusions was the inclusion of the words 'financial transaction tax'.

3. The crisis presents an opportunity for CMU, BU and the digital union projects to be moved forward

The crisis has caused significant market disruption, but the projects which could assist recovery are already underway. A political agreement at the EU Council of Head of States is required for achieving a more genuine single market for financial services.

3.1 For more integrated banking and capital markets in Europe

An industry representative anticipated the world in which banks are going to operate and compete to be even more complicated than six months ago. There is intense competition, a world of tangents, a world of uncertainty, and a world of low rates, sometimes negative, for a very long time. The banking sector needs to absorb the shock but also to finance the economy and projects. Europe needs to be better integrated. Accessing a diverse pool of equity financing requires deep capital markets and consideration should also be given to the coordination of supervision, and the relative tax and regulatory treatment of debt and equity.

Another industry representative stated that the CMU needs to be a priority for the Commission in order to help banks to recover, consolidate, and develop securitisation markets. Investment in digital finance and the green deal needs to take place over the next 10, 20 and 30 years and cannot be done by bank finance alone.

An industry representative was encouraged to hear that there is a willingness to make further progress. The industry will see formidable challenges, such as digital transformation, and needs to be able to invest in order to transform. The industry needs to be able to generate the capital that is required for Europe. The gap has widened with the US, both in terms of profitability and market value. Securitisation sometimes has a negative connotation in people's minds due to the financial crisis, but at the same time it is an instrument which is at the heart of the development of capital markets. Such markets are not just equities or bonds. The industry needs to try to find out what is needed to further improve and deepen the securitisation market and make people more comfortable with this relatively simple and necessary tool.

3.2 Reaping the benefits of a single market for financial services

Unlocking the single market's full potential and the complete range of its benefits, especially in financial services, will provide the much-needed funding to support economic recovery and finance a sustainable transformation. One of the key challenges to overcome in the deepening of the single market for financial services has been regulatory fragmentation. While much 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.

3.2.1 The single banking and financial market has not been achieved so far

An industry representative stated that overcoming regulatory banking fragmentation should be a first step. National options and discretions in the prudential framework should be further harmonised in order to avoid unwarranted ring-fencing practices and let banking groups allocate capital and liquidity across multiple legal entities as are needed and are economically sensible. There are still more than 30 provisions, which require further harmonization. Further steps to complete the BU are also needed, particularly a single EU crisis management framework for further risk reduction measures and a common deposit guarantee scheme. EU depositors should be able to move and use funds across and in different countries seamlessly and without additional charges.

An IFI representative stated that overcoming the fragmentation of capital markets and ring-fencing practices should be a priority. The most difficult response is completing the BU. Europe needs to look at softer ways of coordination between supervisors and the private sector. The Vienna Initiative has worked well. Regarding the CMU, the EBRD is trying to oversee the development of local capital markets in smaller markets and has created a pan-Baltic capital market.

3.2.2 Drawing the lessons of the US experience?

An industry representative explained that, regarding the BU and the CMU, Europe is still awaiting what the US had in 1863 when it created the National Bank Act, which supports uniform U.S. banking policy. Europe still has international bank account number (IBAN) codes that are allocated at national level rather than a single EU IBAN allowing IBAN discrimination within payment systems. This needs to be overcome to establish a truly integrated single European payment platform, given the payments system is the backbone infrastructure of the financial system. In addition, the EU has a single supervisor but is still a conglomerate of 27 countries with 27 regulators and another regulator on top, which adds to the complexity. It is important to start at the European level and have European chartered banks that can work across jurisdictions. Europe needs to create a European league of banks if it wants to create European markets, rather than just national champions.

An official agreed with most of what has been said on the BU, but the US is slightly overrated in that respect and Europe is underrated. The ban on interstate banking in the US was a complete ban. One issue where Europe has an advantage is the supervisory system. It does not have the Office of the Comptroller of the Currency (OCC), established in 1863. The US also has state regulators, state chartered banks, national chartered banks, financial holding companies, and the system of functional supervision where every regulator just looks at function, leading to the fact that a financial institution in the US sometimes has to deal with 15 different supervisors. Europe is lucky not to have that. However fresh thinking is needed in Europe in some areas. The Single Resolution Fund and deposit insurance should be one fund in Europe as in the US and this could make the discussions on EDIS easier. Regarding the CMU, for a long time US banks were banned from holding equity in non financial companies, so there was no way a corporation could get equity from a bank. Naturally, that led to the fact that the US needed to develop capital markets out of sheer necessity. It was not by design; it was by default.

3.2.3 The benefits of a single market for financial services

An official agreed that many empirical studies have shown that when the US relaxed their restrictions on interstate and intrastate banking in the 1990s there was an increase in growth potential due to a better provision of lending and cross-state banking services. The European Union has a buffer that can still be accessed if it finally agrees to enact the Lisbon Treaty. The sister project is the CMU. If Europe wants its banks to scale, then it has to find an idea of how it can move away from the massive overweight of bank lending that it has in terms of the provision of financing to its real economy. That allows the corporates to also fund themselves through markets, which is the second big potential that Europe has in terms of catching up with the United States.

An expert noted that not all barriers inside the United States have been broken down, such as in insurance. The expert asked whether panellists are convinced by the economic evidence of that, and whether the policies introduced in the 1980s and 1990s actually increased the growth potential of the United States.

An official stated that the empirics are there. It is impossible to imply direct causality, but it is a very reasonable assumption.

An industry representative considered that in the US the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (IBBEA) brought significant efficiency gains. Banks and holding companies were heavily regulated and had lost competitiveness to more innovative, less regulated entities. Lastly, Europe does not need a Glass–Steagall Act because European banks are not big players in investment banking.

3.3 Achieving a political agreement at the level of the Council of Head of States is essential for moving forward

A public representative noted that the European Parliament shows a bipartisan, horizontal desire for a real European capital market, and for seeing the Lisbon Treaty fully implemented. The problem is that every time Parliament tries to push these issues there are 19 or 27 national authorities that could be sceptical or unwilling to give up their own prerogatives and competences.

An expert considered that the High-level report on the CMU has put a great deal of emphasis on a new type of process. There has to be political agreement at the highest level.

An official noted that there is a lack of progress on the BU and the CMU. It is unclear whether the crisis would help, because on banking issues the previous crisis had more of an effect to entrench national positions and enhance barriers to avoid the risk of having a subsidiary left alone without liquidity. The key element is whether Europe wants to be dependent on external banks and US banks, or whether Europe wants to have its own capacity to think of itself as an independent power with its own infrastructure and financial capacities (intermediaries, investors, products...). ■

Should we be concerned about post-Covid financial stability?

A regulator stated that the headline question for the panel is whether there should be concern about post-COVID financial stability. Of course, there should, but the panel would be an opportunity to dig deeper into some of the economic and financial threats in the wake of the pandemic. It would form a stocktaking of what has been seen so far, what was surprising and what is to be expected.

1. Overall, the financial system has proved to be broadly resilient to this crisis to date, but the crisis is far from over

1.1 Despite the adverse macroeconomic impact of Covid-19, the EU banking sector has proved to be resilient

The first round of discussion would look more at the macroeconomic impact of the pandemic. At its onset, EU bodies, national governments, central banks and supervisory and resolution authorities took unprecedented action to support the economy and preserve financial stability. The EU financial system entered the crisis more resilient and better placed to sustain financing as a result of the G20 regulatory reforms in the aftermath of the 2008 crisis. In particular, the greater resilience of major banks allowed the system largely to absorb rather than amplify the macroeconomic shock.

A regulator saw that markets largely functioned as normal. However, there was some movement to cash and, despite expectations of strong global growth returning, the recovery has been slow so far and the economic impact will be felt over time. Another regulator believes that it was the swift and bold policy actions adopted by the authorities, including some unprecedented monetary and fiscal measures, that cushioned the global hit and safeguarded financial stability. A central bank official agreed that the global financial system withstood the shock well, thanks to the collective effort of the last 10 years and the forceful reaction of public authorities and central banks.

1.2 The impacts of the pandemic on the level of risks in the banking system

A regulator mentioned how there was a fair amount of activity to make sure that liquidity was provided where needed and an early assessment of risks to avoid excessive pro-cyclicality. Going forward, every bank must carefully reassess the risks in their portfolios and exposures and make provision for them. An industry representative explained how banks are doing just this, taking a more granular approach to the assessment of their clients, as different sectors of the economy are likely to have differently shaped recoveries. The German Mittelstand, for example, will see some problematic defaults. Overall, however, most sectors are well capitalised and do not exhibit any systemic challenges that will spill over into the financial system. Leisure and travel have more problems, so the exercise that lies ahead is to run these analyses and take a more differentiated approach to the various regions and segments.

Supervisors are always extremely interested in what exactly is being done to cope with over indebtedness and this regulator is more sceptical about the capacity of a Mittelstand dominated economy to absorb shocks. An industry representative agrees that these efforts are only a starting point, but likewise supervisors may need to use the banks and other financial industry players when evaluating risks, as their windows into the real economy.

Another industry representative reacted to the panic of the late first and early second quarters by taking some big impairments, in particular because of IFRS 9's forward way of looking at things. Since then, European and national authorities have done a lot to reassure corporates and private individuals. There was a big drop in GDP in Q2, but it did not really matter to the banks, because loans and salaries were still being paid. In fact, some very big corporates opened their lines to ensure access to liquidity. Banks saw an increase in deposits too, both from private customers and corporates. Some sectors did very well, for example agriculture and housing in Denmark, but there are indicators developing that show the recovery might be W shaped, with several major cities entering a second lockdown. There is a limit to how much the authorities can be depended on for support. On the other hand, participants are better prepared now, so perhaps there will be fewer disruptions to liquidity despite some credit losses.

1.3 The release of buffers contributed to keeping banks on supporting the economies

The second round of questions would centre on policy measures in the short and medium terms. A regulator started with the capital and liquidity buffer issues, which another regulator described as important components of the regulatory toolbox that had been applied over the past few months. Many other issues have to be considered now, such as insolvency applications and the danger of zombie companies. The first regulator elaborated that the application of key regulatory measures ensured the competitiveness and efficiency of the banking sector and its ability to replenish capital buffers in the future.

The EBA had encouraged supervisors and banks to make use of the flexibility embedded in the regulatory framework. Early in the crisis, one of the key questions confronting parties was whether the regulatory reforms had enough flexibility built into them to be applied to a downturn of this size, without creating pro cyclicality and a bottleneck in the delivery of funding. In this regulator's view, the release of capital and liquidity buffers early on sent a message to the sector and society in general that the banks were able to help in this process, but there are still some lessons to learn. In parts of the euro area, liquidity buffers had been built but could not be released. In other areas, they were not even in place. The situation was not homogenous, which led to the paradox that buffers may have been released in parts of the economy whose need was not as great as others.

A regulator was keen to hear more from the panellists about the banks' usability of those buffers for relief. There was the sense that some were reluctant, sometimes because of a perceived stigma from stakeholders, at other times because they feared damage to their franchise. Supervisors have been providing more guidance on how long the buffers are expected to last, so all banks should count on taking time to rebuild them, with clear guidance on how to.

Another regulator acknowledged how quick and coordinated action from regulatory and supervisory authorities enabled some leeway in reporting and other requirements in the short term. They adopted a pragmatic and flexible approach, using the existing flexibility of the legal frameworks without undermining their credibility. The clear message is that the regulatory framework is fit for purpose. The framework has proven itself, otherwise the banks would not have been part of the solution. The regulator concedes that the SRB could not postpone Single Resolution Fund contributions since the SRB could only apply the legal framework in force.

1.4 The economic and financial outlook is still largely uncertain

The Covid 19 pandemic constitutes an unprecedented global shock. At this stage, its full and final impact is not known. A regulator gave the latest ECB forecast as a GDP decline of 8.7% across Europe but, whether the downturn turns out to be mild, medium or severe, it will raise concerns for both the real economy and financial services. Another regulator stated that all were confronted with large uncertainty about the speed and strength of the recovery. Many have moved from saying that it could be very quick to saying it may not be at the same speed in different parts of the world or of Europe. Another regulator detects a drop in V shaped predictions; the majority of market participants now anticipate a W or U. The view from another public decision maker is that they might need to stretch the alphabet further.

1.5 Regulators need to continue to work intensively with their EU and global counterparts to address common challenges, share insights on respective market developments and coordinate responses where appropriate

The crisis has demonstrated the value of close and pragmatic cross-border coordination between regulators. One regulator reported how peers are already looking to what lessons we can learn from this crisis. The FCA, together with its international regulatory partners, including within the Global Standard-Setting Bodies, FSB and IOSCO, are looking at what has happened during the pandemic, including the early phase and the impacts of national lockdowns on the markets. Where it sees pressures, they are acting. However, to inform longer-term responses, the FCA, together with other regulators, are developing a complete picture of how elements of the system - , banks, non banks and market infrastructures - are interconnected and how they function under extreme stress, and then potential vulnerabilities can be identified and resolved in the future. Forming this holistic picture is a challenging undertaking, from a data and analytical point of view according to the FCA, as early evidence within this area of work suggests there are significant differences between jurisdictions, market segments and even firms and actors within the same sector. From the FCA's perspective, the markets are functioning well, and the system has proved itself resilient, but the crisis is not over, and the international community must continue acting together.

Another regulator followed up with the perspective from BaFin. Its biggest concerns came in mid March to early April, when there was less capital and indebtedness, so liquidity. Another regulator agrees that there was extreme volatility during this period and central banks stepped in to support the market. Early evidence suggests there were significant differences between jurisdictions, currencies and market segments, so it is difficult to draw firm conclusions, but there is a common sense that central bank interventions helped with market liquidity and reassured market participants. The issue continues to be explored carefully, as part of considering whether to take any further regulatory steps in the future.

Another regulator emphasised that the cooperation evidenced between supervisors and resolution authorities this time must be repeated as they search for answers together.

2. Financial stability concerns are significant when it comes to the outlook for corporate indebtedness, asset quality and the profitability of the EU banking sector

2.1 Corporate debt ratios grounds for concern

A central bank official warned that no one should be complacent. There are a number of risks and liabilities ahead, which were reinforced by the first stages of this crisis. So far, corporate indebtedness has not transformed into a significant and destabilising insolvency shock for a number of reasons. The asymmetry of the macro impact of the COVID sanitary measures and those taken by the public and private sectors helped contain the liquidity issues. This has come at the price of increased indebtedness. An upturn in insolvency risk now could weaken banks' balance sheets resulting in slacker consumption and, in more extreme scenarios, greater credit risk.

There are a number of possible triggers of an increasing insolvency shock: a sluggish recovery, a double dip recession related to the management of the pandemic, the withdrawal of some of the measures taken to address liquidity risks and the end of the moratoria on social and fiscal debt repayments. From a financial stability perspective, it is important to support the capacity of the system as a whole and to strengthen the mitigants of risk. It is essential to support funding for corporates, not as debt but as equity. This is being addressed in many jurisdictions and can help in withstanding future shocks. Another question is the situation for non bank financial institutions (NBFIs) and funds. Massive downgrades could trigger a new liquidity shock alongside the solvency one.

2.2 The Covid-19 crisis should lead to a sharp increase in loan default rates and NPL stocks across Europe

A regulator outlined how market participants are being confronted with large increases in the debt position of corporates and sovereigns. The banks' number one concern is that this increase, joined with a slow recovery after an aggressive shock, is likely be transformed into an increase of non performing loans (NPLs). This is problematic because they will further impair balance sheets, depress credit growth and delay recovery. The size of the hit on the sector depends on the effectiveness of public policy measures. The guarantee schemes initiated by a number of countries supposedly provide a backstop for the large numbers of NPLs in certain sectors but, nevertheless, some of these changes will spill over into the banking sector.

The vulnerability assessment conducted early in the spring suggested that the banks were well enough capitalised to stop the pandemic and confront a large downturn in the system. The size of that downturn is still to be determined, so it will need careful monitoring and discussion. That assessment will need to make sure that each institution is working properly, as the pandemic accelerated a number of trends that were already underlying the financial industry, particularly the banking sector, before the crisis began. Another regulator advised that regulators and authorities now need to be careful to distinguish between companies with a decent business model that warrants support and celebrating the past by keeping things going for incumbents. 'Zombification' is still something to worry about, as it reflects a postponement of insolvency procedures and a prolongation of unnecessary support.

2.3 The structurally low profitability of the euro area banking sector remains a concern for financial stability

A regulator reviewed how profitability had been a challenge for some EU banks, even before the COVID crisis, as they faced intense competition and overcapacities in some markets, coupled with sticky operating costs. Another regulator also commented on this severe profitability pressure. Asset quality deterioration would create an additional burden for institutions that are still recovering from the financial crisis. If the situation were to worsen, the depletion of bank capital would be material.

An industry representative agreed about on the low profitability of many European banks, but an analysis has to be made of which branches and companies are viable. Many with minor problems right now will easily survive, if the economy comes back running. In such a context, participants are urged not to implement the so called Basel IV rules or place themselves under extra capital requirements right now. A proper impact assessment at the end of the crisis must be made when deciding which regulations actually work, before creating more.

Another industry representative agreed that, in the near term, managing credit risk will be a major topic for every player. Beyond that, the crisis will act as a catalyst of margin compression in the industry, increasing pressures on capital requirements. Every major player is focused on costs, but there are limits. Sooner or later, businesses will think more about scale and thus consolidation. For larger players, cross border consolidation is really the only option. A dialogue is needed on whether there is political and thus regulatory support for this to encourage financial stability going forward. The Capital Markets Union (CMU) is another approach to strengthening the stability of the system thus supporting the real economy.

2.4 The technological transformation of the banking industry is also challenging

Another trend that has clearly accelerated as a result of COVID is technological transformation. Going forward, the key policy tool is stress tests. These stopped abruptly when the crisis arrived, but they should be relaunched in January next year. A regulator is actively engaging with the ESRB to make sure the scenarios are appropriate. This will be another opportunity to better assess the evolution of the crisis and how the banking sector is dealing with it.

2.5 The stress in a number of core markets in March 2020 laid bare the vulnerabilities of market based financial intermediation

A regulator summarised much of the above remarks as the re emergence of the three big Cs in the years ahead: credit risk, cost management and consolidation. Panellists were asked for their views on any other vulnerabilities. The central bank official stressed that the impact of COVID 19 on financial markets brought the growth of NBFIs and their role in financing the economy under the spotlight. As tools for liquidity management, NBFIs have shown their usefulness, but also their limits, in a stressed context where shocks are likely to be amplified. A clear illustration of this is provided by what happened to money market funds in March, with significant outflows and an impact on short term funding segments.

The forceful central bank actions taken at the height of the crisis were essential for stabilising markets, but they should not be the new normal for central banks to step in when there are shocks. Without prejudging the outcome of the post mortem underway, the central bank official believes in the need to contemplate revisions to the regulatory framework that governs the valuation of funds and the calibration of liquidity buffers, and to complete the toolkit with a suitable macroprudential framework. Less pro-cyclicality is needed in funds' behaviour and liquidity risk management will achieve a stronger and deeper CMU.

A regulator agreed about the importance of understanding what happened during this crisis and not prejudging it. There is no easy answer because there are differences between how currencies and markets operate. The bank and non bank markets are also highly interconnected, so they need to be looked at as a whole. It could be that regulatory changes made in the light of the last crisis will move risk elsewhere, so caution must be exercised in attempting to reduce risks in one sector, as to not simply transfer it to another part of the system. It is also necessary to ensure that any changes to regulatory frameworks in response to the pandemic do not undermine the markets' ability to perform their essential functions – to allocate capital and manage risks. There must also be recognition that the non bank sector will be critical in enabling recapitalisation to promote growth.

Another regulator appreciated the advice about NBFIs. They repeated the mantra: same business, same risk, same rules. A further regulator did not feel that the famous headline 'shadow banking' has been helpful, as it disguises huge differences in business models across the non bank field. A regulator considered the picture more nuanced. What was shadow banking yesterday has suddenly become market based sustainable finance today.

A regulator summarised the principal vulnerabilities that have emerged as pro-cyclicality and non bank financial markets. Avoiding pro cyclicality usually means scaling down certain rules, but the usability of buffers is a double edged sword: there are ways to make them more flexible, but supervisors keep stressing the cost of making certain things more flexible.

Another regulator stressed the need for CMU now, because rebuilding needs equity. Every crisis is also a chance, and three to six months of working in unique circumstances might trigger faster rethinking about two of the Cs, cost management and consolidation. An industry representative added a fourth C to the list, cybercrime, particularly during a crisis like this, when everybody has been working from home. That is likely to hit some sectors worse than others.

3. Opportunities arising from the COVID crisis

In talking of not only risks, but opportunities, a regulator related how the crisis is revealing how banks can really help the economy. In demonstrating their value to society, they are rebuilding reputations that were severely damaged during the global financial crisis. The crisis is also a good catalyst for the underlying technological transformation of the banking sector.

From a central bank official's perspective, this crisis offers the opportunity to have a dialogue with market participants to further adjust the global framework of the financial system. A case in point is stabilising the non bank financial sector to face shocks. A regulator thinks the responsiveness of the authorities to the crisis was a great thing but, specifically for non bank finance, this crisis is not over. There is a need to consider any responses carefully to guard against any unintended consequences that may stifle recovery.

One industry representative hoped banks will be able to play a crucial role in transforming the planet into a more sustainable place. Another industry representative stated that the level of cooperation between all players, whether supervisors, regulators, policy makers or central bankers, is unprecedented and must be built on, as they work together for more stability in the system. ■

Way forward to address unsustainable sovereign debt in the EU

The global Covid-19 crisis has prompted governments to roll out unprecedented fiscal initiatives to protect economies and societies. However, the COVID-19 crisis occurred while the level of public debt was problematic. Global public debt in advanced economies has grown by 30% between 2007 and 2018 to reach nearly 105% of GDP in 2018, according to the World Bank. In the euro area, the government debt to GDP stands at 86.3%, compared with 84.1% at the end of the fourth quarter of 2019.

The economic consequences of the current COVID-19 crisis are worsening this situation. Each crisis leaves the EU more highly indebted. Each increase in debt leaves it more exposed to the next crisis. The debt burden will become very challenging in some EU member states. Boosting growth is the main way forward to address the debt problem.

1. The sustainability of the public finances of EU member states following the COVID crisis is concerning

1.1 'This time it is different': a unique crisis, a unique policy response

A Central Bank official quoted a well-known sentence: 'this time it is different'. A sanitary crisis has become a severe economic downturn unbalancing across sectors, and with harsher consequences in some Member States. Monetary policy response has stabilised the financial markets and provided economic agents with abundant liquidity. On the fiscal side, three new safety nets for workers, businesses and sovereigns were established in April. In addition, there was agreement in July on a package of €750 billion. The package of measures amounts to almost €6 trillion. The speed and scale of the response explain the success, so far, in the containment of the sharp contraction, but also contributed to an economic rebound and a recovery in the years ahead.

Another Central Bank official agreed that this time is different. The pan-European reaction is very important. For the first time, Europe coordinated monetary and fiscal policies to deliver a consistent economic response to the ongoing crisis. Debt to GDP levels in different member states was different before the crisis and will be different after the crisis. But 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.

A public representative noted that, in the US, the historic record of people filing for unemployment has been broken by tenfold. The situation in Europe was different because of European labour regulations and public policies. Under the EU agreement on Next Generation EU, the Commission will be able to borrow up to €750 billion on the markets and this will provide additional means to address the challenges posed by the COVID-19 pandemic. The crisis is historic but the solidarity debt issuance by the European Commission is also of a historic nature. Nonetheless the fiscal response will take a significant toll on national and European debt.

An industry representative stated that, if a lockdown is imposed, the impact on households must be mitigated through income support. Corporates that lose their revenue must be supported through emergency liquidity and emergency credit. These measures immediately lead to large deficits and will bring the economy back to around 90-95% at best. As was noted by a previous speaker, unemployment in the US increased to 15-16%. However, unemployment is already back below 10%, so there is some V-shape in the recovery.

It is unlikely that the economy will return to 100%. There is some structural damage, some industries will not return to normal and the private sector cannot be relied upon to invest. The private sector has been damaged and faces major uncertainty. Europe will rely on a boost from public sector investment. That is the right answer to get through the emergency phase. Fiscal policy has been accommodated by monetary policy, not just in Europe but also in the US, the UK and Japan. The Bank of England indicated that it would be willing to buy in the primary market. This is close to what could be called helicopter money. The only difference is that the debt is kept on the books, but the expansion of the monetary basis is only temporary.

1.2 The debt burden seems manageable for some

An industry representative stated that for now current debt is sustainable in the EU. The representative's institution has not so far taken any negative actions in relation to the major European economies. Although the fiscal shock has been enormous, the response has been enormous as well. Debt levels will rise by 10 to 20 percentage points on average over 2020 and 2021, even in the most highly indebted countries. Debt affordability is very high as interest rates and spreads are very low. These sovereigns are strong in terms of their economies, institutions, and overall setup. Investors have confidence that governments will be able to sustain the nominal growth needed to cover interest payments and that policymakers will achieve the fiscal and economic outcomes needed to contain and reverse the rise in debt.

However, confidence could vanish if investors conclude that the debt is not sustainable. This could happen through a failure of policy. Debt is assessed on the debt burden, the amount of debt, the level of growth available and the size of nominal GDP available to support that debt.

Another industry representative stated that the laws of sustainability have not been broken. It is uncontroversial that there was a big fiscal loosening in the first round of the current crisis.

1.3 For others the debt burden will become unsustainable and should be addressed without any delay

An industry representative stated that they are more pessimistic than other speakers with regard to debt sustainability in the euro area. 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 the end of 2020. Interest rates are at a record level

Germany and other countries are even in negative territory. Around 70% of all euro-area denominated sovereign debt has negative yields. In that environment, a quasi-temporary sustainable debt situation is possible. However, Europe is not stationary and there is zero guarantee that interest rates will remain at these low levels.

Interest rates will remain low, but negative rates will not remain negative. Negative rates are negative for everyone. Policies, politics and distribution effect will become increasingly important. The distribution of societies has become much more unequal. In the recent past, Greece had a debt restructuring, in terms of a net present value reduction of debt. If the ECB does not act as it does, there will be very different interest rate levels in Europe and very different interest rate differentials among the sovereigns. There are 19 sovereigns in the euro area and one central bank, but fiscal policy remains a national responsibility. Debt sustainability is only a given if growth is created. Growth is lacking in Europe. Even if interest rates remain low forever, there will be less capacity in future to absorb new shocks with higher spending. Today's record debts are not sustainable and must be addressed.

The Chair summarised that the three representatives of the private sector have indicated that debt is sustainable for now, but there are several issues.

2. Boosting growth is key to addressing the debt problem

The record low cost of borrowing is good news for debt sustainability, but there is no guarantee that interest rates will remain low forever. Moreover, the longer the debt problem is postponed, the worse it will become. The time to act is now. There is only one solution to address the record debt levels: boosting sustainable growth by enhancing productivity. This will include using EU funds to reform economies, investing in the EU's common priorities, notably green and digital, carrying out structural reforms and preparing fiscal consolidation.

2.1 A wise use of EU funds combined with a temporary accommodative stance of monetary policy could contribute in the short run to overcome the debt problem

A Central Bank official stated that the speed and scale of the response is key to the success so far and will contribute to an economic rebound in the years ahead, but policy-makers' work is not complete. Monetary policy Pandemic Emergency Purchase Programme (PEPP) should remain flexible and Next Generation EU funds should be used efficiently. The 'whatever it takes' stage must be followed by a 'whatever is worse' stage. There should be a level playing field among sectors and member states. The convergence process should be promoted. Monetary and fiscal policies are needed at the same time.

So far, the crisis resembles a V-shape, but the final miles of this process will be characterised by an increase in labour-market churn. This presents risks but is needed to promote the return to previous GDP levels. The flexibility provided by supervisors should continue to be used to lend credit to the economy. Economies will come out of the current crisis with a higher debt level. The monetary and fiscal responses are temporary measures in response to the temporary threat. Premature withdrawal could be detrimental to any rebound. According to the ECB forecast, at the end of 2022 the euro area will be four percentage points below expectations according to the December 2019 forecast. This is less than what happened in the last crisis in 2008.

There is no indication that the virus affects the animal spirit of economies. A great deal of reallocation is going to happen in euro-area economies and such a reallocation is necessary and conditions should be provided for it to increase its efficiency and growth. Some industries will be replaced by others. Moreover, Europe is the most advanced society in global history in terms of health, education and the welfare state. This is an asset in a crisis.

2.2 Today's monetary and economic solutions (continuous increase in public debt, monetisation of public spending by central banks) cannot last forever

Europe should not rely on fiscal and monetary activism forever, because there will be a moment when it stops.

2.2.1 Monetary dominance or fiscal dominance?

Europe's debt will soar to new heights in the aftermath of the COVID-19 pandemic. 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. Without a plan to 'bend the fiscal curve', debt issuance will be on an unsustainable course. Governments need to show that they can both confront the immediate crisis and plan for fiscal consolidation.

A Central Bank official stated that monetary dominance has to be preserved. Otherwise, inflation will increase, reducing the value of debt. But once the reputation of a central bank is lost, it is hard to regain. The euro is an international reserve currency, and this status depends on the independence of the central bank. Therefore, credible fiscal discipline at the country and European Union level must be guaranteed and compatible with the existent and future investment needs.

Another Central Bank official underscored the importance not to rely solely on low interest rates to manage the possible indebtedness of different member states. Instead, structural reforms are needed. Every country knows what they have to do: there are country-specific recommendations every year. Once countries return to a path of sustainable growth, fiscal policies should aim to achieve prudent medium-term fiscal positions.

2.2.2 How long the situation will last is not known

An industry representative commented that how long debt levels will remain sustainable is not known. Some people believe central banks have artificially created a low interest rate environment. However, most economists agree that the natural rate of interest has been decreasing for decades. Central banks are now trying to push it a bit below the equilibrium rate in order to drive growth in the economy. It seems as if inflation is not coming back any time soon, but this is not certain. The actions being taken now are the correct ones, but the question is if they can be stopped when necessary. When the interest rate and inflation go up, growth must be increased as well. If growth drives up the interest rate, the situation will be sustainable. The denominator, GDP, will be growing and it will be possible to make fiscal adjustments.

Policies and spending should be focused on growth. Demand, for example handing out unemployment benefits, helps now, but will not drive future growth. Currently, money can be printed and does not create inflation. That is the dream for politicians who run for election, because they promise things without having to raise taxes. Central banks are right to act as they are. However, there will be a moment when this may have to change. When money is no longer easy politicians have to be willing to make the adjustment. This may come at a time when countries are not at their best.

2.2.3 Europe should not rely on fiscal activism. The new recovery instrument, Next Generation EU, is a positive step forward but not a game changer. Accelerating CMU is essential

An industry representative stated that Next Generation EU is not a Hamiltonian moment. The EU recovery fund will not be a game changer. It is positive, but not because of its size: €750 billion is only 6% of the 2020 EU national budget. It is positive because it gives the European Commission access to capital markets and allows the European Commission to use the newly created borrowing power for joint debt issuance, for example in the form of perpetual bonds.

It is right that spending should be currently unconstrained, but an orderly exit will be needed. Europe cannot rely on low interest rates and fiscal activism forever. Europe must accelerate the Capital Markets Union (CMU) in order to increase the competitiveness of European companies and to attract long term investment capital from institutional investors such as insurance companies. Raising Europe's competitiveness is the only viable strategy to deal with the debt and for this completing the CMU is key. It is time for Europe to invest capital and in deep capital market reforms.

2.3 Implementing the domestic fiscal and economic reforms needed to revitalise growth and achieving a common ground on mutual support initiatives

2.3.1 Governments need to show they can both confront the immediate crisis and plan to return to a more normalised fiscal situation

An industry representative stated that policy will need to address both numerator and denominator of the debt ratio compared to GDP. Extremely tough policy challenges will be faced across Europe over the next five to 10 years. It is not critical that they should be addressed now. The actions that will be needed to help Europe ride out the crisis are necessary and will not worsen debt sustainability. At some point, attention will need to turn to growth and debt limitation. Over the last 10 years, European policy-makers' success in making difficult choices to revitalise growth and reduce debt burdens has been mixed. The political economy at the moment is less susceptible to difficult policy choices. The risk remains that, at some point in the next decade, investors will conclude that not enough is being done. At that point, the debt may become unsustainable.

A Central Bank official commented that complementary between monetary policy and fiscal policy is the most important aspect. Policymakers will be the main actors. The solution to the debt issue lies not in euro-area-wide monetary accommodation but in fiscal policy and structural reforms that enhance productivity and improve the business climate. The Chair thanked the Central Bank officials for their positive stance and for mentioning structural reforms in order to boost potential growth.

2.3.2 Progress on closer fiscal and economic integration is needed to bolster the euro area's resilience

An industry representative stated that their organisation does not have a precise target for which level of growth Europe needs to achieve debt sustainability as there are too many moving parts. There are two sets of problems: national and collective. It is a national problem because national policymakers are going to take action to undo the legacy of this crisis. It is a collective problem for all the reasons that have become familiar over the last 10 years. The survival of the EU or euro area is dependent on the survival of the weakest. The weakest are those that have the highest debt and the lowest growth.

Around the time the euro was first set up, Romano Prodi commented on the absence of effective economic policy instruments at the EU level. It was politically impossible at that time to introduce those policy instruments, but they would be introduced when a crisis occurred. Some instruments were introduced in the 2007-2012 crisis. The second crisis has now happened. It is not Europe's fault. It is collateral damage from a global shock. Europe has faced two cathartic crises in just over a decade. The question is how far collective action will enable Europe to survive those crises. The recovery fund is larger than expected but the negotiations to achieve this agreement illustrates the continuing difference in vision between different parts of Europe. From a credit perspective, there are the stronger and the weaker nations in Europe. The absence of vision and collective responsibility at the moment is worrying. Nations cannot respond to this crisis alone. Nations that are weaker from a credit perspective are already highly reliant on collective action for their debt to remain sustainable.

Demographic issues will also have an enormous impact on growth. Significant action will be needed to generate productivity growth in Europe to even sustain the already low pre-crisis levels. This is a problem of growth and also a problem of debt. This is not a monetary policy problem. Monetary policy has been, and will continue to be, an enabler, but the actors will be the finance ministers and the economy ministers. They will need to sustain growth and introduce the structural reforms to counter the demographic impact while reducing debt, spending less and raising more in revenues.

An industry representative stated that the divergence in economic performance between Member States of the EU is a huge issue. The north may have a V-shaped recovery. The elephant in the room is Italy. Debt restructuring in Greece has been mentioned by other speakers, but Greece had a very tiny debt in a global context. Italy has the third-largest sovereign debt in the world, at €2 trillion. Currently, 70% of that debt is held by the Italians themselves, but 30% is still held by foreigners. Restructuring is not an option. When the going gets tough, politicians can no longer insist that they are sovereigns and will do what they promised to their voters, when they are now asking for more spending by the central banks. Solidarity goes with responsibility. It is uncertain if the political economy issue has been overcome.

The Chair acknowledged the industry representative's remarks with regard to Italy. There are 19 member states, but the function of the European Commission is to ensure member states work together.

2.3.3 This is particularly necessary in a context where euro-area sovereigns, unlike sovereigns who issue their own (fiat) currency, would not be able to, as a last resort, print their own money to avoid default

An industry representative noted that Europe has 19 sovereign governments with sovereign fiscal policies. In the US and Japan, the democratic vote will vote for a government. That government will implement a fiscal policy and works with one independent central bank. It is much more complicated in Europe, with 19 governments and one central bank. There is not only the intergenerational transfer of debt but potentially also a transfer between different regions and sovereigns.

An industry representative stated that the situation looks similar from Switzerland. There are various quasi-sovereigns and one real currency in Switzerland, but there is a complete CMU and one sovereign.

2.4 Should the unprecedented challenges we face lead to a challenge to taboos?

A public representative commented that this crisis is not a normal crisis. Public finance has previously been put on a sustainable path after a very difficult decade. After the global financial crisis in 2008, politicians, economic policy and fiscal policy delivered. By 2019, debt was beginning to come down significantly. The current shock is external and there is no moral hazard issue. The proper answer by European instruments of debt was correct. Solidarity was needed.

The debt to GDP ratio will be around 20% higher at the end of the crisis. Future generations already have the burdens of demographics, decarbonisation and debt from the financial crisis. Whether an additional burden of this 20% debt to GDP should be put on the next generation's shoulders is something to question. The risk at the moment is not inflation but long term unemployment. If every country in Europe has 20% more debt and everybody starts to put public finance on the correct path, there is the prospect of a decade lost in terms of long-term unemployment. The support for populists and extremists that was seen with Brexit and the results of the elections in France was a result of a long-term lack of prospects for employment and growth in Europe. Additional possibilities on the side of monetary policy should be discussed to avoid an additional burden on future generations.

Regarding Italy, a public representative noted the ratio of debt to GDP in Portugal is also very significant as a result of the financial crisis. The situation in Italy is better than in Portugal, because Italian debt is nationally owned in a much more significant part. The Italian government has to produce the reforms that create growth so that this debt is sustainable. European governments put public finance in a sustainable stance before this crisis. That is the only way to address debt and will need to be done in Italy and the other countries after the shock of the crisis. The shock on internal demand has not ended yet, so after the crisis everyone will have to play a part in returning to sustainable public finance. This should be a focus of monetary policy. Solidarity is necessary.

A Central Bank official commented that the ECB's Governing Council is a very creative and flexible body. Helicopter money is not discussed, but additional steps will be taken if needed.

The Chair summarised that there is general agreement on the assessment of debt sustainability, but speakers' views start to differ when future policies are discussed. ■

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

Monetary policy responses to the crisis were necessary and effective. Financial markets have stabilised, and credit continues to flow. With their pandemic responses, central banks have contributed to avoid an even deeper recession and shown that they can overcome the limits posed by very low interest rates and provide additional stimulus through innovative balance sheet policies.

However, it is essential to recognise the limits of monetary policy. Prolonged monetary policy easing has side effects, can increase financial vulnerabilities, and cannot alone deliver higher sustainable growth. Once the economy has recovered from the crisis, the challenge will be to rebuild monetary and fiscal buffers. The ECB's review of monetary policy strategy should also consider whether the 2% inflation target should be revisited.

1. Monetary policy responses to the COVID crisis were successful

1.1 The extended monetary policy measures implemented since March were necessary to support monetary transmission and to help the economy establish a foothold during lockdown, and this has contributed to avoiding worst case scenarios and the threat of deflation

A Central Bank official opined that the ECB has done what it had to do since the outbreak of COVID 19. In early March there was a real threat of another destructive development in the markets comparable to 2011 2012, when the markets 'had a go' at the debt sustainability of euro membership countries. Europe learned its lesson from the previous crisis: if these dynamics start to take hold in markets, it is essential to take action in a big and decisive way. There is an acknowledgment that in the whole European Institutional Setting, the ECB is probably the only institution with both the balance sheet and the swiftness of decision making to perform this backstopping function for the markets.

1.2 The monetary policy responses to the COVID crisis have clearly been effective

A Central Bank official summarised the effectiveness of the ECB's actions as 'so far, so good'. Any assessment of effectiveness requires an understanding of policy objectives, however. The Pandemic Emergency Purchase Programme's first objective was to restore monetary transmission, i.e. to avoid destructive spirals and reduce fragmentation. Bond spreads are now more or less back at pre COVID levels, which means the policy has been highly effective. In restoring monetary transmission and avoiding these catastrophic scenarios, Europe has also averted deflation risk. In terms of market based indicators of inflation expectations, at one point the market was pricing in more deflationary scenarios, but these have returned to their pre COVID levels. Additionally, the ECB's TLTROs have ensured the continuation of bank lending to the economy.

Another Central Bank official described how the hit to the euro area economy from the pandemic has been extraordinary, noting that the strong response from governments and the ECB was certainly warranted. It cannot be disputed that the monetary policy intervention has been effective so far. Without central bank purchases, bond yields would have risen, tightening financial conditions amid the pandemic. The ECB's response was instrumental in avoiding a financial meltdown.

1.3 Easy monetary policy and fiscal expansion reinforce each other and make the overall response more effective and efficient

An industry representative agreed that Europe needed this kind of swift and decisive monetary policy reaction. However, there is also a need for a strong reaction on the fiscal side. This happened at the national level, and it also happened in a coordinated way at EU level with the Next Generation EU package. An industry representative agreed on the need for the extraordinary monetary support at the start of the pandemic, noting that it has proved effective. Combined with the fiscal response, monetary policy helped preserve economic capital and social cohesion.

2. Prolonged monetary policy easing creates financial vulnerabilities and has long term side effects

A Central Bank official wondered how long Europe could continue with its debt build up and the already very long period of loose monetary policy. The Central Bank official asked whether central banks are risking a loss of independence and fiscal dominance in the future.

2.1 If central bank support continues for a prolonged period of time, debts accumulate and asset prices are further stimulated, which poses risks to financial stability

A Central Bank official explained the importance of side effects. The longer these policies continue, the more there will be an explicit trade off against the side effects. These include the build up of bubbles in financial markets and asset prices, and the ratcheting up of debt. Additionally, there is a more general point about the misallocation of resources in the economy, which also increases in the 'low forever' environment.

2.1.1 The origins of any trouble in the market might be the spill over from corporate bankruptcies rather sovereign debt

An industry representative stated that the corporate sector was hit first and hardest by the COVID -led recession, as the pandemic put entire parts of the economy 'on pause'. More than 20% of S&P's global corporate ratings have been downgraded as a result of the stress on the economy, and most of these downgrades took place at the lower end of that scale and in sectors most exposed to social distancing measures and a collapse in demand. A third of the corporates rated by S&P are rated 'B' and below, which means they are vulnerable to changes in economic and business cycles. S&P forecasts the corporate default rate in Europe for speculative grade credit to increase to 8% in the next 12 months. and estimates that 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.

The next 6-12 months will be a critical transition period where we will see if private demand comes back to sufficiently strong levels, while the extraordinary fiscal support gradually phases out. This unprecedent fiscal support to businesses and individuals will inevitably lead to a sharp increase in government debt, although part will depend on the degree to which indirect support will be drawn on, in particular the guarantees. The speed and strength of the economic recovery will be key to determine how much the crisis impacts governments' balance sheets.

2.1.2 Lasting low interest rates enable corporates with weaker credit profiles to access Liquidity, but solvency risks remain high for low rated corporates

An industry representative described how it is important to look beneath headline debt numbers when trying to understand why increased debt levels at near zero costs can be problematic. Since the outbreak of the pandemic, there has been an increase in corporate debt. The idea of a K shaped recovery is helpful here. Essentially, there are major differences between the situation for corporates at the higher end of the ratings scale – i.e. investment grade corporates – and those at the lower end. A large part of the debt borrowed by investment grade corporates since the onset of the crisis has remained on balance sheets as precautionary cash or was used for refinancing purposes. This generally pauses limited concern from a credit risk standpoint, although the situation varies across industries.

The story is very different for companies at the lower end of the ratings scale, however, and a large proportion of SMEs. Here, a substantial amount of the debt incurred has been used to fund working capital. This is a question of survival, and it is a cause of concern. The industry representative considers it critical to remember that Europe started the year with a record number of companies at the lower end of the scale, including some companies which may not generate sufficient earnings to cover the interest on their debt. These companies are undergoing a massive shock particularly in the industries most exposed to social distancing and a drop in global demand such as transportation, automotive, media and entertainment, retail. The gradual phasing-out of extraordinary support programs, while the pandemic is still weighing on private demand is expected to lead in an increase in defaults. Policymakers will have to manage the delicate balance between preserving the economic and social fabric by preventing the rise in bankruptcies and the long term cost of greater government intervention. Preserving employment is important in the short term, but the survival of companies with unsustainable capital structures or obsolete business models could hinder long term productivity.

2.1.3 If short term relief continues for too long, it could 'plant the seeds' of the next crisis

A Central Bank official emphasised the need to be flexible in monetary policy, but it is essential to do this in both directions. A central bank must be able to react forcefully when required and to dial back this accommodation whenever possible. The longer the policy stays very accommodative, the more its side effects will build up. There is a risk, for example, of central bank interventions weakening the role of markets in adequately pricing credit risk and holding back favourable structural changes in the private sector and necessary reforms in the public sector, both of which lead to lower productivity.

2.2 Lasting low interest rates reduce economic dynamism, increase adverse distributional effects and sap the resilience of financial intermediaries

An industry representative emphasised that, as investors, they do not seek to place blame but rather to observe that the current economic and monetary environment makes it difficult to invest. In terms of negative side effects, there are some general economic considerations. There is an over indebtedness of sovereigns and companies, and a question about debt sustainability. This under pricing of credit risk leads to capital misallocation and asset bubbles, and it increases the risk and magnitude of an eventual market dislocation. Economically, it prevents the Schumpeterian cycle of destruction and creation, and supports 'zombie' firms. This makes things difficult for asset managers and institutional investors and promotes an undesirable 'search for yield' behaviours.

The industry representative highlighted the fact that the side effects do not affect all people equally, noting that a Central Bank official had outlined the divergence between Northern and Southern countries on a previous panel. This point connects to the idea of the K shaped recovery. While some sectors are benefiting from the pandemic, many industries are suffering, such as retail, airlines and hospitality. However, there are other important distributional effects. The low interest rate and very depressing return on savings create a distributional or intergenerational effect between the young and the old. There is also an effect on access to the housing market for first time buyers in some countries. If Europe is not alive to these effects, there could be further social backlash.

Responding to a query on negative interest rates from a Central Bank official, an industry representative opined that QE would be preferable to negative interest rates, because the side effects of extra negative interest rates are worse. In particular, negative interest rates lead to a structural weakness in the banking industry and a squeeze on margins. The ECB's intervention has been well designed, however. They provided an incentive for additional lending, which was needed. Europe emerged from the financial crisis with a huge debt overhang. At some stage, government interventions must support equity injections to ensure the system does not develop an even greater debt overhang.

2.3 Monetary dominance or fiscal dominance?

2.3.1 ECB policies do not constitute 'financial repression'

Turning to monetary and fiscal interactions, a Central Bank official stressed that Europe is going to face the issue of rising government debt. There was a first push after the Global Financial Crisis, and due to the COVID crisis there has been another rise in public debt. In some euro area countries public debt will increase to levels beyond 100%. It has been suggested that this could jeopardise central banks' independence. Additionally, some commentators have even argued that the ECB's asset purchase programmes effectively monetise sovereign debt, which is explicitly prohibited by the treaty.

The Central Bank official highlighted the potential for using counterfactual analysis in addition to considerations of raw data. Counterfactual analysis suggests that the public debt ratio would indeed have been notably higher without the ECB's measures. This is driven mainly by better growth performance and to a lesser degree by lower interest rate expenses for governments. The ECB's monetary policy is not guided by the wish to lower public debt but by its mandate of price stability. There is certainly no feedback loop from sovereign debt developments to monetary policy decisions. For example, there is no systematic relationship between government bond issuance and the amount of bonds purchased by the ECB in the secondary market. Additionally, the surge in debt after the Global Financial Crisis appears not to have led to a structural break in the ECB's reaction function, including in the current COVID crisis. Finally, in terms of fiscal dominance, if the ECB was monetising public debt, there would likely be a spike in medium to long term inflation expectations, as was observed in the 1970s. What is happening now is quite far away from that.

A Central Bank official suggested that the big question for Europe was how to lift inflation to the 2% target. One difference compared with the last crisis is that fiscal policy is now playing a more constructive role. If Europe does not bring up inflation relatively quickly, there is a risk that these policies will have to be in place for a long time. There are already quips in the markets about 'QE forever' and 'negative rates forever'.

2.3.2 The spectre of fiscal dominance

An industry representative observed that there is a huge and worrying build up of public debt. Fiscal policy and monetary policy reinforce each other, and it is necessary for there to be a joint reaction. However, it is also true that monetary policy, in particular unconventional monetary policy, has fiscal consequences. The fiscal-monetary nexus has been strengthened. Therefore, it is important that the decisions taken by different actors are taken by independent institutions and that monetary policy does not react to the fiscal needs of governments. Europe could end up with monetary policy geared towards the sustainability of public debt and 'zombie governments' to the extent that monetary policy interventions create moral hazard and reforms are delayed in member states.

The industry representative agreed that the eurozone has strong institutional arrangements and that Europe does not have to fear debt monetisation. However, the environment in Europe means these unconventional monetary policies are likely to remain in place for a long time. If they last too long, there will be a situation in which these policies become a permanent expansion of the monetary base. While Europe has a strong and independent central bank, it also has 19 sovereigns, which is indeed quite different from any other major monetary area. This robust institutional setting is fundamental, but it will come under substantial pressure for at least two different reasons. First, if other monetary areas engage in a degree of monetisation, this will cause an appreciation of the euro and a tightening of financial conditions in the eurozone. Second, there could be trouble if different euro area states have different preferences regarding the possibility of using debt monetisation to solve the huge problem of debt build up in the EU.

3. The way forward is challenging

The economy will require support for quite a long time. Fiscal policy can now stabilise economies more effectively due to changes in the interaction between fiscal and monetary policy. However, when and how Europe can exit its accommodative policy is a key question. Indeed, it is important not to take for granted that current financial conditions will continue indefinitely. In this context, boosting growth is the key priority. When conditions allow, there will be another challenge concerning rebuilding monetary and fiscal buffers.

3.1 'Fixing the roof when the house is on fire': the economy will require support for a very long time

A Central Bank official noted that current forecasts suggest that the recovery of the euro area to pre crisis levels will take at least two years. It is clear that monetary policy should remain accommodative and support the recovery. At the same time, however, this does not have to mean that emergency measures will stay in place until there is a full recovery.

3.2 Fiscal policy is now more effective at stabilising economies, but it is essential not to take for granted that current financial conditions will continue indefinitely

3.2.1 Secular trends have changed the interaction between fiscal and monetary policy

A Central Bank official stated that the interaction between fiscal policy and monetary policy has changed in recent years. Slowly moving structural factors – such as lower trend productivity growth, an ageing society and global excess savings – have led to long term decline in the real equilibrium interest rate. Therefore, conventional monetary policy now has much less space to stabilise the economy. As a result, years of weak aggregate demand have forced central banks to introduce a wide range of non standard monetary policy tools. These tools have proven quite effective at stimulating the economy, but they also have side effects. The longer these tools are employed, the larger these side effects tend to become.

A Central Bank official underlined the potential consequences of non standard monetary policy. First, a more accommodative fiscal policy is required to lift the economy out of a low growth and low inflation trap. In times of low interest rates, monetary policy alone may be insufficient to stabilise the economy. Fiscal expansion is indispensable to sustain demand and mitigate the long term costs of the crisis. Second, fiscal policy has not only become more important but also more effective. Fiscal spending seems to be more effective at or close to the effective lower bound. This could be because fiscal stimulus normally triggers expectations of a tightening of monetary policy, while at the lower bound investors anticipate a prolonged period of low interest rates and accommodate the fiscal response. Thirdly, the cost of debt has fallen. The extent of this drop has been such that countries may no longer need to run primary budget surpluses to stabilise or reduce their debt burden over time, provided interest rates are lower than nominal growth rates.

3.2.2 When the crisis has been overcome, monetary policy should step back

A Central Bank official highlighted the importance of the interest rate growth differential. Taking a longer perspective, it is possible to observe that this differential is currently negative, which implies two things. First, governments should strive to foster potential growth, i.e. work on the 'g' part of the interest rate growth differential. For Europe, this means the money from Next Generation EU must be spent wisely. Second, governments will have to regain fiscal space once the economy has recovered. If debt levels are too high for too long, it will hurt growth and make the euro area more vulnerable. Moreover, when inflation is on a sustained path towards levels consistent with price stability, central banks will have to exit their loose monetary policy. The ECB will ensure this does not happen too early and thereby choke the incipient recovery.

3.3 Boosting potential growth should be the priority

3.3.1 Monetary policy cannot be 'the only game in town'

A Central Bank official stressed that monetary policy cannot be 'the only game in town'. This was clearly the case in the aftermath of the previous crisis. Here, it is vital that fiscal authorities and economic authorities also do their part. Without sufficient sustainable and productive investment on both the public and private sides to put the economy on a permanently higher growth path, it is difficult for sustainable growth to take hold. If the ECB is again left to act alone, Europe will remain in this environment for a very long time, and the side effects will also manifest themselves. Another Central Bank official agreed that the ECB will not be able to ensure Europe's recovery alone. There is a need for fiscal authorities to step in by directing spending towards productive investment. If capital markets union (CMU) were fully operational, it would help with the transmission of monetary policy.

3.3.2 After COVID 19, productivity growth will be paramount to cope with higher debt

An industry representative underlined how a lower cost of debt helps governments. Taking the example of Italy, S&P forecasts the ratio of general government debt to GDP to increase to 160% of GDP at the end of 2020 from 132% in 2018. At the same time, the cost of debt, which is the interest revenue ratio, should remain just slightly above its 2018 level of 8% of revenues. While low interest rates are providing short-term relief for almost all sovereigns, higher government debt is not without posing risks.

Ultimately, the effect of the COVID shock on government's balance sheets will depend on the timing and strength of the economic recovery and how these large amounts of new debt will fund productive activity and help boost national income and government revenues on the medium to long term.

3.3.3 Next Generation EU – funded by common debt issuance and including grants – is welcome

An industry representative expressed strong support for the Next Generation EU package. This is a huge contribution to the stabilisation effort needed. It can increase the structural resilience and growth potential of the EU and will lead to the initial creation of a safe asset, which will certainly help the implementation of monetary policy within the eurozone. It is a very welcome step, which ideally should be strengthened further. There are still changes needed within the eurozone regarding fiscal rules, which are excessively complex and based on estimates of data. This package will also help drive the advances Europe needs in the projects of the Banking Union and the CMU.

3.3.4 When the economy has recovered, governments will have to commit to regaining fiscal space

A Central Bank official emphasised that governments will have to make a credible commitment to regain fiscal space once the economy has recovered. In the past, many countries failed to take advantage of the good times to create a sufficient amount of policy space. There are two broad and complementary ways to address high debt – boosting potential growth and cutting budget deficits – and both have a role to play.

However, there is a clear hierarchy in the sequence: governments must give clear priority to boosting potential growth by directing spending towards productive investment. Public investment in the euro area has been too low for too long, which has held back economic growth. ECB research demonstrates the beneficial effects of higher potential growth on debt dynamics: an increase in the potential growth rate of one percentage point would reduce public debt as a share of output by more than 10 percentage points in some economies. Fiscal consolidation should follow once the recovery has matured. It must reflect the lessons learned from previous crises and should maximise the use of growth friendly measures. Similarly, it should be accompanied by an overhaul of the euro area's fiscal framework, now more than ever. Fiscal rules are still too complicated, too politicised and too pro cyclical.

4. Should the 2% inflation target be revisited?

A Central Bank official turned to the topic of the 2% inflation target, wondering whether this should be revisited. The monetary strategy of the ECB is now under revision. The Central Bank official described the idea that, if inflation does not reappear, it might be possible to 'throw all of the textbooks out of the window' and allow central banks to print as much money as they want. The Central Bank official queried whether there could be other unintended consequences of monetary policy if inflation does not reappear or undershoots the 2% target. A disincentive to the efficient allocation of resources could be created both on the government side and the corporate side, which is linked to the suggestion that inflation still exists in asset prices and creates inequalities.

4.1 Monetary policy has contributed to the low level of interest rates

An industry representative stated that the issue around monetary policy is whether the market environment is attributable to the central bank and its monetary policy or whether it is due to insuperable forces. When there are negative interest rates or depressed rates, the risk free rate is very low or negative, but the risky rate – i.e. the corporate rate – is very low. Monetary policy contributes to this through QE and through the policy of negative interest rates, but this is also due to insuperable forces such as demographics, the reduction in the working population of the eurozone and reduced productivity growth.

4.2 Inflation performance would have been much worse without unconventional instruments

Emphasising that they could not pre empt the ECB's strategy review, a Central Bank official reiterated the relevance of counterfactual analysis. It is important to ask how inflation would have evolved in the absence of the measures taken by the ECB. According to the models, inflation performance would have been much worse. Even though inflation is still well below the target level, current forecasts at least demonstrate that the numbers are moving in the right direction, though very slowly. Additionally, other institutions have a role to play here. The lack of conventional monetary policy space is related to the evolution of the natural rate of interest, and central banks can do very little about this. At the moment, there is extremely low inflation, but it will not always be so low. While some people have suggested that inflation could rise soon due to supply side constraints, this is not currently occurring. Current projections suggest that demand side factors are so strong that this will not happen any time soon. Of course, the supply side factors are indeed there, and it is not possible to exclude the return of inflation.

4.3 There should be sufficient flexibility in the way inflation targets are set

A Central Bank official suggested that a deflationary episode would be very low on their list of risks. The word 'deflation' is used too often in the context of a 1% inflation rate. 'Deflation' usually means 1930s style deflation, which is probably the only deflationary episode in history with negative spirals of postponed consumption and investment thereby exacerbating the downturn and lowering inflation even further. By far, most episodes of 'deflation' in history have been benign deflation.

A Central Bank official described how, for a central bank like the ECB, monetary policy always takes place in a global context. There seems to be an emerging consensus around the 2% inflation rate, which is a global standard for central banks. It is hard to argue, as an individual central bank, for a deviation from that standard. For example, any structural deviation will have costs in terms of exchange rate consequences.

Despite the neat convergence towards 2% in the ECB models, the Central Bank official prefers seeing inflation in data instead of models. There have been many predictions of rising inflation which did not materialise. This should make central bankers more modest about their ability to control inflation. The financial industry should acknowledge this limited degree of control: when it comes to inflation, there are relevant factors outside the realm of central banks. This demonstrates a need for sufficient flexibility in the way targets are set. In terms of the international dimension, the Central Bank official highlighted the fact that what is happening in Europe bears similarities with what has happened in Japan. In terms of demographic distribution, Europe lags behind Japan by roughly 15 years. This should make Europe more modest in terms of its ability to deliver 2.0% inflation in an environment with a structural savings glut, an ageing population and the maturation of much of the productive apparatus.

A Central Bank official agreed on the need for flexibility. Of course, there is already some flexibility. Depending on the side effects, it is possible to adjust the speed of the ECB's measures, which provides a degree of flexibility. There is a problem, of course. If Europe deviates from 2% for too long, there could be a de anchoring of inflation expectations.

4.4 Ultra loose monetary policy has not been able to control inflation

A Central Bank official stressed that there are forces putting downward pressure on inflation such as demographics and international trade. However, it is important to be modest and recognise that it is impossible to fine tune inflation with monetary policy. In terms of the 2% target, Europe is dealing with monetary policy as a single entity despite being composed of 19 different economies. There must be a single policy for the entire euro area, but the fact that different countries can be at different points in the cycle in terms of growth argues in favour of having a buffer in the inflation target.

A Central Bank official noted the lingering question of below target inflation, which is a challenge not strictly related to the COVID crisis. This has already been a challenge since 2014 2015. Despite the employment of a 'full arsenal' of monetary instruments, inflation seems to have anchored closer to 1% than 2%. There are different issues at play here such as supply side factors. When markets have stabilised, this will be the challenge. Europe will again have an output gap and an inflation gap, and any measures it takes will again have to prove themselves to be effective.

An industry representative suggested that, given Europe's track record of being generally stuck at around 1%, the most Europe can do is to move to the symmetric target of 2%. The embedded assumption in models and counterfactuals is that the inflation process is linked to the decline in the natural interest rate and the savings glut, but an alternative way to understand could be the debt overhang and the money glut. It is vital to consider the data, which shows that Europe has not been able to control the inflation process. Additionally, inflation has appeared in the prices of assets, which has produced tremendous harm and tremendous dislocations.

4.5 Financial stability should be considered when designing monetary policy

An industry representative agreed that Europe should consider financial stability when designing monetary policy, but this is easier said than done. There are two contradictory impulses here. First, one way to make over indebtedness more manageable is to overshoot the 2% target and use higher inflation to bring down the real value of the debt over time. Second, if inflation has been 1% for a very long time, it is possible to say that this is what the financial industry was seeking all along. The ECB's strategic review should consider this. A way of making this possible would be to tackle the bank sovereign loop. When Europe established the SSM, one of the objectives was to ensure the bank sovereign loop would be broken and this has not been achieved.

5. How will the development of a vaccine affect the markets?

A Central Bank official invited panellists to comment on what effect the development of a COVID 19 vaccine would have on the markets, noting that this might imply the end of stimulus from central banks. Another Central Bank official disagreed, suggesting that the single most decisive factor for future economic development will be the management of the health crisis.

A Central Bank official stated that the markets 'absolutely' would rally and there would be a general bout of optimism. The upside of a vaccine would clearly dominate the more moderate response that central bankers would take. Europe is in an environment of unprecedented uncertainty, but it is important to remember that uncertainty also sometimes works positively. An industry representative agreed that the market would go up. An industry representative offered a different view. Although a significant step forward, this is not a 'black and white' question. Multiple challenges would remain: the manufacturing of billions of doses; the cost of widespread distribution; ensuring availability to both developed and emerging markets; people's willingness (or lack thereof) to be inoculated; and the likelihood that efficacy will be less than 100%. An industry representative stressed the importance of managing expectations here. There is a considerable amount of pent up demand, so there could be substantial upside. However, news about a vaccine and its adoption will be changeable from positive to negative. There will be a bumpy road towards a strong recovery. ■

Should financial sovereignty be a key objective for the EU and what are the priorities?

1. Defining 'sovereignty'

A Central Bank official outlined that sovereignty is a complex topic with tensions between maintaining control and taking autonomous decisions on the one hand and the reality of global financial interdependence on the other.

A policymaker confirmed that one of the key objectives of the European Commission is to consider what can be done to make Europe more sovereign. In the past, there has been a great deal of reliance on the change in the rule of law between Europe's jurisdictions and other parts of the world, but the world is changing, and Europe needs to re-evaluate its role in the world. The geopolitical background is now one of competing interests and competing jurisdictions. This relates not only to financial services but also digital and security. Europe needs to consider what its role is in these things and how sovereign it wants to be. These questions are particularly pertinent in light of the supply chain issues that have arisen in the wake of the COVID crisis.

The Commission has three particular concerns: financial stability with control over Europe's financial market infrastructure; competitiveness with key financial companies in and outside Europe; and Europe's ability to conduct its own policy without outside undue influence from third countries

A Central Bank official underlined that the COVID-19 crisis, Brexit and the issues in Hong Kong have demonstrated the fragility of global economic integration. Global financial markets might not always be available. Therefore, it is an important discussion "how much" sovereignty Europe needs.

2. Improving EU financial sovereignty

2.1 Three key elements

A policymaker highlighted three elements for improving EU financial sovereignty. First, the EU financial markets need to be attractive internationally. Completing Capital markets union (CMU) and Banking Union are very important in this respect.

The second element is financial market infrastructure. There needs to be an assessment of the vulnerabilities Europe's financial market infrastructure to political pressure by third countries and an assurance that Europe will retain control of it. Equally, consideration needs to be given to what can be done to make the euro more attractive for commodities trading. In addition, one has to have a state-of-the-art digital financial infrastructure for the pan-European use of tokens, cloud solutions, blockchain technology, etc.

The third element is sanctions. Sanctions linked to financial market infrastructures and currency are increasingly used to project foreign policy. A blocking statute is in place, but it is difficult to enforce and has not always worked the way it should have. Consideration needs to be given to better enforcement of sanctions by member states and to whether the blocking statute can be improved.

2.2 Effective and fair enforcement of international agreements is essential

A Central Bank official noted that the European Parliament rejected the first SWIFT agreement in February 2010.

An official highlighted that the Commission is sometimes hesitant to apply its own rules, as seen with the European financial sector delivering data to the US despite the US not being compliant with the General Data Protection Regulations (GDPR). The Commission needs to be able to stand up to the Americans during negotiations rather than undermine its own rules out of fear.

2.3 IT sovereignty is essential

An industry representative stressed that financial sovereignty cannot be achieved without 'sovereign IT'. Sovereignty has three components: the technological component; the legal framework; and the economic core of European players.

2.4 The strength of EU financial players is essential for EU sovereignty

An industry representative stated that a strong financial sector is necessary for a sustainable economy and that that financial sector should not be at the mercy of non-European actors, which would leave it in a position of dependency.

Another industry representative stressed that the purpose of financial sovereignty is to ensure the efficient provision of financial services to the real economy.

There are two components to a financial services sector: its strength and its stability. Strength can be measured by the capital ratios of the banks and by their earnings capacity. Currently, the capital ratios are depleted, and their earnings capacity are not strong enough to invest or to absorb further shocks. Meanwhile, stability has been affected in the wake of the 2008 financial crisis with changes in the mix of international and domestic banks in particular territories.

The question for Europe is what control it has over its financial infrastructure. It is not about excluding foreigners but rather it is about governance and influence at a time of crisis to ensure stable provision.

A Central Bank official highlighted that Europe is trying to develop something new in terms of sovereignty at a non-state level.

2.5 The expectations of shareholders regarding the EU banks should factor in the positive consequences of a now stricter banking regulation

An industry representative stressed that return on equity should be linked to the interest rate level and to the risks that are borne by the equity, the bank or the issuer in question. Banking institutions can be content with relatively lower returns on equity where there are no shareholders demanding a larger percentage dividend. Regulators and the general public are calling for a less risky banking industry with lower real returns on equity and even lower nominal rates on equities. The issue is not just about the inefficiency of the banking system but also about changes in the environment and in the business models.

3. The risk of unbalanced EU sovereignty

An official highlighted that 'sovereignty' implies control over people but that this is not what the financial system is designed to do. Some jurisdictions, notably the United States, are using their currency as a weapon but this will backfire because it undermines the attractiveness of their jurisdiction as a destination for investment. Adopting such behaviour would penalise the EU even further because the euro is not as important as the US dollar in global financial and trade transactions.

In terms of financial flows, 'financial sovereignty' makes as much sense as 'trade sovereignty'. Financial flows are simply the flipside of trade flows. If Europe does not want to shut itself off from a globalised world, it does not make sense for it to talk about financial sovereignty.

It is clear that the Commission is trying to make Europe more attractive as a destination for investment and to improve the payments infrastructure. The issue here, however, is Euro currency clearing in London, which is a part of the financial infrastructure that is beyond Europe's jurisdiction. This therefore has less to do with financial infrastructure and more to do with risk management.

The other elements that will make Europe more attractive, such as CMU, banking union (BU), modernisation, the digital economy, greening and investor-friendliness, are all worth pursuing but they are an end unto themselves, not a means of reaching financial sovereignty.

An industry representative suggests that people should not be caught up in semantics over the word 'sovereignty' and acknowledges the tension between control and interdependence. What is important is that Europeans are in charge of the financing of their continent. There is nothing wrong with interdependence but, equally, dependence is a concern.

A Central Bank official acknowledges the tension between a liberal approach and the observation that the environment has changed. Sovereignty is usually attributed to states. Applying it at the European level is an interesting idea but perhaps has some flaws with regards to financial markets, as it is impossible to be completely independent and sovereign in this world.

4. The importance of a level playing field between EU and non-EU players

An industry representative stated that openness is good for the development of the financial system but only if there is a level playing field. In that regard, Europe should not be naïve when setting out its regulations and legislation. Otherwise, globalisation will turn into Americanisation.

An industry representative suggested that sovereignty does not necessarily mean being closed behind borders. It could be open, but this requires a level playing field. European values of transparency, openness, reversibility, and not having a locked-in market must be adhered to by anyone operating in the market.

There needs to be clarity on which statute or regulation applies to data and whether, for example, any Chinese or US extraterritorial regulations apply. The trade association CISPE is developing a data protection code of conduct, which will soon be approved by the European Data Protection Board. A level playing field with competitors has already been developed with certain rules, for example rules stating that European data should only be stored and processed in Europe and rules limiting access to customer data. A single code of conduct should be developed on reversibility, data protection and cybersecurity that takes account of all the rules that apply to the financial sector in Europe.

5. Cyber-risk and IT sovereignty

An industry representative stated that financial institutions take cyber-risk seriously and that they are taking necessary measures. The difficulty is that the hackers may be states rather than private individuals or private companies with access to greater means than the financial institutions. Fortunately, there is a great deal of cooperation amongst institutions under state supervision. Institutions want to ensure that control over data is maintained but this can be difficult in the current environment.

Keeping data within Europe and improving cybersecurity is more an issue of physical capacity and global standards rather than just money. Europe, in terms of data storage and IT in general, is in a situation of dependency and has lost its sovereignty, partly due to the number of skilled Europeans that have gone to work for non European providers.

An official confirmed that Europe's Finance Ministers are aware of the cybersecurity risk and the importance of proper data storage. Sovereignty, however, is not just about rules but also about political and military strength. The EU has perhaps the best data regulation framework in the world, but it is hesitant to apply it. European actors seem ready to break their own rules in order to provide American institutions with data.

6. The role of policymakers and financial players in achieving optimal sovereignty

A Central Bank official stated that a dynamic financial market in Europe cannot be constituted by politics but instead has to be built by market forces. The European Union, as a regulator and legislator, is unable to guarantee financial sovereignty but it still has a role to play because the legislative and political framework can inspire and encourage market forces that then lead to a stronger European financial market.

7. The next steps

7.1 Transparency further empowers EU citizens to make their own choices

An industry representative stated that, in order to increase financial sovereignty, greater transparency within the financial sector is required. The sector needs to be far more open about what it does and what it contributes towards the communities it exists in.

7.2 Market openness and the improvement of resilience and efficiency

A Central Bank official suggested that the shift in attitude towards financial markets should not be one of moving away from participation in global financial markets. The objective of all European financial regulation has been to open up the markets within the EU, for EU and non-EU market participants. The aim of EU financial regulation is to build a strong European financial marketplace. For building up such a strong, international, relevant financial market, progress in important projects, such as the BU, the CMU and various others, is needed.

Consideration needs to be given to the notion of financial sovereignty from the supervisors' point of view. The ability of EU regulators, supervisors and central banks to secure European financial stability on their own may be in question if relevant market operations take place outside the EU regulation. EU domestic financing should be handled on capital markets within the continent. Today, however, one third of the EU capital market activities are handled in London, for example. Trading in interest rate swaps is 85 percent conducted in London, while 37 percent of global foreign exchange trading is conducted in London and only 11 percent in the EU.

With the new digital technologies, a new means has opened up of combining all the strengths of the various European marketplaces together to function like one "digital market" with the necessary depth and product variety to be attractive to outside investors.

Another Central Bank official noted that central clearing counterparties (CCPs), while important for financial stability, are a monopoly by nature because the greater the concentration the greater the benefit for clients. London provides a great financial centre, but the United Kingdom has decided to leave the EU.

In the context of whether different EU countries are competing against each other, a Central Bank official remarked that, when people have a cake in front of them, they can either compete for the largest slice or they can work together to make the cake bigger.

7.3 Understanding what investors want

An industry representative stated that BU and CMU are both trying to achieve the same goal, which one could call 'financial sovereignty', but there is a significant difference between the two in that the BU requires a greater focus on legislation while the CMU, though it also requires legislation, cannot be ordered top-down. Investor flows and the buy side are required. The buy side in the UK has always been one of the core strengths that has been misunderstood in the Brexit discussion. This broader perception needs to be understood in terms of what the investors want and how to attract them. There is an opportunity for Europe to leapfrog others and to create the markets, particularly in the space of environmental, social and governance (ESG) in terms of climate bond initiatives. The Americans are not doing this under their current administration, and so there is a tremendous opportunity to be at the forefront.

7.4 Improving the efficiency of retail payment infrastructures and becoming closer to clients

An industry representative stated that the European Payments Initiative (EPI) is a prime example of European banks taking their destiny into their own hands and illustrates that sovereignty need not lead to inefficiency. Historically, attempts at cooperation between multiple banks have failed but the environment is different now. Coordinating the 16 banks involved in the EPI and achieving the desired goals will still be a challenge but the timing is certainly right.

Banks also have a tremendous opportunity to be closer to their clients with digital interactions across channels having increased by 7 to 10 times during the current crisis. In the last crisis, the banks were seen as the 'bad guys' but, this time, the banks are part of the solution. Banks need to leverage this opportunity to be closer to their clients and to better understand them. This will allow banks to step up and ultimately support the European economies.

An industry representative stated that their organisation is taking steps in relation to data and the EPI in order to be a better master of its future. In both cases, it is a matter of the cost benefit. The bank's main asset is the trust of its customers. A customer's data is, in a way, a customer's trust and banks should therefore be prepared to pay extra to protect that data. In addition, if European banks do not invest in the EPI, others will step in and payments will end up going through a non-European provider.

7.5 IT, data and data service providers

An industry representative the importance of knowing which regulations apply to data. For instance, where data is stored does not necessarily determine which regulations apply to it.

Most of the value of an ecosystem will come from the data. The question is how that data will be shared amongst the players of that ecosystem to generate value. The European Commission published a data strategy in February 2020, looking at how data will be used to generate value in Europe.

Value generation out of the data can be done by any financial institution but it can also be done by technology providers. A pure player in the financial sector may be reinforcing their future competitors by using their algorithms. They therefore need to think carefully about who they want to work with and who could extract value out of their data. In particular, continuously reinforcing non European organisations means that European actors could be in a weaker position when negotiating with overseas entities.

7.6 The importance of various levers alongside 'EU digital autonomy'

A policymaker outlined that the Commission wants to keep the EU open and stated that a more pertinent concept than 'financial sovereignty' is 'open strategic autonomy'. European foreign policy is being influenced by the use of secondary measures leveraging on financial market infrastructures, other financial companies and the use of the dollar. Several dimensions are at play, such as financial stability, competitiveness, the level playing field, BU, CMU and foreign policy at large. These all come together and there are different instruments that can be used to try to achieve these different goals. This must all be considered in a broader strategy that touches on, for example, security, technology and data.

The Commission is aware that not everything can be achieved through legislation; it is also up to the market.

Europe has to consider the value of the independence and the control that it has over its own infrastructure also in view of preserving financial stability in the EU versus the trade-off in relation to, for example, additional costs for setting up such infrastructure at least in the short term.

An official noted that economic strength obviously increases economic power, which relates to the importance of Europe having its own critical infrastructure. The issue is whether that infrastructure can be upscaled to the extent that the US financial system is no longer needed. This is a particular problem in relation to money transfers and the system of correspondence banks in Africa where American institutions are unavoidable because there are only two institutions left that go through the trouble of dealing with anti money laundering (AML) regulations.

An industry representative calls for more alignment along the European and international layer. Clients find it impossible to consolidate their balance sheets and achieve integrated liquidity management in European markets due to differences amongst national regulators. Though there may be competing interests at play, a more coordinated effort is required to understand what the European banking and financial sectors need and how to improve them.

A Central Bank official cautioned that the new environment of digitisation might also make it necessary to modernize "classic" projects like the BU and the CMU. When a clearer picture of the desired outcome has been reached in relation to a digital financial market, it might be necessary to identify new priorities.

8. Key success factors

A Central Bank official recognised that the concept of 'financial sovereignty' may not mean the same thing for everyone. It also needs to be recognised that the world is changing. Europe today, unlike its founding fathers, has perhaps been too inward-looking. Europeans could be brought together on the realisation that Europe has enemies that are building their capabilities to destroy or attack them. At the very least, this realisation will help in properly assessing the risks.

It is important to develop a legal framework and the capacity to resist some partners worldwide while at the same time building up the competitiveness and the efficiency of the system.

The consumers and the citizens have not been present during this discussion, and so the views expressed have only come from the industry and public authorities. The public opinion may be different, but the main goal remains increased efficiency and ensuring that finance is going where it is needed. In that regard, there have been some failings, particularly with regard to energy transition and population reskilling.

There are many good reasons to retain some control. It is about making the choices that the democracy wants to make at a certain moment, and the indications given by the European Commission on digital and climate are the right ones and properly reflect some of society's main concerns.

Europe can be proud of what the euro system is doing, even if this constantly has to be proven. As compared to the financial crisis, Europe has reacted well in the face of the COVID-19 crisis by providing liquidity solutions and facilitating better coordination with respect to the independence of both the monetary and the budgetary sides. ■

BANKING AND INSURANCE REGULATION

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

1. COVID-19: a non-financial crisis which impacts the banking sector

A Central Bank official explained that a narrative of the crisis has been created based on two facts: the banking sector was not the origin of the crisis and banks are not part of the problem. However, the crisis is going to have, and is already having, an impact on the banking sector.

2. Immediate support provided by Central Banks to the banking sector to continue lending activity and transmit the monetary policy

Another Central Bank official pointed to the rapidity of the reaction - both by supervisors and central banks. Within the existing frameworks and mandates, they used maximum flexibility, which created immediate support. And also, the fiscal side came in. The supervisory action was mainly to give capital relief, and also to postpone a certain amount of initiatives and reforms that were still part of the implementation agenda of the previous crisis. Some forbearance was exercised in the burden that the banks would have in their reporting, and flexibility was used to deal with the procedure for non-performing exposures and loans. The most important aspect in the short term was the capital relief that was extended. There was even encouragement for the banks not to shy away from using these existing buffers.

A Central Bank official noted that monetary policy, fiscal intervention and credit guarantees introduced in more or less all European countries have also been instrumental in maintaining the flow of credit. An industry representative noted that banks reacted quickly to the COVID crisis by providing cash support to their customers, first with moratoria then with loans partially guaranteed by the state. A Central Bank official stated that the capital relief allowed the banks to continue their lending activity, and there were unprecedented levels of loans to companies. It was more subdued to households. For the corporate sector, a 7% increase month-on-month and year-on-year was reached due to this capital relief.

An industry representative noted that banks played a key role in the transmission of monetary and fiscal policy. A Central Bank official added that differently from what was observed during previous crises, this time an immediate credit crunch was avoided, as lending flows have been satisfactory during the crisis.

3. Policy makers need to address possible cliff effects triggered by the end of existing support schemes and the structural weaknesses of EU economies' unprecedented indebtedness levels

An industry representative noted there is a very significant increase in indebtedness, particularly across the corporate and the sovereign world, and an increase in unemployment rates. There has to be concern about the default cycle. The NPLs will weigh on the balance sheets of the banks.

An industry representative stated that the impact on banks will be significant and long lasting. The SSM estimates the impact of the crisis on banks' CET1 ratio to be between 1.9 and 5.7 points. The EBA also calculated that the COVID-19 crisis would hit European banks' CET1 from to 250 to 380bps. Banks are living a large-scale stress test, but there is adequate capitalisation and liquidity. However, the risk exists of a severe scenario which would need further measures from the authorities and further bank support to the economy. It is not the time to add new layers of capital requirements.

A public representative reinforced that banks' better liquidity, capitalisation and leverage served Europe well. It is essential to have a common European response that preserves the integrity of the single market, avoids national fragmentation and ensures that the financial sector can be part of the solution. In record speed the CER quick fix has been adopted to boost lending by up to €450 billion until the end of the year. Public authorities and supervisors have taken swift and decisive action. The green deal will need €260 billion of additional investment per year. Increased lending to citizens and business is needed.

An industry representative indicated that in the first half of the year bank capital ratios moved backwards by about 50 or 75 basis points, despite a material amount of regulatory forbearance. In the near term, stage one and stage two loans will go to stage three. That will provide headwinds for the banking system in terms of capital ratios.

A Central Bank official noted that the release of the counter-cyclical capital buffer contributed very little, due to the limited build-up before the crisis Euro area banks still face structural issues predating the current crisis. During the second quarter, the return on equity in the European banking system went negative. There has been an increase of provisioning, but still too few loans were reclassified, and if banks are hesitant in reclassification there may be considerable cliff effects if the public measures stop.

4. Basel III and the lasting effort to clean NPL in the EU have been essential to reinforcing the banking sector

A Central Bank official noted that while in the past there have been discussions (and different views) around the Basel III regulatory reforms introduced after the global financial crisis, it must now be acknowledged that Basel III has been a very important step in reinforcing the banking sector and making it more prepared and resilient in the face of another crisis. The legacy NPLs had been reduced drastically during the previous years, and the most important reason for reducing the stock of NPLs was to be prepared for the next crisis.

5. EU economy recovery success factors

5.1 Structured and lasting support of the governments to corporates and economic policies conducive to growth and productive investments are essential

A Central Bank official indicated that the structural and growth-enhancing policies are extremely important for putting the (public) debt-to-GDP ratio on a declining trend, as well as for making possible an improvement of the corporate sector's economic financial conditions. That said, these are structural policies that will provide benefits in the medium term. In the short run, because of the current cyclical challenges, it is reasonable to expect that NPLs will increase in the coming months.

An industry representative noted that the corporates will help take people through the recovery process and get them back on their feet again. A corporate in trouble that has lost a great deal of turnover does not start by looking for new loans; it starts looking for liquidity saving measures. It is important, now that the economies may be starting up again, that there is the support of the governments and the private sector going forward.

A Central Bank official added, regarding bad loans and the quality of credit, that their evolution is inevitably linked to the macroeconomic outlook. The next generation of Europeans will have to pay back the debts that the Commission is now incurring, which underscores the importance of governments using these resources for increased growth, good investment and good debt.

5.2 Banks are essential to finance the economy during stress periods

A public representative stated that with the current crisis the completion of banking union and CMU is gaining even more importance. An industry representative stated that the crisis has shown that lending by banks is and will continue to be essential in Europe. Capital markets are not always there, particularly in stress situations, so the banks will be all-important for lending going forward.

6. Regulatory priorities

6.1 Dampening the RWA pro-cyclicality

An industry representative stated that with the pro-cyclicality of CET1 ratios the problem is with the pro-cyclicality of capital ratios, particularly around RWAs. In terms of the capital buffers applied in the capital stack, there should be a much greater proportion of counter-cyclical buffers.

6.2 Adjusting leverage and liquidity ratios

An industry representative noted on the leverage ratios that the classic response in crises, given interest rates are zero, if not negative, is going to be expansion of central bank balance sheets. The central bank reserves on bank balance sheets also expand, and there is the cyclicality in the leverage exposure in the midst of a crisis. There should be a serious debate about whether some of the temporary exemptions of central bank reserves from the leverage ratio need to be more permanent in nature.

6.3 Better communication on stress tests

A Central Bank official noted, regarding the pro-cyclicality of capital requirements, that regulators and supervisors have used all the space that current rules allow. Banks are reluctant to go into the buffers because of stigma effect, and until there is no evidence of a credit crunch, further action to push them to use buffers seems of little use, also in the light of the possible deterioration of asset quality in the next quarters. One thing that is important is the communication around the next EU-wide stress test, as there is a risk of giving conflicting messages (need to use buffers, on one side, and need to preserve them to face future shocks, on the other).

6.4 he short-term positive impacts on bank capital bases resulting from the general bank dividend restriction are challenged by an anticipated reduction of the access by banks to capital markets

A Central Bank official stated on the dividend restrictions that there was very strong support from the other political bodies, but it was a difficult decision for the private sector. Blanked dividend restrictions had been extended in order to maintain the capital within the banks, but there is awareness that such policy action could increase the banks' funding costs and thereby limit their capacity to fund the economy. It might have an impact on their access to capital markets at a moment when they are being encouraged to diversify the composition of their core capital and to issue more AT1s. It will make European banks less competitive, so this is a measure that cannot be prolonged for too long.

6.5 Digitalisation and fewer regulatory disincentives should favour the consolidation of the banking sector

A Central Bank official indicated that, also in order to face the profitability pressures, a process of consolidation might arise in the European banking sector. While supervisors have no role to play as planners of this process, it is important that the supervisory environment is at least neutral in terms of consolidation. A Central Bank official added that the supervisor has no views on who should merge, as this was competition policy, but there is a case for consolidation as there is a problem of low profitability because of overcapacity, and banks doing too many things which are not profitable.

6.6 Securitisation shows important limitations although it should help to address NPL challenges

A Central Bank official indicated that the new securitisation proposals raise questions, because they imply new tasks for the ECB beyond its mandate foreseen in the Treaty. These tasks will put the ECB in a conflict of interest because, as a supervisor of banks, it wants to de-risk banks and keep risks off banks' balance sheet. Transparency and risk retention are a product surveillance activity and not prudential. There is an authority in charge of investor protection which would be a better fit.

A public representative stated that the prudential aspects can be neatly separated from the conflict of interest aspects. It is important that securitisation markets take off, but it is also important that there are actual transfers of risk away from bank's balance sheets, so it would be reassuring for the ECB to take a clear interest in promoting, regulating and controlling this. Additionally, next year NPLs will start skyrocketing, and there needs to be a debate as to whether a traditional "bad bank" is going to be the solution, especially given that now the bad loans will be corporate and SME loans and not collateralized mortgages. In this way, private and public sector players should start thinking of new approaches that would allow for a genuinely European solution, and not just "networks" of national AMCs.

6.7 Home host relationships and funding of bank resolution at the EU level should be addressed in order to make progress regarding the Banking Union

A public representative warns that the crisis is increasing differences between countries. That means the banking union is more important than ever, because these divergences will only foster the vicious circles between banks and sovereigns. As home and host regulators for cross-border European banks fight to ensure sufficient capital and liquidity in each market that a bank might operate in, solving the home/host issue will be particularly important in order to make progress towards a banking union.

A Central Bank official added that the faster the move to banking union the better with a central element being the introduction of a European deposit insurance scheme. Restructuring a bank is a government task, and monetary financing of a government task is not possible. Therefore, a guarantee from the ESM would be needed if the ECB were to provide liquidity

A public representative stated that the first two pillars of banking union, supervision and resolution, are delivering but the gradual implementation of the third pillar on European deposit insurance and progress on the regulatory treatment of sovereign risk are also needed.

6.8 No research is available to cover smaller or mid-sized companies seeking market finance

An industry representative noted that with MiFID II there is the issue of the unbundling of research costs. This has led to many of the smaller or mid-sized companies not being covered by research anymore, which means investors are not as interested in investing in them. A public representative stated on CMU that basic building blocks have been adopted but much remains to be done to ensure equal access to investments and funding opportunities.

7. The anticipated pro-cyclicality and cost of the forthcoming bank regulatory capital framework has to be addressed, taking both the global regulatory perspective and EU specificities

7.1 The low level of banks' profitability is a concerning weakness in the EU

An industry representative remarked that the resiliency of the banking system is not just a function of its capital and liquidity buffers but also of its profitability. Forward projections of profitability for the banking sector are in the range of 2-3% over the next two years. That is a reflection of an unhealthy banking system, and one that might be one more accident away from having material financial stability issues.

A Central Bank official noted that, when assessing the profitability outlook for the banking sector, one dimension to take into account is the increase in competitive pressures, especially due to technological innovations. More in general, there are issues of efficiency, economies of scale, overbanking and consolidation that have been present for some time; the experience related to the recent Covid-shock shows that there is a clear need to address them effectively as soon as possible.

7.2 The bank regulatory framework is pro-cyclical

An industry representative stated that the pro-cyclical capital framework aggravates the situation in downtimes, but most corporate customers across Europe are fairly small or mid-sized. It is not realistic for them to go out and get an external rating and have a listed security, which will be the requirement if they are not to be punished by the coming framework. If a new framework that actually punishes high-quality, low-credit risk companies is introduced, and the incentives are skewed towards less capital for high-risk ventures and lending, the situation will be different. The small and mid-sized companies, which are not rated and do not have a security listed, will not help in the move out of the crisis.

An industry representative stated that the 24% increase in capital requirements resulting from the transposition of Basel IV would freeze a lot of financing necessary for the recovery and the greening of the European economy. The amount is estimated at €7 trillion based on SSM assumptions. If there is a problem with dividends representing less than 2% of the CET1 of European banks, then that capital requirement increase has a huge problem. Before any transposition of Basel IV is considered, there should be a thorough analysis of the economic situation and an analysis of the impact of COVID-19 on the financial needs of the European economy.

7.3 Basel III is a multilateral agreement adopted in December 2017

A Central Bank official expressed support for the multilateral approach versus renationalisation or a situation where everyone is trying to undermine the policies in other jurisdictions. This principle should also be supported beyond Europe, at international level. Re-opening Basel III would be the wrong discussion to have now.

Another Central Bank official emphasised from the Basel Committee perspective that the need to preserve multilateralism when defining the financial system framework is particularly relevant. The interrelations among the financial sector all over the world are huge. The full and consistent implementation of Basel III also needs to be preserved. It is inconsistent to say that banks have entered into this crisis in a much better position precisely because of implementation of Basel during the last decade and all of the financial sector reform, and to also question this implementation down the road.

An industry representative stated that the current situation is a real-life stress test that could not have been predicted, which is probably harsher than anything ever anticipated, and the absolute level of capital has so far been sufficient. There are concerns in terms of the pro-cyclicality of RWAs and the impact on the CET1 ratio. There is no major issue with Basel IV, but the extent to which this is a stock issue, or a ratio issue should be considered.

A Central Bank official noted that a distinction should be made between what is needed now in an exceptional situation and a steady state situation. This unprecedented situation has seen prudential authorities relaxing some requirements and encouraging banks to use all buffers to the full. That banks' capital buffers and capital requirements have been built up during the decade has been one of the very important foundations of their ability to withstand the crisis. It is right to be flexible in the short term. It is also right to be rigorous in the steady state, including the completion of Basel III. It is important to remain committed to the strengthening that has been decided at an international, multilateral level.

An industry representative noted that even though banks have been stronger than going into 2008, they are not immune to problems in the real economy. Delaying or phasing in new requirements will give banks time but is not sufficient. A framework that is properly risk-sensitive is sought, because it is very clear that capital is there to bear losses when they occur, and losses are inevitably driven by risk and nothing else. Financial services are increasingly supplied by institutions other than banks, which do not have the same rules as banks, are not supervised like banks, and do not have internal governance, capital and liquidity. In order to preserve consumer protection and financial stability, the same regulation is needed, irrespective of who the provider is.

A public representative added that the global standards need to be implemented in line with Basel by January 2023. Good care must be taken of Europe-specific business models, and that is the responsibility of the European Parliament and the Council. ■

Does the Covid-19 crisis reinforce the case for the Banking Union?

A Central Bank official described how the idea of the Banking Union started with the advent of ECB supervision, which took place in the aftermath of the general financial crisis (2008–2009) and the Eurozone sovereign debt crisis (2011 2012). Now, Europe is dealing with a new and previously unforeseen crisis. COVID 19 is an almost academic example of an exogenous crisis impacting the financial sector, and there are important questions concerning how it will interact with the project of the Banking Union.

1. The COVID crisis shows that Banking Union has been successful in promoting a more resilient banking sector, but Banking Union needs to be completed

1.1 The Banking Union has been a game changer in terms of developing bank resilience

Thanks to the Banking Union, the EU banking sector entered the COVID crisis in much better shape than in previous crises. An official considered it is obvious that the Banking Union has been a game changer despite the fact that it is still incomplete. If the financial industry had faced the current crisis as it had been in 2007, the banks would have been heavily affected.

An industry speaker noted that the COVID crisis began in the real economy and necessitated decisive action in fiscal policy, regulation and state aid to stabilise the economy. The risk of fragmentation in member states' fiscal policy responses will hopefully be mitigated by the historic €750 billion recovery fund. However, when assessing the functioning of the Banking Union in times of COVID-19, this concerns is a project about regulation and supervision, where there has been consolidation instead of fragmentation. The ECB introduced a set of COVID related supervisory measures, and the EBA issued recommendations. In all member states, Finance Ministries and supervisory authorities have taken action. This suggests that regulators and supervisors have ample flexibility to act decisively.

An official underlined the substantial benefits of the SSM and the project of a Banking Union. The Banking Union and all the other regulations, including the NPL rules, have left the banking sector better prepared than in previous crises. This success has been achieved due to the Single Supervisory Mechanism (SSM). The official described how Germany would seek to make progress on a Banking Union and a Capital Markets Union (CMU) during its Presidency of the European Council. During the COVID crisis, corporates and companies were forced to borrow money from the markets, which illustrates why the project of the CMU is also essential.

A regulator considered that to improve real growth an economy needs equity and a vibrant equity market, which highlights the importance of CMU. The Banking Union and the CMU share many problems, however, such as the lack of a harmonised company law and insolvency rules.

1.2 The COVID crisis has created a divergence in member states' economic performance and further fragmented the Banking Union

An industry representative agreed that the key difference between the current crisis and the global financial crisis (2008) is the fact that the banks are not the crux of the problem; rather, they are at the centre of solving the problem. Nonetheless, the situation in the financial markets demonstrates how there is still a risk of economic and fiscal divergence in the Eurozone. This divergence contributes to the risk of a sovereign debt crisis, which suggests that Europe needs a safe asset. Despite the positive summit in July and the new European recovery fund, the Northern European countries are able to increase levels of stimulus and extend fiscal stimulus measures while other countries will have to wait until at least next year to do this.

1.3 The COVID crisis demonstrates the importance of breaking the link between sovereigns and domestic banks and therefore avoiding any amplification of divergent forces in the Eurozone

An industry speaker considered the crisis to have increased the need for and likelihood of founding a Banking Union. The crisis has increased the fragmentation of EU banking markets. The impact of the COVID 19 crisis was extremely uneven. There was a common shock, but there were different features in different countries. The initial reaction necessarily included a relaxation of the state aid framework, but this created a problem for the single market. The subsidies and guarantees offered to bank customers varied significantly from country to country and banks' holdings of home country government bonds have significantly increased.

A public representative agreed that the COVID crisis made achieving a Banking Union even more important. Before the crisis, the project of a Banking Union was 'moribund'. Of the three pillars, only the SSM was operating properly. Even though the Single Resolution Mechanism (SRM) was well established, states have managed to circumvent it (e.g. the rescue of the Veneto Banks). Additionally, there was no deposit insurance scheme and the precautionary recapitalisation rules allow some banks to avoid the European solution and undertake national recapitalisation. This has been exacerbated by the crisis. Each state is undertaking its own action and there is a lack of European instruments to manage the situation. Regulators have sought to ensure there is sufficient capital and liquidity in each market, which means that markets have become more local. In order to avoid this, the SRB should manage EDIS once it is created. The public representative considered that Europe needs a system modelled on the FDIC, noting that the BRRD review is a clear opportunity to introduce EDIS.

1.4 Fortunately, EU leaders reacted swiftly and decisively

A policy maker praised the 'European leap' taken by leaders to issue bonds at a European level. However, the situation around a Banking Union is extremely difficult. Europe must address liquidity in resolution and the backstop to the Single Resolution Fund (SRF). An industry representative observed that the Next Generation EU package is a very encouraging reaction. This package makes a Banking Union not only more necessary but also more likely, because it includes the embryo of a common safe asset.

1.5 Completing the Banking Union and realising a Capital Markets Union (CMU) are urgent needs

An industry speaker emphasised that the restoration of growth and investment will require a CMU. It is certainly important to finalise the Banking Union, but Europe's growth requires more venture capital or risk capital. In this respect, the CMU is more helpful than the Banking Union. A Central Bank official noted that Banking Union and CMU are necessary and complementary.

A regulator described how banks, the public sector and supervisors have sought to be accommodative during the first phase of the crisis. However, it is essential to find a 'wise exit' from the support measures. The industry must decide which businesses have viable business models and which businesses already had problems which were aggravated by the crisis. The crisis must be a catalyst for transition and reform.

2. The unprecedented magnitude of the current macroeconomic shock is deteriorating the asset quality of banks, and the expected increase in distressed exposures will require specific measures, such as a European bad bank

The financial and economic outlook is still largely uncertain. 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, the depletion of bank capital would be material. An industry speaker suggested that there will eventually be a cliff edge effect in the eurozone when governments' support measures expire, which creates a risk of increasing NPLs. Banking Union must continue in order to avoid the future divergence triggered by NPLs, defaults and insolvencies.

A public representative stressed the importance of ensuring that loan deterioration does not hamper growth. This current crisis is specific: although many bad loans will be from large banks to corporates, a substantial share of NPLs is likely to be small loans to SMEs with little collateral. This demonstrates why the legislative work on NPLs must continue. A network of national bad banks would not be an appropriate solution, however, because coordination would simply increase banking fragmentation. Experience shows that enforcing a common interpretation of European rules would be impossible. In matters such as asset transfer prices, it is hard to imagine a member state tying the hands of its Asset Management Company (AMC). As the Wirecard example shows, there would be massive regulatory nationalism.

A public representative highlighted the fact that widely different levels of available funding in each country would produce vastly different levels of recapitalisation in different banks and therefore lead to further fragmentation. If the solution is a network or federation of national bad banks, it will not perform as well as it did during the general financial crisis, because SMEs are much harder to manage than real estate. If there is a bad bank solution, it should be European and based on EU common rules. Innovative AMCs could be set up at a European level. The BRRD already enables the creation of EU wide AMCs funded by the SRF. Following the BRRD, aid outside resolution would be allowed through precautionary recapitalisation if it is not granted to offset losses that have already been or are likely to be incurred.

3. Solving the home host issue

Until now, the existence of the SSM and the SRM has not had a marked impact on the banking industry's structure in Europe. Obstacles to the integrated management of bank capital and liquidity within cross border groups operating in the Banking Union remain persistent. Therefore, it is still a key priority to find a pragmatic agreement between the SSM and host national authorities on how to abolish ring fencing.

3.1 Fragmentation and local particularities prevent European banks from fully benefiting from economies of scale and diversification within the Banking Union

An industry speaker described how times of crisis produce 'national reflexes', noting that this crisis is no different. Local decisions often do not match the decisions taken by the SSM. The short answer to many of Europe's problems caused by these 'national reflexes' is further integration of the banking sector and the finalisation of the Banking Union. The industry speaker's firm tries to manage liquidity and capital freely between its subsidiaries, but there are always local constraints. There is a similar situation in relation to dividends, as the SSM has recommended a carve out of intra group dividends but this has not been implemented by most local supervisors in Central and Eastern Europe. The lack of consistency and fragmentation also affects shareholders. Europe wants strong and well capitalised banks, but its banks must compete at a global level when it comes to capital markets and raising capital. This is a component that is factored into the valuation of European banks.

3.2 The possibility of consolidated capital and liquidity ratios for EU banking groups

An industry speaker described how the desire for a Banking Union is often a desire for 'more SSM and less national authorities', noting however that their firm considers that the idea of 'more SSM' should entail the facilitation of a free flow of liquidity and capital within European banking groups. It is very important to consider capital ratios and liquidity requirements at a consolidated level rather than fragmenting these assessments and considering each legal entity in a cross border banking group individually. While local authorities could find this idea somewhat concerning, the European regulators have a mandate to do this. There is an opportunity to develop a reassuring framework for remediation measures to be taken by local entities, subsidiaries and individual countries. In that context, the industry speaker highlighted the potential for a waterfall scheme, for example. The SSM can consider this issue in a consolidated way and encourage the freedom of capital and liquidity across banking groups.

3.3 The creation of a common European deposit insurance scheme (EDIS) could help the home host issue

An industry representative suggested that even approaching the coordination problems of cross-border banks in the Eurozone in terms of home and host is paradoxical. This is incompatible with a genuine single market in financial services and reflects the inconsistencies of an incomplete Banking Union. When Europe has common deposit insurance, however, the paradox will disappear.

3.4 Solving the home host issue is essential for cross border banking consolidation

A policy maker stressed that solving the home host issue is difficult but unavoidable. The profitability of European banks is forecast to decline, with a rising cost of credit and extremely low interest rates. It extremely important to create more incentives for banks to consolidate on a cross border basis. It is essential to break the deadlock between those who want the full prepositioning of MREL liquidity and capital and those who want to manage this centrally.

An official suggested that the SSM has a well-known stance on trying to integrate the market further. To do this, however, it is essential to convince national authorities that the European authorities are as concerned with local financial stability as with European financial stability. The SSM is not a home supervisor; it is both the home and host supervisor. The SSM is also responsible for subsidiaries, and it takes this responsibility 'very much to heart'. This is why the SSM is ready to try, even after seeing the regulation, to embed this responsibility for subsidiaries.

3.5 Additional conditions for fostering cross border banking

3.5.1 Fostering cross border banking does not need EDIS

An industry speaker suggested that solving the so called home host issue does not require EDIS, as restrictions on the free flow of capital and liquidity are set by supervisors. In a recent article published in the Financial Times, Axel Weber 'points his finger' at the regulatory barriers to cross border banking, specifically highlighting the ring fencing of capital and liquidity and the absence of an EU payments scheme. The ring fencing and unequal treatment of parent subsidiary structures and parent branch structures in Europe is the principal disincentive to cross border mergers. One example of a supervisory practice which is a roadblock to pan European banking is the G SIB methodology, where cross border activities are strongly penalised. Such obstacles to cross border banking will not simply disappear with EDIS.

3.5.2 The lack of attractive business models is the main disincentive to cross border mergers

A regulator highlighted the economic reasons for the lack of cross border mergers. There must be a value proposition and a business case for a cross border merger. Mergers are taking place, but they are easier to achieve on a national basis because it is easier to realise synergies through national mergers. In reality, there must be decent value propositions and business proposals for European mergers.

4. A further strengthened and aligned crisis management framework is needed

4.1 Europe needs a harmonised bank liquidation regime for small and medium sized banks

A policy maker emphasised the importance of enhancing the EU crisis management framework which could be improved in a number of ways. The achievements of the BRRD could be complemented by a harmonized bank liquidation regime. Europe should assess how to use certain tools of the BRRD toolbox also in national insolvency proceedings for banks.

A panellist suggested that the current resolution toolbox should be able to be applied more easily, which might involve an adjustment of the public interest test. This requires an assessment of the existing funding architecture and liability structure of banks in order to determine how these tools can be used effectively for less complex deposit taking banks. Additionally, there is a case for improving the conditions for DGS funding in crisis management through the least cost test and/or potentially adapting the conditions to access the resolution fund.

A policy maker described how the EU has diverse insolvency rules. It is important to ensure the triggers for 'failing or likely to fail' and normal insolvency proceedings are consistent to avoid loopholes between the European level and the national level, i.e. the so called limbo situations. Insolvency ranking is another issue, particularly questions about whether there should be a higher level of preference for deposits.

4.2 Paths towards a clear and predictable liquidation regime

A regulator stated that the resolution framework is fit for purpose. There are several issues for the industry to address, and not all of these actions require legislative changes. The Commission must ensure that there is a consistent way of managing resolution, insolvency and the 'creative' forms of market consistent measures. Banking communication must be aligned or there will always be circumvention.

A regulator agreed that there are clear issues with the bank liquidation framework, however. There is a European resolution framework which is matched by 19 different liquidation frameworks. It is essential to establish a European framework to deal with all banks that need to be liquidated, and in particular the deposit funded medium sized banks with no access to wholesale funding markets. These banks might be too small to be resolved while at the same time too big to be liquidated.

4.3 The completion of the Banking Union is a matter of consistency

An industry representative considered that the missing elements of the Banking Union are well known. There is no rationale for Europe to have two pillars of Banking Union – i.e. supervision and resolution – without the third one (a common deposit insurance). Additionally, Europe must fix the resolution regime, and there are issues about what action to take on NPLs and sovereign risk.

A policy maker stressed that EDIS remains high on the list of priorities. If Europe wants a unified market, there must be unified protection for depositors. Over the last two years, views have converged on a hybrid model. This can evolve over time, and it will be possible to adjust different parameters in this model. The project can start slowly with a focus on the provision of liquidity through the embryo of a European fund, and then it can move gradually towards a European centre that gains in importance and progressively moves to loss coverage.

4.4 Improving the crisis management framework is one of the priorities of the German Presidency

An official described how Germany's Federal Ministry of Finance is working in close cooperation with the Commission on the Banking Union. There is a potential for further refinement in two areas. First, there are frictions between the EU resolution framework and national insolvency regimes. Key point here is a further harmonisation of the ranking of deposits in the creditor hierarchy. Second, there are smaller banks below the threshold of the public interest for which the requirements of resolvability are not a suitable standard. The official outlined how the German Presidency will seek to advance a harmonised liquidation regime that adds to the toolbox for the liquidation of banks. This will ensure the market exit of non viable banks while minimising the disruption caused by insolvency. The intention is to lay the basis for a legislative proposal by the European Commission that will move forward next year.

An official stated that the issue of fragmentation has become more difficult to address during the COVID crisis. There is ring fencing in some member states, but Germany is committed to continuing the discussion with home and host countries to find a suitable solution. Overcoming this fragmentation will be essential to the project of Banking Union in the long term. Banking groups need to be able to allocate capital and liquidity within their groups, but cross border banking should not come at the expense of local financial stability. It is a task for the SSM to assuage these concerns. The official stressed that a common deposit reinsurance scheme is only one element in the long term picture of the Banking Union. The principal element to address is the finalisation of the common backstop. Responding to a query from a Central Bank official, the official suggested that it difficult to predict whether the backstop to the SRF will be finalised during the German Presidency, expressing cautious optimism about the fact that several member states are in favour of the package on the table.

A Central Bank official stressed that the COVID crisis created the possibility to finalise some of the previously outstanding elements of the Banking Union and to launch some new initiatives. The revision of the BRRD and the question concerning liquidation are two key topics here.

5. The situation remains unstable

An industry speaker opined that the present situation is unstable. If Europe does not move forward, it will move backwards. The industry speaker considered that the industry realises the situation is unstable. Hopefully, mistakes will not be made in tackling the COVID crisis; but if this is the case, the fact that European supervision and resolution are backed by national deposit guarantee schemes and ultimately by national taxpayers is a source of tensions. Even if the resolution framework is excellent and even if the deposit guarantee scheme is protected by any means necessary, the credibility of the deposit guarantee scheme ultimately depends on the implicit guarantee of the treasury. This fact becomes even more relevant without a liquidity in resolution mechanism. Europe is probably the only area in the world without a framework for liquidity in resolution, which exacerbates the inconsistency of the current framework.

An industry speaker stated that there are many right ideas for developing flexibility in the resolution framework. The implementation of the resolution framework has been disappointing, however. Each crisis has been different, and there is no consistency in the way Europe has approached the crises. However, it is important not to forget that the bail in tool is the cornerstone of the resolution framework. Additionally, Europe's insolvency rules should be harmonised. Spain experienced the problem of having a different creditor hierarchy in resolution and liquidation.

A public representative noted that the panel did not discuss the possibility of a full blown banking crisis as a result of COVID. In its analysis on 28 July, the ECB declared the banking sector to be more or less sufficiently resilient, but the ECB did not anticipate a second wave of COVID 19.

A Central Bank official described how the ECB published its vulnerability analysis in July on the basis of the data available at the time. The ECB made assumptions about the real evolution of the COVID crisis and its economic implications incorporating macroeconomic scenarios as least as severe as those published by the ECB. The impact was around 50% more severe than the EBA stress testing exercise that did not take into consideration the health crisis. This suggests that the banks will not emerge unscathed from a second wave of COVID 19. Even in this situation, however, the industry would not face problems on the scale of the financial crisis in 2008. If there is a second wave, the authorities will need to act. The ECB will need instruments of action and will need to work closely with the SRB. The events from July to September have in fact been better than the ECB's forecast. The ECB's message is that something will have to be done in the event of a second wave, but the system is not completely frozen, and it does not have the kinds of structural problems it had in the past. ■

What does the Covid-19 crisis mean for insurance companies and their regulation (Solvency II, global framework)?

1. The impact of the COVID-19 crisis

1.1 The crisis is unique with multipronged consequences for the insurance sector

A regulator stressed that the COVID-19 crisis is different from previous crises, particularly the last financial crisis. It is a health crisis in the first instance, but it has also created severe economic impacts. It has elicited a huge public response and it has required everyone to adapt.

The crisis initially posed an operational challenge for the insurance sector, which then had to respond to the effects of the crisis. Market volatility continued to be an issue. The interest rates in areas, due to the massive interventions of central banks, created even more of a push for the 'low for long' scenario on the interest rate side.

There have also been consequences on the liability side because insurers are also insuring and protecting households and the real economy. Initially, claims arising from the crisis were more focused on life and health but, with government interventions and lockdowns, the crisis began to affect insurers more on the property and casualty (P&C) side with event cancellations, business interruptions, and so forth.

The reactions of supervisors in terms of insolvency, profitability and business model risks are being monitored. The industry is 'not out of the woods yet'.

1.2 On the liability side, the extent of the impact depends on the product mix

An industry representative explained that the extent of the impact on an insurance company depends largely on their product mix. While there has been a much bigger impact on the life side, product and geographic mix remains very important. For many firms, an offset between mortality and longevity risk will lessen the impact. Large insurers have benefitted from their product mix in balancing out the different impacts of COVID-19, making the crisis fairly manageable on the liability side.

1.3 On the asset side, significant liquidity provided stability

An industry representative underlined that all markets were affected on the asset side, not just the insurance sector. The initial market liquidity problems were improved, however, by the significant balance sheet liquidities of individual companies that, in turn, provided a source of market stability for the industry as a whole. Large companies have been able to take advantage of some of this dislocation by being a net purchaser of assets, even in the most disruptive quarter. With their long-term liabilities and ability to invest, they have been able to weather the short-term market disruption. The insurance industry has therefore acquitted itself very well and has been a force of stability.

Despite this success story, another industry representative underlined that the industry was nevertheless unprepared for the crisis. It was an unexpected event, but it is the job of insurers to manage unexpected events. More work is required on risk management, looking beyond the quantitative models that have been the focus of Solvency II.

1.4 Operational challenges

An industry representative outlined the operational issues, particularly related to business continuity, monitoring and planning, that were caused by the crisis. Focusing on these issues has been important in avoiding collapse or disruption and in keeping staff safe as well as providing consumers with confidence.

Suitable governance and business continuity plans have proved effective in dealing with the crisis. Such plans can entail, for example, crisis cells convening on a daily or weekly basis to address constantly evolving developments and to disseminate information throughout the company. Companies have also had to initiate, or expand, remote and home-working plans. The representative's organisation had already implemented home working before the crisis and plans to expand this in the future.

1.5 Reputational issues

An industry representative highlighted the issues that have been raised in the media about non physical damage business interruptions, ambiguity, litigation and so on.

Another industry representative stated that the reputational concerns have been very different from one market to an other. At both the European level and the national level, a solution needs to be devised that involves public-private partnerships. This is first and foremost a political decision and there are many technical hurdles, but these can be overcome. The European Council and the European Commission have to decide whether they really want a European cover and whether it would be acceptable to have some citizens protected and some not.

An industry representative (Engelhard) stated that reputational risk is a mixed issue in the US market as compared with the European market. On the P&C side, business interruption insurance became an issue in some markets.

There is no real private sector solution for government healthcare mandates to shut down the real economy, as this is not really an insurable risk from the private sector side. The reputational issues have largely been addressed by 'ex post facto' cover with the significant fiscal and monetary stimulus. Ultimately, however, there is no ex ante way to insure against the entire economy shutting down.

2. Effectiveness of the measures to deal with the crisis

2.1 Solvency II

An industry speaker stated that Solvency II has responded well to the crisis because of the way that it is built around bricks of risk drivers. Whatever the reason for a financial crisis, it can be captured under the proper submodules of

Solvency II. Combining the bricks to create scenarios in a creative and modular way leads to good responses and correlations between the different types of risks. This is where the analysis in Pillar 2 may need to be deepened.

Solvency regulation cannot simply be built around scenarios, however. Scenarios help build a story and allow for clearer communication both internally and externally but, in the end, the bricks are doing the job in the first place.

A regulator pointed out that the resilience of the industry is due to Solvency II. In addition, insurance sector supervisors did not provide capital reliefs, as banking supervisors did, but instead concentrated on operational relief, allowing for, for example, Solvency and Financial Condition Reports (SFCRs) to be delivered later. Aside from that, not much had to be done.

Another regulator warned that the crisis is not yet over and that there will be more to learn over the coming weeks and months.

Solvency II worked very well in March and the volatility adjustment (VA) helped to stabilising the effect of the crisis. The European framework has proved that, in the face of high volatility, it can provide ways of stabilising the insurance market. However, there are certain elements that need to be reassessed, for example in relation to the wave of downgrades.

In addition, supervisors were able to exercise some flexibility in the short term. Overall, supervisors did not have to do much because it was not necessary to go beyond what was decided at the European Insurance and Occupational Pensions Authority (EIOPA).

2.2 The long-term perspective

A regulator cautioned that the long-term picture is not yet clear. The significant measures taken by central banks on rates will mean that the rates will be lower for longer. This has an enormous impact on the liability side for life insurance companies in particular. This needs to be assessed and potential future lessons need to be identified as the crisis unfolds.

Another regulator stressed that the crisis will impact the profitability of the undertakings in 2020. For 2021, insurers are expected to take this decrease in profitability into consideration when distributing earnings to external shareholders.

The solvency capital requirement (SCR) is under pressure somewhat in some cases, though not dramatically, due to a declining yield curve. The volatility adjustment has proved its effectiveness.

2.3 Addressing the operational and reputational challenges unveiled by the crisis

A number of regulators stressed that there is a risk of customers discovering ex post that their contract does not in fact cover pandemic-related risks due to unclear policy wording.

A regulator noted, however, that the problem of unclear policy wording may be exaggerated in the media. A survey of the French industry showed that only 4% of contracts were unclear as to whether pandemic risks were covered. The media stories nevertheless give rise to a reputational risk. Supervisors need to therefore ensure that insurers are sufficiently clear in their contracts and in their advice to customers as to what is and is not covered. Clarity ex ante avoids reputational risk ex post.

Another regulator stressed that the German picture on wording clarity is not as clear-cut as in France, with many insurers using different wording. Policy wording should therefore be more standardised so that there is clarity over what is and is not covered. This greater clarity, however, will likely mean that policies will generally not cover pandemic-related risks unless they are very expensive.

A regulator stated that supervisors need to be able to deal with relatively new risks that they have not been used to dealing with, or have not prioritised, in the past, such as cyber risks and reputational risks arising from unclear contracts. Supervisors should have a review process that ensures that good governance of these risks is taking place.

In addition, the relationship between supervisors and the industry needs to be simplified. In particular, the system of reporting could be more efficient.

Overall, the measures taken to address the risks should last beyond the crisis and apply equally to normal circumstances.

An industry representative commented that the crisis has revealed a need to re-evaluate the definition of a pandemic risk. Pandemic risks were previously only linked to mortality or morbidity, but this crisis has impacted upon the economy, social issues and business norms.

3. Future implications

3.1 The consequences of the Solvency II review

An industry representative stated that attention still needs to be paid to the issues that existed before the crisis and highlighted the importance of having a system that does not produce volatility. Equally, the system should not over-calibrate but rather help to provide look-through views so that supervisors do not overreact.

A regulator stressed the need to finish the Solvency II review by the end of the year, even though the full dimensions of the crisis will still not be known then. The main lesson learned so far is that no fundamental changes are necessary to the current proposals but that some fine-tuning may be required.

COVID-19 has provided valuable information on where the crisis management tools from the regulation, such as the volatility adjustment, are ultimately fulfilling the tasks that they were designed to fulfil. Though there is a potential for overshooting, the VA has worked well to dampen procyclical effects. The problem in some countries is that this overshooting might lead to an inappropriate profit distribution, which should be worked on by local generally accepted accounting principles (GAAP). However, an industry representative stressed that risks of the VA undershooting during times when the interest rates spreads would be much more magnified than during the Covid19 crisis and be similar to those observed in the 2008-2011 crisis – exist and still have to be addressed.

Undertakings' leeway for dealing with additional streams is becoming increasingly limited, which will put pressure on supervisors to ensure that there is a balanced solution for the Solvency II review. A regulator (Bernardino) stated that EIOPA is aiming for a balanced solution for the Solvency II review.

A regulator highlighted the need to define what a 'balanced' revision of Solvency II means. What matters over the coming years is rebuilding the economies. Insurers, as investors, have a role to play in that, and this should not be forgotten in the revision of Solvency II. While prudential objectives should not be mixed with other objectives, equally, long-term investments should not be penalised, as they are necessary for the economy. Without a strong economy, there is no strong insurance sector and no strong banking sector, and this systemic dimension needs to be embedded into the review of Solvency II.

A regulator stated that the volatility caused by the crisis has hugely influenced the SCR of the companies. This can limit the amount of flexibility that supervisors can use. Supervisors need tools within the framework that work better in smoothing excessive short-term volatility. Emergency measures should be put in place if necessary. The long and complex process of extending the recovery period in the case of a breach of an SCR needs to be simplified in order to provide more flexibility to supervisory intervention in the future.

While liquidity risk has generally not been an issue during the crisis, it certainly was a concern for supervisors at the outset. A monitoring system was therefore put in place and supervisors investigated any possible access to emergency liquidity sources. These measures are not sufficient, however. Instead, they also need to ensure good risk management of liquidity, involving better monitoring, better stress tests and a better capability of the companies to set their own liquidity buffers and contingency plans. This should apply to all companies and not just the big groups.

3.2 Global standards

An industry representative stressed the need for a long-term perspective, particularly when looking at the lower-for-longer rate environment. The public sector needs to consider whether it wants a system where policyholders can get the long-duration-guaranteed products to protect them in crises. The low interest rate environment makes it very hard for insurers to provide those kinds of products and a prudential system that artificially creates 'non-economic volatility' will make it almost impossible. This is particularly true in the life insurance industry where companies take on very long liabilities. From a global standards perspective, it is important to balance the goals of long-term investment and long-term protection.

A regulator (Bernardino) maintained that the above concerns will be taken into consideration during the development of the Insurance Capital Standard (ICS).

3.3 The role of the insurance industry

An industry representative acknowledged that insurance companies can play an important role in supporting the economic recovery but that a few facilitating factors are required. In particular, the taxonomy project needs to be finalised and investments for insurance companies need to be made available. Insurance companies are eager to invest in infrastructure but there are not enough good infrastructure projects. Equally, insurance companies are very eager to invest in SMEs and yet there are not enough SME vehicles in Europe.

Another regulator (Bernardino) stated that the prime focus going forward should be on the recovery and on having a sector that can deliver for the consumers, for the citizens and for the real economy. There are three key points related to this: sustainability, particularly in relation to climate change; digital changes, which will persist in business models after the crisis; and long-term investments where demand will be incentivised by regulatory measures but where governments, the real economy and companies also need to generate supply.

4. Dividend policies

An industry representative acknowledged that the Solvency II review needs to be more focused on the long term so that insurance companies can invest long term and sell long-term protection products. However, consideration needs to be given to the fact that insurance companies use solvency to pay dividends. In this regard, the regulators have created a great deal of confusion with their ban on dividends, which will damage the Solvency II framework in the eyes of investors. Currently, the ability to pay a dividend in Europe depends on location, which is unacceptable from a competition point of view. The regulators need to come together to address these issues. ■

SESSION SUMMARIES

FUTURE STEPS OF THE CMU

CMU: is the High-Level Forum report the right way forward and what are the next steps?

1. Implications of the COVID crisis for the CMU

Several speakers on the panel emphasized the importance of the Capital Markets Union (CMU) for addressing the economic challenges caused by the COVID crisis.

A policy-maker stated that CMU is a key priority for the EU and has become even more urgent with the COVID-19 crisis because the recovery cannot be financed through public finance alone. Private finance is also needed to fund the green and digital transformations of the EU economy and to relaunch job creation. A new CMU action plan will be published at the end of September covering areas such as access to finance, market infrastructure, retail investor participation and the removal of barriers to cross-border investment. A public representative stressed that CMU is needed in particular to make it easier for SMEs to access equity and to provide savers with appropriate investment opportunities. An industry representative felt that in the face of the challenges raised by the COVID crisis, CMU potentially creates major opportunities for Europe. These include the possibility to double the size of the European capital markets and to increase the share of savings flowing into productive, socially useful, sustainable long-term investment, thus improving prospects for the next generation.

While strongly supporting the CMU, a regulator emphasized that it will come too late for addressing the consequences of the COVID-19 crisis and that we will measure how detrimental it is not to have a CMU in this context. This is particularly regrettable concerning equity financing, which is needed for diversifying funding sources and avoiding an excessive growth of indebtedness. A strong push forward regarding the CMU to prepare for the next crisis was advocated by the regulator, who also underlined that Europe does not have the right supervisory tools either to deal with crisis management. As an example, embedded in the founding regulation of the ESAs is an article about so-called action in emergencies, but this process is too complex to trigger and delegating to an authority which is not the regular ground supervisor in order to take some urgent decisions is not likely to work. Additionally when supervisory decisions have been made in the past for mitigating certain market risks, such as short selling bans or the implementation of liquidity tools to limit fund outflows, different options were taken across the EU by domestic supervisors for tackling the same risks: such a lack of harmonisation is neither effective nor sustainable.

An industry representative agreed that the completion of CMU may arrive too late for this crisis. Despite this, progress must be made in its implementation, because every minute lost will protract and delay the recovery of the EU economy further. CMU is essential and unavoidable for economic recovery in Europe and the current scheme that has been proposed is the right way forward. But there has been a lack of rigour and urgency over the last few years with the implementation of the first stages of the CMU, which should not be reproduced. Governments and banks responded appropriately at the beginning of the COVID crisis and avoided a credit crunch and liquidity crisis. However, this has significantly increased the level of debt and when leverage is poured into a fragile economy at such a magnitude, it is only a question of time for the solvency rates of corporate balance sheets to hit rock bottom. A discussion is needed on the next steps for repairing corporate balance sheets. The provision of further leverage is not the right response. Rather, access to private equity is required. Another industry representative observed that it is not just government and corporate balance sheets that are stressed as a result of the COVID crisis but also the private individuals' balance sheets.

An official also noted that the financial sector and governments had responded adequately to the COVID crisis, avoiding a credit crunch. There now has to be consideration of how the financing process can be normalized going forward, following this expansion of credit. CMU plays a part in this and particularly the measures related to simple, transparent and standardised (STS) securitisation. There is also a need to revive the discussion concerning the secondary trading of non-performing loans (NPL). NPL numbers are not yet increasing to critical levels, but it is just a question of time, because there is always a correlation between recessionary tendencies and the growth of NPLs.

An industry representative explained that the situation is variable across the EU. In the Nordic region, SMEs that needed capital used the stock exchange to get it. The reason for the success of the stock market in Sweden in particular is education and tax. The tax system has been relatively favourable for retail investors for many years. Statistics also show that companies that list on public markets grow faster and create more jobs.

The official pointed out some other encouraging developments in Europe on which the CMU can potentially build. Good progress has been made in terms of digitalisation. Europe also has the potential to become a hub for venture capital (VC). A great deal of venture activity is being conducted by the EIB and several domestic development banks and venture finance incentives are also being included in the public funds provided in response to the crisis. This is the case for example in Germany where the €10 billion "future fund" will include incentives to stimulate VC activity and maximize its impact.

2. Key areas covered by the CMU HLF report

The CMU High-Level Forum (HLF) report was very positively received by the speakers on the panel, who considered that it constitutes a well-balanced and comprehensive action plan covering both supply and demand factors. It is also relevant that it combines a top-down vision of the approach needed for developing EU capital markets with a granular description of the practical actions that need to be implemented and a detailed timeframe. An official noted that the calendar for implementation is ambitious, but it can be achieved. The coherence of the package and the mutually reinforcing nature of the actions proposed were also emphasized, meaning that there should be no cherry-picking within the CMU action plan.

2.1 Key themes highlighted by the panellists

2.1.1 Access by companies and particularly SMEs to more diversified financing

An industry representative indicated that about 75% of the European economy is financed by bank loans, which is not a healthy situation. An official emphasized the importance of providing SMEs with a proper choice between banking finance and capital markets. Another official stressed the relevance of the measures proposed in the HLF report regarding listing rules and the facilitation of IPOs.

The importance of increasing equity financing particularly for SMEs was stressed by several speakers The more equity there is in the financing system the better the risk is spread throughout the economy, and the less entities are vulnerable to any particular whim or crisis that comes through the banking system, a market observer noted. A public representative considered that SMEs need to become more comfortable accessing the equity markets. An industry representative suggested that regarding SMEs there is a need to work both on the supply (issuance) and on the demand sides. In this regard, the European single access point proposed by the HLF for facilitating the access to company financial and ESG data will be critical, because a standardised set of data is needed to be able to analyse companies and investment opportunities and to then direct money where it can be used most effectively. The need to review prudential frameworks for fostering more institutional investment in equity was also emphasized. However the industry representative stressed that there should be caution when allowing SMEs to disclose less information compared to larger companies, because the larger pension funds and investors in particular need maximum transparency.

2.1.2 Development of retail investment

A public representative stated that there is a need to focus on financial education, because investors who are most likely to diversify their investment portfolios are those who have sufficient financial knowledge. An official confirmed that retail investors must be prioritised. They have to be able to not just access the capital markets in Europe but also to do so with sufficient trust and also with an understanding of the implications of investing in capital markets. That requires improving the level of investor protection and financial literacy. An industry representative agreed, suggesting that investor education should start at an early age through the educational system and that the financial industry is ready to contribute to this effort. Providing effective digital platforms is also essential for facilitating further retail investment.

The industry representative also emphasized the link that needs to be made between the objective of developing retail investment and pension issues in Europe. Considering on-going demographic changes and the difficulty of sustaining the public pension schemes, it is obvious that the private sector needs to contribute more to retirement savings. This view on long-term pension savings needs to be clearly brought into CMU 2.0.

2.1.3 Further integration and competitiveness of EU capital markets

A public representative suggested that removing legal and fiscal barriers, such as those related to the withholding tax, and creating a market infrastructure that allows equity to move more easily across the EU are essential for building a more competitive CMU that can attract more capital within the EU and also from foreign countries. This is particularly important with the UK leaving the EU. There is a need to attract foreign companies to the EU capital markets to find investment and also to provide EU companies with sufficient capital for funding their expansion. An official agreed that further harmonisation and achieving a large enough internal market for capital are essential and supported the ideas put forward in the CMU HLF report in this regard.

A market observer queried whether merging smaller exchanges into a pan-European platform could help to build a more dynamic capital market in Europe likely to increase the liquidity of EU SME markets in particular. An industry representative did not believe that there is much added value in consolidating domestic exchanges further. Synergies and scalability can be achieved in other ways, for example by sharing the same trading or surveillance systems or by interconnecting platforms digitally. This is the way forward that has been chosen in the Nordics. Domestic exchanges serving local needs share the same platform and technology but have not been fully consolidated.

2.2 Proposals requiring stronger emphasis in the new CMU action plan

Two main areas of improvement that could have been more strongly emphasized in the CMU HLF report were mentioned by certain speakers: the improvement of securities market transparency and a further integration of supervision.

2.2.1 Market transparency

While supporting the Report of the High Level Forum and most of its recommendations, a regulator noted that a proposal to establish a European consolidated tape is missing in the Report, as such a tool is needed for improving the post-trade transparency of equity and bond markets. An industry representative disagreed, considering that a European consolidated tape would not constitute a game changer for the development of EU capital markets. The focus should rather be, as suggested previously, on helping SMEs to gain access to the capital markets and on strengthening equity financing. With MiFID II the European market has become 'darker and darker', but this is more the result of changes in the market structure with the strong development of Systematic Internalisers (SI) and over-the-counter (OTC) transactions. Only large size orders should be transacted on SIs and OTC. This issue needs addressing in the new CMU action plan.

2.2.2 Integrated supervision at the EU level

A regulator emphasized that the issue of supervision is key for the CMU, but is not properly addressed in the recommendations of the HLF. The basics for a union in the area of capital markets are very simple. There needs to be a single rulebook and a harmonised implementation of it, based on harmonised supervision. The problem is that at present there is no real single rulebook because a large part of the EU legislation is based on directives and even with regulations there is often the possibility of opting-out from detailed EU guidelines. For example, answers to Q&A at Level 3 are not binding. The proposal of the HLF will result in increasing the level of scrutiny that the ESAs exert on domestic supervisors, rather than favouring a truly European supervision. This is not an appropriate response to the issue, because it maintains nationalistic approaches, increases bureaucracy and limits the agility of supervision at EU level. The only sensible answer is a more integrated European supervision. This is especially relevant for cross-border entities and financial activities, which are essential for the CMU, and for ensuring financial stability. The recent crisis has revealed deficiencies in this respect. In addition, it is necessary to consider that the current patchwork of national rules and supervisors that favours regulatory arbitrage and jurisdiction shopping is not attractive for third-country investors. Not addressing this issue will be very detrimental for the CMU project.

A public representative stated that without single supervision there will never be a real CMU. The huge social and economic crisis that Europe is currently facing cannot be tackled by just focusing on the national interest. Moving forward on this issue will be a major challenge for the Parliament and the Council and also for the Commission, but it is essential for the effective implementation of the new CMU action plan.

A market observer explained that the HLF proposed a hybrid formula for supervision with some increase in the horizontal powers and governance of the ESAs, but with no additional direct supervisory powers. Indeed many large financial firms are not comfortable with supervision conducted at the EU level. What is needed is some rationality in defining what needs to be supervised at the EU and at the national level. The HLF report proposes some criteria for EU level supervision that include the cross-border nature of activities and their systemic relevance.

3. Links with the Banking Union, Digital Finance Strategy and Recovery package

The links between CMU and other key EU initiatives, such as Banking Union, the recently proposed Digital Finance Strategy and the EU Recovery package, were emphasized by several speakers. These different initiatives are part of an overall roadmap for relaunching growth and supporting the financing of the European economy. They are also mutually reinforcing and provide different drivers for enhancing the role of the EU financial sector.

An official emphasized the synergies between the digital finance strategy and CMU, which are 'sister projects'. It is unacceptable that a fintech in the United States can immediately access an internal market of hundreds of millions of consumers, whereas a similar start-up in Europe can only access 27 separate internal markets. Indeed, due to different consumer protection, AML, KYC requirements across the EU, the cost per unit of reaching consumers is much higher for European fintechs. A policy-maker mentioned that besides addressing fragmentation issues, the new strategy for digital finance will provide a framework for tools that may support the CMU such as DLT, crypto-assets, cloud services and artificial intelligence and will also propose adaptations to existing financial legislations in order to take into account the impacts of digitalisation.

The official also stressed the linkages between CMU and Banking Union. As long as banking markets remain fragmented across the EU, it will be difficult to develop an integrated and deep financial market in Europe such as the one that exists in the US. Market making is particularly important in this perspective and the CMU HLF report has rightly proposed measures in this area. The tension between prudential requirements and the ability for banks to provide sufficient liquidity to capital markets is something to be further considered. Prudential requirements need to be optimised in this regard, even if this is a challenging task.

That the recovery package introduces what can be interpreted as a European safe asset is encouraging, another official added, because this may support the development of a more liquid and deeper capital market in the EU.

4. Conditions of success for the implementation of the CMU HLF proposals and next steps

The need for a strong political backing of the priorities put forward in the CMU HLF report was emphasized by several speakers. A policy-maker explained that CMU is an area where close engagement with representatives from the industry and academia is indispensable for producing results, but above all, support from the member states is needed.

A public representative agreed that for moving forward on the CMU, an impulse has to come from the top with an agreement on the key recommendations of the new CMU action plan from the Commission, the Parliament and the Council. In addition, the decision-making process needs to be quicker than in the previous stages of the CMU. The current political situation in some of the member states does not make this easier, but that does not mean it is impossible. Without that high level consensus, it will be difficult to reach an agreement on the more specific proposals further down the line.

An official stressed that the necessary steps will have to be taken in the course of the German EU presidency for translating the key insights of the CMU HLF report into actual policy actions. The goal is to find agreement among the member states on priorities and give the Commission a clear mandate from the member states by the end of the year on where the priorities are and which topics to focus on. The Commission has already front-loaded part of the CMU action plan in the Capital Markets Recovery Package, which was tabled in July and aims to help businesses to access capital markets with targeted adjustments to prospectus, MiFID II and securitisation rules. It is hoped that an agreement can be reached by the end of this year on the legislative proposals corresponding to this package, as this will be an important test for the rest of the CMU action plan. Indeed, while member states all concur with the importance of the CMU, an agreement is more difficult to obtain on specific actions. In the Capital Markets Recovery Package, the most complicated issue to be tackled is probably the STS securitisation framework, as it raises controversy both in Parliament and among member states. However improving the current framework is essential for enhancing risk transfer within the EU and between banks and capital markets. In addition, the objective is not to replicate the opaque securitisation system that existed before the 2008 crisis, but to foster a standardised and transparent securitisation process in line with European standards, which hopefully will be achievable. An official felt that the timeline is ambitious and there has to be realism about the pace at which approval can occur, but their country would be supportive of the approach proposed.

The policy-maker hoped that the legislative process can be managed fast enough to obtain clarity by the end of 2020 on the support there can be from the different stakeholders on the CMU action plan that will be published at the end of September. The action plan however covers some very sensitive topics which need to be approached in a smart way. An industry representative was concerned that the political process may move forward at the cost of the more politically sensitive recommendations, specifically those on shareholder rights and withholding tax. Progress on these topics is nevertheless essential. Today an investor in European securities is faced with 27 different definitions of a legal owner, 27 different operational processes and 27 different sets of tax forms. Managing this complexity is a challenge for wholesale market participants and practically impossible for retail investors. A key priority for the work going forward is to keep the idea of a package and to deliver significant progress on all of the topics put forward in the CMU HLF report with a sufficient sense of urgency. ■

Can the EU manage without the City and how will financial services regulations with third countries evolve post-Brexit?

1. State of progress of EU-UK equivalence arrangements in the financial sector

An official stated that the UK's aim for financial services relations with the EU is to establish complete equivalence findings under existing laws before the transition period ends in areas where equivalence arrangements are available. This should be supported by clear processes for regulatory cooperation allowing industry to understand how the situation will evolve as regulation continues to change. Unfortunately equivalence is not yet in place and will not be considered by the Commission this year. Negotiations will continue on the services component of the Free Trade Agreement (FTA), but the UK is not where it aimed to be. This includes MiFID and the substantial cross-border trade flow between the EU and UK. Another aim was to have CCP equivalence in place before the transition period ends, following the definition of the relevant supervisory processes. ESMA and the Bank of England are discussing the necessary Memorandum of Understanding (MoU), which will be challenging to define but is achievable, as both sides want to manage stability risk. The UK is also considering its own equivalence decisions regarding the EU and other third-countries. A temporary permission regime that will operate after the transition period should however alleviate any cliff edge concerns.

A regulator confirmed that the relevant MoUs between EU and UK regulators will be in place. Clearing remains a stability concern, so there will be time-limited equivalence after the transition period and ESMA and the Commission will ensure that clarity is provided on UK CCPs' recognition sufficiently in advance. The situation is different concerning MiFID trading obligations, which will not have stability implications and therefore can be managed without equivalence arrangements.

An industry representative regretted the persistent uncertainty about Brexit that impacts many policy discussions and hoped that next year will bring some certainty relative to the future relationship. This also requires having a discussion about whether there exists a similar strategic view on how to regulate financial markets and the effects of regulations on the firms operating in the market.

A market observer noted that three main issues come into play in discussions about cross-border operations. One is financial stability, the second is consumer protection which can also be part of stability and the third is competition issues.

Regarding the preparedness of financial firms and possible cliff edge risks, an official explained that firms reacted to the news about the delay on MiFID equivalence by assuming that there will be no deal, so they have been preparing for this scenario. Client readiness challenges seen during dry runs are still being tackled, but there are no financial stability risks related to a possible immediate cliff edge, since there is now a better understanding of risks and more transparency about how they can be managed than in the earlier stages of the Brexit negotiations. The wider economic situation was not anticipated however, and authorities are monitoring this as well. A regulator confirmed that public and private sector stakeholders had had ample time to prepare for a no-deal scenario and thus ought to be ready now.

2. The risk of regulatory divergence between the EU and the UK

2.1. Short term situation

Regarding the possibility of regulatory divergence, an official stated that the UK has set out its post-Brexit approach to existing and planned EU regulations and their implementation. There has been much debate about the UK's intentions, hence the need for clarity. The main area where the UK intends to review the acquis is Solvency II, as this includes areas of challenge for the UK such as risk margin and matching adjustment. This will be done progressively starting with a call for evidence that will be launched later this year.

In addition, the UK will not implement the MREL[1] component of the new Bank recovery and resolution directive (BRRD) as it has its own framework, the Central Securities Depositary Regulation (CSDR), some Securities Financing Transaction Regulation (SFTR) reporting requirements and the requirement of the Investment Firm Regulation (IFR) for firms to re-authorise under the new regulation. These changes are quite measured in the UK's view and constitute in no way a 'bonfire of regulation'. The UK moreover intends to be as transparent as possible about the decisions made that will be based on cost impacts as well as the broader strategic context of the market.

2.2 Longer term evolutions

An official noted that in the longer run, the UK will not be mapping detailed changes to the EU acquis as it evolves, since these changes will be negotiated between member states without consideration of UK needs. The EU and UK will however continue to share similar challenges and operate in similar risk environments. It is likely that the policy thinking of the UK in areas like sustainable finance, crypto assets and technology for example will stay close to the EU's and that both will be aligned with the international debate in these areas. It will also be interesting to see if the absence of the UK changes anything to EU policy decisions in the capital markets area in the future.

A regulator considered that although political decisions will be made on regulatory alignment and possible divergences,

[1] Minimum requirement for own funds and eligible liabilities (MREL).

because the EU and UK are sovereign, regulators will need to continue cooperating within that framework, because the UK will continue to be important for EU financial markets, and cooperation is vital for effective supervision and regulation.

An industry representative stated that there has to be a step back from the political FTA negotiation. Financial policy issues should be considered from a global standpoint, without opposing EU and UK perspectives, because the financial market is global and many financial firms and their clients operate globally. The proposed EU pandemic emergency measures in particular, which include changes to MiFID II, raise some questions in this regard. For example, issues like commodity derivatives position limits that took months to negotiate may apparently be scrapped by the EU with the intention of creating an energy commodities derivative market. If the EU rulebook is changed significantly as a result it will be difficult for the EU to argue that global rules must conform with their rules.

3. Expected evolutions of the financial sector in Europe post-Brexit

3.1 Impacts of Brexit on the structure of the European financial sector

A market observer emphasized that although the final outcome of the Brexit negotiations is unknown (at the time of the panel), passports will disappear and it is expected that 40 to 60% of UK-based bank balance sheet assets could be affected. €300 billion of banking assets have already flowed from London to Frankfurt, with another €100 billion likely to be transferred by the end of 2020 and a further €400 billion are ready to move. In addition the clearing of close to 20% of euro-denominated interest rate swaps has been transferred from London to Frankfurt, with costs on par for market participants.

An industry representative agreed that Brexit will cause further business restructuring towards Europe and additional transfers of people and activities. The challenge is to manage these transfers without creating frictions. This can be addressed thanks to technology to a certain extent, but it is a complex process requiring changes to a huge amount of legal relationships between banks and their clients.

An official, referring to the title of the session, believed that the EU will not have to manage without the City, since it is not going anywhere, although frictions in the relationship will increase. The UK financial sector is competitive, open and safe and will continue to be so. In addition, the official believed that moving a significant part of business to the euro area, beyond the transfers underway, would be complex and may not be justified in terms of efficiency. Fragmentation is inevitable but has many angles that will require to be closely monitored in the future. The main shift of clearing activity to the euro area concerns at present euro-denominated government securities, which makes sense. Most of the rest will remain in the UK due to efficiency considerations. Capital fragmentation occurred as banks set up entities in the EU to mitigate the impacts of a no-deal exit, but the impacts on non-bank assets are more difficult to establish, as the sector is more complex and global norms favour managing portfolios cross-border. As for jobs, impacts are limited due to the use of technology and effective cost-cutting in the UK. Job moves out of the UK into Europe due to Brexit should be under 10,000 out of a total of about 300,000 people employed in financial services in London. Impacts on liquidity also need to be considered because of the consequences for the funding of economies, for investors and also in terms of competitiveness. Finally the official stressed that the main question raised by market participants is not about fragmentation within Europe, but globally. It will be vital to assess the possible movements of activity, assets and liquidity from Europe to the US or Asia in the future rather than trying to 're divide the pie' regionally.

Another market observer was convinced that there would be further changes in the financial activities conducted in the EU and the UK. A great deal of change has already happened with legal entities built in the EU in areas where equivalence arrangements are not available, such as banking, insurance or some parts of asset management. The ECB SSM has clearly indicated that banks would have to progressively move operations to the EU and the corresponding bulk of responsibilities and operations, in order to avoid disruptions. Equivalence arrangements will be negotiated, but careful evaluation is needed to ensure that financial stability and control of the liquidity of the euro can be preserved. Other aspects that need to be considered in this perspective include the delegation of asset management responsibilities. ESMA has advised the Commission about the conditions for the delegation of core functions and the need to ensure that a critical mass of effective management is performed in the EU. Back-to-back operations are another issue. The ECB allows back-to-back operations, but this should not result in the main part of the euro market being outside the EU, which would not be acceptable from a financial stability perspective.

3.2 Potential impacts of Brexit on the competitiveness of European financial markets

An industry representative stated that the main issue for third-country financial institutions concerning European financial markets is their competitiveness. It is at risk with Brexit and this may lead capital to be reallocated from Europe to the US or Asia. EU and UK legislators and regulators must cooperate in order to reduce disruption to the financial industry at the end of the transition period. London is one of the biggest financial markets globally and will remain prominent, acting as an investors' gateway for Europe, the Middle East, Africa and Russia. It is not clear at this stage whether a financial centre in the EU is able to challenge this position in the future. In addition, which EU or UK financial centre 'wins' is secondary from a global perspective. London's attractiveness ranking has deteriorated to number two since the Brexit referendum and is now close to Tokyo, Singapore, Shanghai and Hong Kong. Regional economic growth is another factor for third-country financial institutions. Recent GDP growth in Asia-Pacific (APAC) is around 5%, compared to 2% in the US. That is before COVID-19, but Asia will be better positioned than Europe. A second element is each market's scalable opportunity. The US is the biggest capital market with $39 billion in 2019, Europe is second with $15 billion and APAC third with just $13 billion. Third is capital efficiency, which is lower in Europe Middle East Africa (EMEA) than in the US and Asia, due to an average cost-to-income ratio of European banks 10-20% higher than the US. Varying regulatory regimes and market uncertainty in the EU make this worse.

Another industry representative emphasized that activities such as share and derivative trading should be approached differently from interest rate swaps clearing in the equivalence discussions. While ensuring financial stability in the clearing area and sovereignty over instruments such as euro-denominated swaps is important for the EU, there is a risk of valuing a market structure objective over the competitiveness of European financial providers in other discussions about equivalence (e.g. concerning share and derivative trading obligations). European financial institutions could be placed at a disadvantage in this case without achieving any useful objective in terms of price discovery or liquidity. Ultimately, liquidity cannot be mandated in one direction or another. Markets evolve and seek the place where there is the least friction.

A third industry representative agreed that capital is global, and people can choose where to access it. Competition is good, but liquidity cannot be trapped or forced. It comes through genuine, superior systems, so it is good if standards rise globally. This is what clients need, so market participants must 'cut the politics and get on with it'.

An industry representative stressed that cost implications should not be forgotten in the discussions about Brexit and equivalence, because the complexity of doing business in the current environment is increasing for financial institutions, with geopolitical challenges and the economic consequences of the pandemic. Market volatility is also expected to increase given the current divergence between market valuations and the real economy, potentially leading to significant price correction in the near future. Prolonged negative interest rates are impacting bank profitability, at a time when banks also need to invest in new digital business models. The increasing substitution of fiscal policy through monetary policy is also leading central banks to lend directly to the real economy, in competition with banks. Caution is advised that these temporary measures designed to relaunch growth do not become permanent. The more structural and long term these actions become, the higher the challenge will be to exit them and private investment must continue to be encouraged. This difficult environment however also offers many opportunities, provided policies are appropriately focused on what is needed to support the funding of the economy in the long term.

A market observer suggested that efficiency impacts should be approached more holistically. Costs not only occur on banks' accounts, but also on state budgets. A 'scaremongering' figure of €100 billion additional costs for moving European bank activities to the EU was put forward. Today there are no significant costs, with further stability and competition benefits, so well-chosen fragmentation can add to stability and competitiveness in the market. Moreover concerning clearing, given the importance of financial stability, standing on two feet (the EU and the UK) is eventually better than on one that is difficult to control.

3.3 Implications of Brexit and the Covid crisis for the Capital Markets and Banking Unions

An industry representative emphasized the importance of the Capital Markets and Banking Union initiatives for strengthening the European financial ecosystem and commented on their factors of success in the present context. Banking Union may foster further, much-needed, banking consolidation, with important benefits for consumers of financial services. CMU also offers many opportunities, such as the possibility of providing consumers with easier access to capital markets, increasing market liquidity and depth across the EU and also reducing the complexity of cross-border investment. At present EU households only hold about 20% of financial assets in equities compared to around double that percentage in the US, showing that there is a strong potential for private investment in the real economy besides that provided by central banks. Realising the benefits of these initiatives in terms of economic growth and competitiveness of the European financial sector vis-à-vis the US or Asia however requires a focus on the role of financial services in the funding of the economy rather than on protecting EU markets. In addition, it is necessary to understand that the benefits of these initiatives will take years to realise, so time is of the essence. There needs to be a win-win situation for member states participating in these initiatives, who should not feel that their national interest is diminished by a European level project. The same goes for third-country participants who can play an important part in the CMU by facilitating global capital flows to the EU if they benefit from an appropriate equivalence regime.

Another industry representative considered that in a context of mounting conflicts among countries, Europe should return to the basic strengths of its financial market, which are to be international and competitive.

A market observer noted that the Covid crisis created a push towards digitalisation and solidarity in Europe that even surprised optimists. This may be the early days of a safe asset class that could accelerate the creation of a new common capital market and the completion of the CMU. Europe has grown under stress in the past and there is room for optimism.

4. Improvement of the EU equivalence system: initiatives underway and possible additional needs

A regulator stated that equivalence is a tested regime that has been widely applied, particularly for capital market activities, and has recently been reviewed also in the context of Brexit. The process takes time to implement but once it is granted it is generous, providing third-country entities with the possibility to fully participate in the single market. There has also been recognition that this process has helped to reduce fragmentation.

A certain number of limitations of the current EU equivalence system were discussed by the panellists, as well as the initiatives underway for addressing them.

4.1 Reliance on third-country supervisors

A regulator stressed that a key limitation of EU equivalence arrangements is the reliance on third-country supervisors, who might overlook certain financial stability risks for the EU. The EMIR 2.2 reform addresses this issue for CCPs with a more elaborate regime for the supervision of systemic third-country CCPs, which is currently being implemented. The possibility of supervising third-country market participants in certain cases is also reflected in the IFR regulation where ESMA is endowed with certain quasi-supervisory tasks regarding third-country investment firms, provided there is equivalence regarding UK investment firms offering services in the EU. As a result of changes to their founding regulations, the responsibilities of the European Supervisory Authorities (ESAs) regarding the monitoring of third-country supervisory frameworks have also been increased. This will help the ESAs to monitor changes to the regulatory and supervisory system in third countries and any implications for equivalence, which is crucial with the UK continuing to be an important market for the EU.

4.2 Outcomes-based equivalence determination

Several industry representatives on the panel emphasized that equivalence determination must evaluate the outcomes of legislations, rather than compare regulations line-by-line. One representative suggested that equivalence means that the 'direction of travel' is the same, although the details of legislation may differ. This idea is reinforced by the fact that EU legislation is evolutionary and is periodically reviewed. Another representative was in favour of 'reasonable equivalence' comparing outcomes, which is less costly than the US-type line-by-line compliance arrangements. A third representative suggested that equivalence determinations should consider the outcomes of third-country regulations against internationally agreed standards, rather than comparing local regulations line-by-line. If requirements stem from global standards, equivalence should be presumed. This will facilitate equivalence determinations, lead to more harmonisation and help to level the playing field. Several speakers were also in favour of international cooperation and stronger international institutions in order to facilitate the implementation of global standards and reduce fragmentation.

Other speakers on the panel stressed that the present EU equivalence process is already outcomes-driven and is not a line-by-line comparison. The process, which does not cover all financial sectors, has recently been reviewed by the Commission in order to provide more transparency.

A market observer pointed out that the EU's approach is to assess whether rules broadly match up, and is not a line-by-line comparison, as in US, where equivalence means exactness. Although it would seem logical to use global rules as a reference, this is not possible at present, because there are no binding requirements to use international standards. One issue that needs to be avoided is the politicisation of this process, which should be a technical exercise. Another market observer agreed that strong international institutions are needed. Much work is being done by IOSCO and the Basel Committee among others but fragmentation cannot be avoided, because the US in particular is not in favour of multi-lateral cooperation at present. When the 'political heat' about Brexit is down, informal cooperation between the EU and the UK will be possible.

A regulator noted that although outcome-based equivalence determination seems desirable as a principle, it is not always compatible with the maintenance of a level playing field and risk mitigation. EU regulatory and supervisory requirements have become more granular over time, moving from directives to regulations, because this matters from a risk perspective and also reduces regulatory arbitrage and costs within the EU, which is necessary for a well-functioning single market. This is not relevant for all financial market activity, but in some areas details are very important. For example it is difficult to conduct outcome-based assessments of margining models, which determine clearing costs. There would be an unlevel playing field when a member state leaving the single market could re-access the single market as a third-country via equivalence evaluated on a high level, while the EU member states would need to continue to respect granular requirements. Fragmentation is an inevitable result of the UK leaving the EU. Detailed assessments of third-country standards and supervision should be limited as much as possible in everyone's interest, but they will be necessary in certain cases.

4.3 Unilateral decisions

An industry representative was concerned by the possibility of withdrawing equivalence arrangements unilaterally, as this poses a material risk to business continuity and may threaten the funding of the European economy.

A market observer believed that there is no room for discussing the key concepts of equivalence, such as its unilateral nature. Equivalence must remain unilateral so that regulatory and supervisory convergence can be judged at all points in time and discontinued if this is no longer the case. This contributes to preserving the interests of the EU, so it is outside the FTA framework. Informal discussions will nevertheless take place with third-country partners about the process and also possibly about some legislations. For example, if the UK reviews the Solvency II framework in an appropriate way (i.e. with an approach that is not unfairly competitive and does not create new financial stability risks), this could push the EU to make some improvements as well and help to find a convergence point. ■

What more needs be done to strengthen equity funding in the EU?

1. State of development of EU equity markets and on-going domestic initiatives

1.1 Characteristics of small domestic equity markets in the EU

Two speakers emphasised the limited size of certain domestic equity markets in the EU and the role played by SMEs.

An official explained that the success of the equity market in Estonia is a mixed picture. An appropriate market infrastructure is in place and sufficient credibility has been achieved for example with steps taken to ensure market transparency and integrity. Initiatives aiming to develop a pan-Baltic capital market in addition to EU integration efforts have also allowed the increase of the scale of certain segments and have supported the development of both bond and equity markets. The pension system, which is an important element on the supply side has also been successfully reformed and the environment for investment funds has been improved. Estonia's public equity market however remains relatively small with low transaction volumes and limited liquidity and it is mostly composed of small and medium-sized companies (SMEs). This does not mean that companies are poorly capitalised or not lucrative. In addition the deals carried out, where companies have raised equity in the market, have been quite successful. But the capital market appears to be more active outside the usual public market domain, with relatively high levels of risk capital raising and crowdfunding activity in equity-like finance, even on the retail level. There may however be a spill-over of this activity to the public market. This tends to indicate that the system of taxation might actually play a bigger role in financing than public capital markets. Digitalisation has supported equity markets to a certain extent also, however alternative channels seem to be benefitting more from technological change than the public market.

An industry representative added that the Austrian market has similar characteristics, with a high proportion of small SMEs (87% of all Austrian enterprises have fewer than 10 employees) and equity finance and capital markets that are relatively under-developed.

1.2 Measures put in place in larger markets: the example of the French market

Two speakers highlighted the measures that have been put in place in France to stimulate the domestic equity market.

An official explained that France has developed a comprehensive strategy and set of reforms to attract both foreign investors and domestic retail savers. A 30% flat tax was implemented, which fosters equity revenues and incentivises investors to invest more in the French market, because that extra revenue can be reinvested in the country. This has been very successful for attracting foreign investors in particular. France is also implementing a long-term strategy to decrease the level of corporate tax, with a level of 25% targeted for 2022. This reduced level of taxation should help SMEs to scale up and invest more. Another improvement has been to treat carried interest as capital revenues rather than remuneration, which has fostered significant investments.

The PACTE legislation ('plan d'action pour la croissance et la transformation des entreprises') is another initiative that has been put in place in France, the official mentioned. It introduces a new individual pension product aiming to channel both employee and retirement savings towards equity funding with incentives and extensive communication. The objective is to increase the contribution of employees to the value creation of their companies. The tool is very flexible so it can be used in SMEs, as well as large companies, and it can adapt to the cycle of the economy, being more ambitious when there is a positive cycle.

An industry representative noted that whilst the PACTE legislation has succeeded in creating a new product with commercial success it is still relatively marginal, because the public pension provision is very generous in France. Life expectancy, from when individuals start receiving public annuities, is 24 years and the average pension is higher than the average level of salaries. The only way to have more widescale retail investment in equity would be to decrease public pensions. However reforming the pension system is challenging in France and has so far been postponed.

2. Main remaining issues and challenges

2.1 Remaining issues to be tackled regarding the access to equity markets

An official indicated that although a number of steps have been taken by the EU to improve the functioning of equity markets, they may not be sufficient. Financial literacy is a first problem, in particular that of the managers of companies seeking funding. It means that raising capital through equity markets remains quite a distant objective in their minds, particularly in the current context of the Covid crisis, with extraordinary measures such as subsidies and credit to the market being put in place. The overall cost of raising funding on equity markets (prospectus and market research costs, regulatory requirements…) is also stopping SMEs from considering public market financing as a prime option. These problems exist both for small and larger markets and are worsened by cross-border fragmentation of infrastructures and rules. Digitalisation may however help to address some of these issues and also help to improve links between infrastructures in the EU.

An industry representative agreed that the cost of participating in capital markets for small enterprises (notably regulatory costs) must be considered. Very often SMEs have limited collateral, irregular cashflows, higher risks and are not able to provide sufficiently reliable and comparable financial information, which are all decisive points for investors. Some of the measures discussed at the EU level, for example in the context of the Capital Markets Union initiative (CMU) may therefore need to be adapted to smaller SMEs.

Another official added that another challenge is attracting the younger generation to the equity market. The PACTE legislation introduced some measures for parents to encourage their children to invest in equity and to keep that investment when they are growing up. An official agreed that there is a need for education in this area since young people are those who could benefit the most from building up equity investment over time.

An industry representative noted that fiscal incentives are also an issue and need to be defined in a coherent way. Tax incentives have been implemented to encourage equity investment, but at the same time governments have been discouraging the distribution of dividends during the Covid crisis, lowering potential revenues for retail investors. Large institutional investors such as insurance companies also face problems: although there is a plan for reducing corporate tax, an additional tax of €1.5 billion has recently been imposed on French insurance companies, which is a huge amount. Although insurance companies can pay this amount, that is money that cannot be invested in SMEs, which in the end results in even more taxes for everyone if these SMEs run into difficulties. To grow equity funding there has to be a stronger belief in market forces and more coherent policies.

2.2 COVID-related opportunities and challenges

An official considered that the development of equity markets is brought to the fore by the Covid crisis. Europe has been hit by an extreme supply and demand shock. There is an opportunity to rebound thanks to the measures and reforms proposed, but this requires immediate investments and using available sources of funding, including equities, in a balanced way.

An IFI representative explained that at the end of 2019 i.e. before the Covid crisis, there was an estimated amount of about € 250 billion missing in equity financing in the EU. This concerned very young enterprises, as well as more mature ones at a pre-IPO stage, needing equity to grow. The COVID-19 crisis has since created a liquidity crisis for most companies in Europe and the world, which EU member states have handled quite well. There is also a solvency crisis starting, as well as a potential investment crisis, which could be quite detrimental to the economy. Most corporates, small or large, will substantially increase their debt to equity ratio and it will be difficult for them to borrow more and invest in the next few years. This latter risk may be the most detrimental to the economy going forward.

An industry representative added that there may also be a crowding out effect because of the crisis, with big companies appealing to the market for more equity, limiting the possibility for SMEs to raise money. Another industry representative suggested that the risk around COVID-19 could potentially be systemic if significant liquidity shortfalls and equity losses were observed throughout the industry.

3. Policy measures proposed for further developing equity markets in the EU

Speakers on the panel generally considered that the appropriate measures for developing equity markets have been put forward in the initiatives underway at the European level (CMU, MiFID II, Next Generation EU package).

An official stated that the CMU High-Level Forum (HLF) issued a report with 17 recommendations, at least six of which can be brought back to the theme of greater equitization. The challenge however is the implementation of these measures and providing the appropriate incentives.

3.1 Measures for facilitating access to the capital markets and developing the equity ecosystem

A public representative set out a list of concrete measures to help equity financing for SMEs that has been agreed by the ECON Committee of the Parliament and should be taken up by the Commission in its new CMU action plan. The list is ambitious and includes three key points.

The first measure is facilitating investment research for SMEs, the public representative explained. This should already be part of the MiFID quick fixes, with different solutions on the table. The second point is to streamline the definition of SMEs across EU legislation. For example it is difficult for them to understand whether they qualify for specific EU support schemes at present. The third point is to ease issuance requirements for SMEs that are ready to go public. The creation of SME growth markets was a first step, but an ambitious pan-European plan for initial public offerings (IPOs) should be proposed, with, for example, a simpler prospectus for SMEs at least during the COVID-19 crisis, and tax incentives for investing in equity. These measures can only work however if European citizens are ready to invest. This is why it is also necessary to foster the development of an equity culture in the EU. It needs to be easier for citizens and particularly the younger generation, as investors, to understand how their savings can play a direct role in the real economy. For example, a mobile app could be provided, allowing investors to check in real time where their money is going and to vote directly or via proxy voting in order to participate in the governance of the companies they have invested in. The Commission is also being asked to propose initiatives on employee share ownership, building on domestic initiatives such as PACTE in France mentioned previously.

An industry representative agreed that most of the CMU measures are very positive, as well as the MiFID quick fixes. Reviewing the unbundling measures which significantly affected the coverage of SME equity research is essential. The Spanish exchange for example has been obliged to fund independent analysts to cover companies that were no longer followed by brokers. SMEs that go to the market for financing are indeed dependent on the analyses and recommendations provided by medium and small brokers who are a key element of the ecosystem that supports the funding of SMEs (also including specialised lawyers, intermediaries and advisors). It is hoped that these measures will help to revive SME equity research. US capital markets are often taken as an example in the EU. Beyond the fact that they are more developed, one key characteristic is the ecosystem in the US and the fact that in every city there are brokers offering equity and commercial paper issued by the local companies. That is how the US market works, with citizens encouraged to invest in companies operating in their region. SME success stories rarely start with large investors; often the first funding comes from smaller investors part of a specific ecosystem, who know the sector or activity and help the company to grow.

'Moving the needle' further in the SME equity market would require stronger incentives, the industry speaker believed and notably changing significantly the taxation system with an equal taxation of debt and equity, because otherwise debt will continue to be preferred by issuers. An official noted that the relative taxation of debt and equity could be an issue to be handled by the OECD.

Another industry representative indicated that the HLF report includes interesting proposals for developing equity financing, but these will take a long time to implement and will not solve the funding needs of smaller SMEs in the short term. For example, the proposal to implement a European single access point for issuers to company financial and ESG data is relevant, but it requires a significant standardisation of reporting. There are also useful proposals in the CMU report regarding ELTIF (European long-term investments) funds, but these will also be long to implement.

An IFI representative added that the funding of smaller SMEs that are prevalent in certain member states is a specific issue that needs addressing with innovative solutions, beyond public support, such as new channelling instruments. These instruments include fintech platforms that may be able to provide quasi-equity quickly to a large population of SMEs.

3.2 Adjustment of prudential requirements for institutional investors

Several speakers suggested that the prudential treatment of equity investment in insurance company and bank balance sheets needs to be reviewed.

An industry representative considered that the reasons why insurers under-invest in EU capital markets had been appropriately identified in Recommendation 3 of the CMU HLF report, which proposes reviewing Solvency II capital and risk margin calibrations and accounting rules. This is not only about capital charges but also the way the Solvency II framework is built. The overall charge for equity is such that there is no possibility for insurers to invest and even with some relief on capital charges, the current interest rate environment makes the solvency of insurance companies so low that it is impossible for them to invest in equity. There is a need for relief on some other elements, such as the interest rate charge and the risk margin, as explained in the HLF report. In particular there are € 180 billion trapped in the risk margin that cannot be invested. The report also mentions IFRS 9 and IFRS 17, suggesting that insurers should work with the IASB on this. This has been done but the IASB has made its decision. Europe now has to make the necessary carve out to allow insurers to invest in equity.

A public representative noted, regarding Solvency II, that the negotiating team will look at incentives and the overall balance of the package in the future review. Incentives for equity financing are very important, especially for SMEs that need to have sufficient trust in the future to grow and create jobs. The coverage of the pandemic risk in insurance contracts plays a part in this and also needs to be debated in the context of the Solvency II review.

Another industry representative suggested that if Basel III is being implemented, the current risk weights assigned to equity financing by banks have to be maintained because Basel III is increasing them up to four times, especially for smaller enterprises.

An official emphasized that there will be attempts to promote an ambitious review of Solvency II and an adequate but cautious revision of Basel III that remains consistent with the approach taken by other jurisdictions.

3.3 Measures related to the post-COVID recovery package

An IFI representative noted that the Juncker plan, the European programme put in place following the financial crisis to stimulate economic growth, has had positive effects on the equity market. Although it was initially focused on providing guarantees and loans, equity or quasi-equity products were brought into the programme and represented more than 40% of the delivery of funding. The Council decisions on the EU recovery package (Next Generation EU) at the end of July are another important step forward, particularly with the joint funding capacity through the Commission that has been proposed for the first time. The way the €700 billion of grants and loans of the package has been attributed to the countries is also remarkable. For the first time this money will be allocated - according to a specific set of metrics - to the countries that need the financing most, and there will be less investment made through the pan-European and European institutions.

This approach seems relevant, the IFI representative believed, considering the number of projects that are cross-border in their nature and need European rather than national financing. One example is the hydrogen project. The biggest countries have announced significant investment in this new technology and there are no real European projects at present, even though there are similar challenges across Europe for providing the necessary infrastructure. A second example is private equity and venture capital, which are critical for fostering growth and innovation in Europe. There is at present more of a national approach to this business, even though this is an area where a European approach would be very relevant, notably because fund managers mostly operate on a cross-border basis. With this package in place, more European initiatives around equity should be federated so that they are more impactful and made consistent with the European approach to climate change and digitalisation.

An industry representative considered that the solvency support instrument in particular will be quite important for the smaller enterprises. ■

How to develop retail investment in the capital markets in the EU?

1. Recent market trends since the Covid outbreak show increased retail participation

An industry representative emphasized the positive trend observed this year in the development of retail investment in equities. At one of the main French e-brokers, turnover increased by almost 49%, and the number of new clients by 232%, many of whom were investing in the markets for the first time. A vast majority of retail orders were purchases, showing that retail investors played a vital role in the liquidity of the market during the high volatility period of March and April 2020.

Another industry representative confirmed that overall in France there had been three times the number of stock subscriptions and newcomers in the market during the first months of 2020, compared to previous years. A significant amount of savings was also accumulated by retail savers during lockdown (€ 100 billion in France, which is the equivalent of about 10% of the annual GDP and approximately the size of the recovery plan recently announced by the French government). Similar trends were observed across Europe, although there were some differences, for instance, Germany saw massive cash withdrawals. Caution however prevailed, because most savings were in cash deposits, rather than equities.

A regulator confirmed this positive trend, highlighting some conclusions from a quantitative study recently published on the impact of Covid on retail investment behaviour. The study examines whether individuals bought or sold more shares of the domestic index during the crisis and analyses whether behaviour differs by age group and investment frequency using a comprehensive set of more than 3 million transactions. The results show that during the peak of the crisis, between 24 February and the end of April, investors traded five times more index shares than in the period just before. Younger investors between 18 and 35 years of age were the most active during the crisis period. 'Infrequent investors', meaning those who made a maximum of five transactions in the two years before the crisis, bought 10 times more index shares in March compared to the previous year. Generally, the study confirms the tendency of retail investors to take a contrarian strategy and go against market trends.

2. Main objectives and reasons for developing retail investment in capital markets

The speakers on the panel agreed that developing retail participation in the capital markets, both direct and indirect, is essential for ensuring pension adequacy and funding the real economy and also for achieving the Capital Markets Union (CMU). The role played by retail investors in market liquidity and maintaining an equilibrium in the market, especially in volatile periods such as the beginning of 2020, was also emphasized. The 'contrarianism' of retail investors means that they are likely to provide more liquidity than institutional investors and financial intermediaries when markets are under stress, an investor representative emphasized.

2.1 Ensuring pension adequacy and increasing returns for investors

A major reason advanced by a policy maker for developing retail investment is for them to obtain better returns and prepare more appropriately their retirement, especially in view of the current strains on public finances.

An investor representative added that more retail investment in capital markets is necessary for ensuring pension adequacy. Studies show that current long term pension savings are not likely to provide savers with sufficient real return. In the EU, 35% of financial savings are in bank accounts and 38% in very packaged products, such as life insurance, with a dominant share of the investments in fixed income. This is due in part to the fact that some regulators and providers have wrongly assessed investment risks by failing to take the time horizon and long term impact of product costs into account. One example is money market funds, which are still one of the main asset classes in which corporate defined contribution (DC) pensions invest in France. These funds may be less volatile in the short term but lead to quite high losses in the long term, compared to other instruments. With the Covid crisis, financial repression[1] has reached an all time high, and EU citizens and pension savers have been losing a great deal of money after fees and inflation with bank saving products. The situation is the same for all life insurance capital guaranteed and long term packaged products, which are mostly invested in fixed income.

A regulator agreed that in a low interest rate environment, relying heavily on bank deposits and fixed income is counterproductive. The figures show that net performance of equity, for example, annualises to around 7% between 2008 and 2018. It would have been nearly zero for banking savings. The situation however varies across the EU with higher levels of investment in capital markets in certain countries, from which lessons can potentially be drawn.

Another regulator added that investments that offer better returns and prospects are an opportunity for retail investors, who are faced with low interest rates for a prolonged period. The development of ESG-compliant products could provide another source of attraction for the younger retail investors in particular.

2.2 Funding the real economy

A policy maker also stressed that developing retail investment and facilitating the channelling of household wealth into businesses is an important element of the response to the Covid crisis. While bank lending is instrumental in mitigating the impact of the pandemic on firms in the short term, it is unlikely

[1] Policies that result in savers earning returns below the rate of inflation in order to provide cheap loans to banks and governments, reducing the burden of their debt.

to cover the magnitude and duration of the EU's financing needs sufficiently. Funding sources have to be better balanced across the European economy because market financing is essential for sustaining recovery and growth in the longer term.

The investor representative explained that households are the major source of funding for the real economy, as they are by far the biggest net creditor among economic agents. Individual retail investors are indeed more long term oriented and relatively less risk averse than institutional investors. It is also documented that they are willing to invest more in SMEs, which is greatly needed for European job creation and innovation. A regulator added that encouraging more SMEs to go to the market would also provide investors with more diversified investment opportunities.

Another regulator agreed that retail savers are the largest holders of financial assets in Europe, but pointed out that only 18% of these assets are invested in financial instruments.

An industry representative also saw new opportunities associated with the investment of the huge amount of excess savings accumulated during the first months of 2020 into infrastructure projects, company equity and responsible investments for the longer term.

3. Conditions for developing retail investment

3.1 Ensuring investor protection and trust

Maintaining a high level of consumer protection and market integrity is necessary for fostering retail participation in capital markets, a regulator stated. Trust is key to this. This means that the easing of market abuse rules that has been proposed (e.g. regarding insider information), should be handled cautiously, because it may lead to a negative perception of the integrity of the market. Another regulator emphasized that investors need both appropriate products and an adequate level of protection. This is because equity investment involves participation in the capital structure of companies, which entails significant risks. Investment funds may provide retail investors with appropriate diversification and protection. However, in order to attract more retail investors, the financial community should endeavour to provide simpler products with an adequate level of fees and costs and that are compatible with a long term investment perspective, such as ESG-compliant products.

An industry player added that the involvement of retail investors is also conditioned to transparent and liquid markets that make the expectation of future gains possible.

3.2 Providing adequate access to capital markets for retail investors

An investor representative felt that the access of retail investors to capital markets is very limited at present and this is partly due to investor protection requirements imposed by the public authorities and financial intermediaries.

A regulator considered that allowing the access of retail investors to capital markets is a question of democracy and that creating inequalities should be avoided. It is however a controversial question, particularly in times of crisis and with the persistence of low financial literacy standards. An appropriate balance needs to be found and policy makers must act carefully both in terms of regulation and supervision to ensure investor protection and avoid the unintended consequences of hindering retail participation to capital markets. A precondition is for retail investors to understand that, in case of economic difficulties, investment losses may occur in capital markets.

Another regulator added that retail investor participation in the capital markets is both a demand and supply-side issue. For the time being European citizens have mainly relied on financial intermediaries such as banks for saving for their old age. One reason is that banks are close to their clients and there is a large number of branches that provide their customers with all the essential financial services including savings. It is also important therefore that distribution networks supply their clients with the right information on capital markets to enable them to make the right choices about their savings and investments.

The investor representative moreover questioned whether retail investment is really a priority for the EU public authorities, when considering the different recommendations made for achieving the CMU, including those from the CMU High Level Forum (HLF) published in June 2020. One example is the recommendation of the report not to 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. Later in June, the Wirecard scandal was further proof of the need to restore trust in individual investors. About €20 billion was wiped out, notably from pension savers, laying bare huge failures of corporate governance, public supervision and external auditing. Despite this and the HLF recommendation mentioned previously, the EU authorities did not include individual shareholders in the scope of the proposed directive on collective redress. Addressing this issue now should be a major priority, the investor representative believed.

4. Policy priorities for increasing retail participation in the capital markets

The panellists welcomed the focus in the recommendations of the CMU High Level Forum (HLF) on increasing the participation of retail investors. The development of retail investment should indeed be one of the key themes of the CMU 2.0 project. A policy maker stated that the relatively low level of retail investor participation in a large number of domestic EU markets is one of the main reasons why EU capital markets are not achieving their full potential. While household savings in the EU are high, retail investor participation is relatively low in a large number of domestic EU markets, though there are differences between member states. The speakers highlighted some priorities.

4.1 Ensuring the adequacy of costs and charges

A regulator considered costs and fees to be a key issue; at present they are sometimes too high in the EU and not always sufficiently transparent and comparable, undermining investors' confidence and significantly impacting investor return. Another regulator reported that ESMA had issued a supervisory briefing indicating how European supervisors should converge in their interpretation of undue costs. Given their impact on investors' returns and confidence, ESMA has to make sure that costs are transparent, comparable and supervised in the same way across Europe. The recommendation of the CMU HLF on disclosure and distribution should also be translated into concrete measures that allow for proper cost and return comparison tools. ESMA has undertaken work on performance fees and making sure they have an appropriate framework in order to ensure their transparency and fairness. The guarantee that the same products and risks are regulated and supervised in the same way across the EU would not only provide protection, but also foster cross border investment.

Another important issue concerns inducements and the potential conflict of interest between providers, distributors and clients they may create. The first regulator welcomed the recommendation of the HLF report to further assess this issue. Some EU countries, by restricting the acceptance of inducements, have indeed improved access to high quality services and low cost products. The second regulator considered that stricter inducement regimes would lead to more transparent cost and fee disclosures and would also help to enhance cross-border investment.

An industry representative stated that the costs of cross border retail trading should also be reviewed. These are too expensive in the EU, especially because of the post trade process. Clients consequently prefer to trade in the US market, on Nasdaq or NYSE, which are less costly. Further legal and fiscal harmonisation are needed in the EU to tackle this issue. A regulator added that creating the appropriate context for cross border retail investors would further enhance the attractiveness of EU's capital markets.

4.2 Improving transparency, disclosures and research

An industry representative noted that, although there is a complete set of legislation on product disclosure, the goal of providing investors with meaningful and comparable information between investment products that was pursued with PRIIPs has not been achieved. An investor is not looking for detailed information about each type of product, but for thematic information about the sectors or areas covered by different investment products and the related risks and performance. Different rules or interpretations across member states e.g. in the case of ESG investment add an extra layer of complexity. More harmonisation is needed in this respect for achieving a common CMU.

A regulator agreed that improving PRIIPs and further aligning the MiFID and PRIIPs frameworks is necessary. Comparability across all products is essential for providing investors with appropriate and comparable information. Improving equity research is another objective. However the regulator advised care in rolling back the unbundling rules of MiFID II[2], recalling that these were introduced to improve the overall distribution and clarity of the money being spent on research. Solutions need to be found for improving the availability of research on SMEs, but this does not necessarily mean suppressing the unbundling provisions which were an important improvement of MiFID II.

The recommendations of the CMU HLF on financial literacy, investment culture, disclosure and distribution 'fall a little short', in one regulator's view. These issues, which relate in part to governance, professionalism and ethics should be at the top of the European priorities given the behavioural problems that have been affecting the market in the last few years. Such issues are key to fostering investors' confidence. It is important in particular to launch a harmonised complaints regime in Europe, and ensure that ESG products and supervision are appropriate, provide investors with clear and credible information and meet investors' needs.

4.3 Developing private pension and employee shareholding schemes

An industry representative emphasized that employee shareholding schemes are a relevant and concrete solution mentioned in the HLF report for developing retail participation. However, such a solution should be based on investment funds in order to facilitate cross-border investment. This would help to provide liquidity for non listed companies as well as larger pan European groups. The CMU action plan is an opportunity to push for such a concrete solution. Investing in the equity of your own company is often the first step towards investing more in equity in the future. A regulator added that it is important to foster more retail and household participation in private pension systems. Some member states already offer good examples of this.

4.4 Improving investor education and information and assessing the role of inducements

Several speakers mentioned the importance of investor education in supporting more retail investment. A regulator stressed that this ambition put forward by the CMU HLF must be encouraged. Ensuring that retail investors and SMEs make wise financial decisions is however a complex task. Initiatives have been put in place by some domestic supervisors, such as the Wikifin Lab in Belgium. This is an interactive experience centre for financial education designed for secondary-school students, with a fully digital trajectory, located at the premises of the FSMA. It provides them with tools allowing them for example to balance their budget by analysing their own consumption, their saving capacity and related risks and the consequences of these choices for society.

Some limitations to action at the EU level in this area were also discussed. An investor representative pointed out that the EU has no competency for young people's education. A regulator agreed that financial literacy is mostly the responsibility of member states, but felt that this action could be better coordinated at EU level with a combination of top down and bottom up approaches. Another regulator suggested that ESMA could play a concrete role in coordinating domestic financial education actions. This would be relevant because educational programmes in different member states could learn from one another.

The investor representative believed that much can also be done at EU level to improve the level of information and education of adult consumers on capital markets, starting with actions at the point of sale. The way to favour better information at the point of sale is to put an end to kickbacks or inducements for packaged products. This would put them on an equal footing with direct investments such as exchange traded funds or ordinary stocks, for which there are no inducements. This has also been picked up by the CMU HLF, which suggested that the Commission should study the role of inducements in the adequacy of advice and sales processes, including the role and impact of inducements in execution-only services, and that it should examine how the inducement rules under IDD (Insurance Distribution Directive) can ensure a sufficient level of consumer protection consistent with the investor protection standards applicable under MiFID II for insurance-based investment products (IBIPs). The Commission was also invited by the HLF to put forward the appropriate legislative proposals, including a prohibition to accept and retain inducement paid for the distribution of IBIPs where distributors provide independent advice or portfolio management services to clients.

4.5 Reviewing retail investor categorisation

A regulator considered that the uniform application of investor protection rules may unnecessarily hinder the access of more experienced retail investors to certain products. Introducing a new category of qualified investors in MiFID, as suggested by the CMU HLF, could solve this problem. Another positive

[2] Through which sell-side brokers are now obliged to unbundle their research from other services provided to clients and on the buy-side, asset managers now explicitly need to pay for research themselves.

proposal of the HLF report is to introduce a definition of 'shareholder', which is a challenging issue however because it is linked to civil law in certain member states. Developing ELTIFs would also help to improve the participation of retail investors in more long term sustainable investments that may be too illiquid for direct participation. But there are currently differences between the target investors identified by ELTIF producers and distributors, hindering the access of retail investors to these products.

4.6 Ensuring effective and convergent supervision

Several speakers emphasized the importance of appropriate supervision and supervisory convergence for developing retail investment.

A regulator considered that supervision has a critical role to play in providing investors with appropriate levels of protection and that enhancing supervision is preferable to additional regulations, which may create extra burdens. This is the objective pursued by ESMA's Investment Management Standing Committee, which has been working on measures aiming to provide investors with the appropriate conditions for investment and increasing their level of trust and comfort. Actions are also being undertaken by ESMA for improving supervisory convergence, which may help to unify supervisory and management practices and tools pertaining to retail investment products such as liquidity management tools for investment funds.

Another regulator agreed that adequate and more consistent supervision is necessary for achieving appropriate disclosure and risk/reward for investors. Supervisors can for example put in place actions to ban products that are excessively complex. A voluntary ban on complex products, which was proposed in Belgium 9 years ago, has been very successful and is now widely supported by the financial industry. Supervision can also ensure that information is appropriately communicated to retail investors, particularly with on-going evolutions such as digitalisation. It is also important to define who is best placed to supervise parts of the capital market, the regulator stated. For wholesale and third country aspects, this is ESMA. But for specific national financial markets, the National Competent Authority (NCA) is usually better placed, provided there is sufficient supervisory convergence.

Another regulator added that proactive and effective supervision can help to ensure market transparency and integrity, which are important for investor confidence. For that the European institutions need to work closely with the NCAs. ■

How to maximize the role of investment funds in the post Covid recovery?

1. The role of investment funds in the economy

A policy maker stated that the EU asset management sector remains crucial for building the Capital Markets Union (CMU) and more generally the single market. Asset management will also be essential for the post Covid recovery, because it provides citizens and businesses with much needed access to market based finance in a cost-efficient way and within a well regulated environment.

An industry speaker emphasised the role played by the asset management industry in connecting businesses with investors willing to provide capital, making it a crucial tool for the financing of the economy and the recovery in the context of the Covid crisis.

An official mentioned that the sector also has an important role to play in terms of financial stability, because it supports a diversification of funding and investment, which enhances shock absorption.

The industry speaker added that risk management is a frequent topic of discussion between investors and asset managers. When assessing risks, it is important to consider the risk of the overall portfolio, rather than that of individual products or securities. Otherwise, the opportunity cost to investors will be higher. In this context, it is also important to understand the role of derivatives in managing risk. Derivatives are often associated with speculation, but most investors use them as a risk management tool.

2. Current market trends in the asset management sector

2.1 Sustainability

An industry speaker emphasized the general movement towards sustainability. Sustainability means investing according to ESG criteria but also investing in a sustainable way from a capital perspective. For example, for large institutional investors seeking long term returns, asset managers are endeavouring to provide sustainable returns rather than annual returns and to connect these investors with projects or entrepreneurs that have a long term perspective such as sustainable infrastructure projects, for which there is increasing demand. This also means that in the broader sense, the financial community must evolve beyond traditional return on investment metrics towards the inclusion of sustainability criteria in its assessment of investments and reporting.

Another industry representative added that the Covid crisis has confirmed the need for the industry to enhance its action on sustainability. Beyond Europe, sustainability is also being tackled by several countries in Asia, most notably China, Japan as well as Hong Kong. A committee of the CFTC in the US has also raised climate risk as an area of concern for the US financial industry, although this is still a minority view in the US.

A regulator agreed on the importance of ESG and sustainable finance and the role that investment funds can play in this regard, noting that their regulatory body endorses these objectives and encourages the creation of sustainable investment products by the asset management sector. An official also agreed on the importance of sustainability, adding that this is a complex objective to address that requires a real change in how the industry operates.

2.2 Customisation and new technologies

An industry speaker suggested that customisation is a second major trend in the fund sector, with investment vehicles increasingly being adapted to the needs of specific investors. This approach has been present in the institutional space for a long time and is now also extending to the retail space with the adoption of artificial intelligence and machine learning, allowing the mass-customisation of products to the needs of different groups of customers. This trend, which will drive the development of new products and is particularly relevant in relation to ESG, is due to grow exponentially over the coming years, the speaker believed. Ultimately asset managers may be able to treat each investor in a tailored way, as is the case at present for institutional investors. This however requires understanding precisely the needs of each investor and customising solutions for them with the use of technology.

Another industry representative agreed that technology and digitalisation are due to play an increasing role. The fund industry should also seek to benefit from these evolutions for the marketing of funds.

3. Key challenges facing the fund sector

3.1 Lessons learned from the Covid crisis

Several speakers stressed that the asset management sector demonstrated its resilience through the first stages of the Covid crisis. A policy maker noted that the pandemic created major disruptions in a number of key segments of the European economy, but the financial markets have functioned in an orderly fashion notably thanks to an effective supervisory coordination at the EU level. An industry representative added that the limited number of market issues concerning investment funds in the EU observed during the first months of the Covid crisis demonstrated the relevance of the risk-management features of the AIFMD and UCITS frameworks.

A regulator highlighted the fact that assets under management are currently at their highest ever levels, which means that the market has returned to its pre crisis level, following a substantial drop in March. The role of the asset management industry in the economy has not changed following the Covid crisis; if anything, it is now more important. One great difference compared with the financial crisis is that in 2008 finance and banks in particular were at the centre of the crisis. Today, there is no suggestion that banks or asset managers are the source of the problem; rather, they are contributors to the solution. The regulator however cautioned the audience regarding the risk posed by the current disconnect between financial markets and the real economy, which is due to remain. Additionally, markets have not yet returned to their normal volatility, which is still more than double its normal level, though this varies across asset classes.

An official provided a different perspective, emphasizing liquidity mismatch and leverage issues observed in the funds sector during the first weeks of the Covid turbulence. The need to implement a range of financial stability measures in the funds sector, in particular with enhanced liquidity and leverage rules, had been identified before the Covid outbreak and was confirmed by the events of March and April. These issues will need to be addressed in the coming months to ensure there is a strong confidence in the sector, which is needed for it to fulfil its potential to support the European economy.

Liquidity mismatch, which happens when the redemption period of a fund is misaligned with the liquidity of the underlying assets, remains a major issue to be addressed, the official felt, particularly during periods of stress. In 2019, ESMA's STRESI stress simulation for investment funds indicated the existence of potential liquidity issues, notably concerning high yield bond funds, which were confirmed during the period of turbulence in March / April 2020. As a result of liquidity mismatches, asset sales by funds may have increased asset price pressures and played a role in amplifying the stress being experienced. The overall pattern of redemptions was moreover consistent with the presence of first mover advantage dynamics among investors, which in some cases amplified redemption pressures.

Concerning leverage, the official described the analysis provided by the BIS on the role of leveraged hedge funds in the dislocation of government bond markets during the March / April period, which shows how leverage can create an impetus for earlier sales. The official thus encouraged the EU authorities to conclude the work underway on Article 25 of AIFMD and on leverage in the investment fund sector more generally. ESMA is considering these issues in a number of pieces of work. A policy-maker mentioned that a review of AIFMD is also planned.

A regulator echoed the remarks made by the previous speaker about the exposure of high yield bonds to the crisis. However, other asset classes have behaved differently. Money market funds (MMFs) have seen quite a positive evolution and some substantial net inflows during the crisis for example..

3.2 Challenges related to the international geopolitical context and Brexit

The official also emphasized the challenge of maintaining the benefits for investors and the EU economy of the EU fund sector's close integration with international financial markets, in the current uncertain geopolitical context. Issues include growing protectionism, pandemic induced concerns about dispersed supply chains or the disruptions caused by Brexit. It is important to avoid creating new barriers to the greatest extent possible. Regarding Brexit, a key question is how to ensure that linkages remain strong with the City while addressing the financial stability and regulatory concerns emerging from the new Brexit configuration.

In terms of future policy developments, the official felt that the EU should continue to lead the way in regulating fund markets so the standards it adopts are seen as benchmarks for regulation globally. Significant work is also being performed by ESMA on the Brexit relocation process, bringing together senior supervisors from affected EU jurisdictions to discuss issues such as substantive presence and its potential impacts on the fund industry and its outcomes for investors.

4. Policy measures proposed for enhancing the role of investment funds in the economic recovery

4.1 Risk management tools

An official was in favour of enhancing rules concerning liquidity mismatch and implementing a robust macroprudential framework for tackling remaining liquidity and leverage risks in the asset management sector. Although asset managers might be acting individually in the appropriate way for their own risk profile, what emerges collectively may not be in the interest of financial stability, of the wider economy or of the sector. An example of this would be market participants selling assets all at the same time and creating stability concerns as a result. Such a macroprudential approach has been implemented for the banking sector with new capital buffers and liquidity measures, following the observation during the financial crisis that despite existing regulations, banks were not always acting in the interests of citizens and the wider economy. The same goes for the asset management sector. Despite the measures already in place for mitigating financial stability risk, more progress is needed on tools to manage the problems stemming from suboptimal collective action. In other words, if central banks are required to intervene in certain cases, this means that collective liquidity has been outsourced to the wider community. As in banking, it is important to strike the correct balance between having central banks as ultimate backstops and ensuring that financial stability risks are appropriately internalised by actors.

An industry representative stressed that many liquidity management tools are already available in different EU countries for mitigating the liquidity risks associated with asset management activities. In addition, the EU regulatory framework of AIFMD and UCITS supports the resilience of the sector, as was demonstrated during the first months of the Covid crisis. Concerning liquidity mismatch, an essential element for mitigating this risk is providing investors with the appropriate assets. Regulators have a responsibility in this regard, together with the industry, in making sure that a fund submitted for authorisation has a profile that is appropriate and likely to deliver positive outcomes for investors, and subsequently ensuring that market players apply fund rules adequately.

A regulator agreed that regarding liquidity management tools there is no need to 'reinvent the wheel'. The basic work on this topic was completed by the FSB and IOSCO at the international level. Moreover EU jurisdictions have many tools at their disposal, including swing pricing and gating, which were successfully used in the last few months, resulting in very few fund suspensions. The issues that regulators in the EU are facing relate more to the better use of existing liquidity management tools and their harmonisation across the EU, rather than the creation of new ones.

4.2 Additional areas of improvement for enhancing the economic role of the EU fund industry

4.2.1 ESG policies

A regulator emphasized the need for a regulatory framework supporting the evolution towards more sustainability. Positive work is being carried out by the European Commission, ESMA and many private firms in this area, notably concerning ESG disclosure. An industry representative was in favour of developing EU level ESG funds. At this stage, Europe is among the few leaders on sustainability due to the European Commission's action plan. A practical way for enhancing this position would be to implement an ESG label for EU based funds. This could be a significant contribution to the real economy and to ensuring the competitiveness of the EU fund industry.

4.2.2 ELTIF review

The industry representative suggested that reviewing the ELTIF framework would also be beneficial. This review, aiming to make ELTIFs more flexible and usable has been pending for over a year. Further harmonising the taxation regime of ELTIFs at EU level is however necessary for these funds to develop in the retail area. A policy-maker was pessimistic about the possibility of addressing this taxation issue at EU level, because that would necessitate the unanimity of member states.

4.2.3 Rules for retail investors

A regulator stressed the importance of increasing the participation of retail investors in capital markets and investments. There are many retail funds, but a substantial proportion of their investors are professionals. Further developing retail investment requires enhancing investor trust, with appropriate investor protection, and also increasing the scale of fund distribution across the EU in order to reach a greater number of investors. Marketing rules need to be further harmonised, because there is still significant divergence between national regimes. Second, it is important to consider how digitalisation may facilitate cross-border distribution and to establish a framework for marketing funds through digital channels.

4.2.4 Equity research

The industry representative suggested that the MiFID research regime is another area that could enhance the contribution of investment funds to the financing of the economy. The current MiFID research regime has many unintended consequences. The Commission is consulting on this currently. Moving towards a dual-regime, with the re bundling of some parts of research would be challenging to handle for large players since it would mean managing two different regimes within the same portfolios. In addition that may be confusing for investors. Instead, the industry representative suggested promoting an issuer sponsored research regime at EU level that could come into play and support liquidity when there is no external research available, e.g. in micro, small and mid cap capital markets. ■

Improving EU securities market transparency and infrastructure: priorities for CMU

1. Improvement of EU securities market transparency

1.1 Benefits of pre and post-trade transparency

An industry representative considered that ensuring a fair and efficient functioning of markets is critical for further developing the real economy and ensuring that investors, savers and pensioners are getting appropriate returns from their investments. According to empirical evidence and academic research, increasing post-trade transparency, particularly in non-equity markets, narrows bid-ask spreads and enhances liquidity. It empowers investors to measure execution quality, which allows them to demand accountability from liquidity providers and to obtain best execution. It also removes information asymmetries in the market, which allows all liquidity providers to better manage risk, more confidently quote prices and commit capital and warehouse risk in the markets. Transparency moreover makes markets more resilient, particularly in times of stress. Taken together these benefits lower the cost of capital, which increases the efficiency in the allocation of capital for both the public and private sectors.

A regulator stated that pre and post-trade transparency is an important requirement for effective price discovery and ensuring fair markets and fair competition and is thus a key element for well-functioning markets. However transparency and disclosure alone are not sufficient. The behaviour of investors also requires consideration for instance. In addition other objectives of MiFID that are important are still to be realised, including a reduction of the proportion of over-the-counter (OTC) transactions and moving towards more transactions on lit markets, while striving for less fragmentation.

A market observer noted that the Capital Markets Union High Level Forum (CMU HLF) which proposed in June 2020 measures for relaunching the CMU recognised the importance of transparency but did not consider it to be a "game-changer" for further developing EU capital markets. In addition to transaction data there is another aspect of transparency that needs considering, which relates to company financial and ESG data. At present this data is not harmonised and it is fragmented across Europe. This is why the HLF has put forward the idea of implementing a single access point in order to facilitate access to this information, particularly for international investors. It is hoped that the Commission will take that forward in its upcoming CMU proposals.

1.2 Main issues remaining to be tackled

1.2.1 Equity markets

A regulator confirmed that for the equity market the topic of transparency remains a major concern. There is a complex waiver structure at present. There are also continuous discussions on how the thresholds for large-in-scale waivers may be enhanced and how the double volume cap, which is over-engineered and not meeting its purpose may be simplified. Fragmentation has increased in the equity market, despite the objectives put forward in MiFID II. This is due mainly to the increasing competition of systematic internalisers, issues with post-trade data quality and the lack of a consolidated tape.

A market observer noted that it was originally thought that so-called dark pool venues would be used for handling large block trades, with delayed reporting, etc. That has changed, and it is uncertain whether this change is positive for the market.

1.2.2 Non-equity markets

An industry representative stated that concerning the post-trade transparency of non-equity markets, the main issue is the real-time public reporting to investors of transaction prices and sizes. MiFID II fully recognised the importance of this real-time public reporting and laudably aimed to improve it, but that remains an unfinished task. Today only about 5% of off-venue trading in OTC derivatives are subject to post-trade transparency requirements. In addition, even for on-venue transactions, four-week deferrals from public reporting are the norm across bond and OTC derivative markets.

A regulator emphasized that the large-in-scale and size-specific-to-the-instrument waivers are also subject to enhancements. Another issue is that the non-equity market is far less-advanced than equity markets in terms of market structure and often lacks common market platforms. Although some new entrants facilitate electronic trading on multilateral platforms, request-for-quote systems and voice-trading systems are still common in non-equity markets.

Another industry representative added that non-equity markets are also less familiar than equity ones to many policymakers and regulators in charge of determining the appropriate method for improving transparency. Some of the current challenges in MiFID II may relate to an imprecise understanding of how non-equity markets operate.

1.3 Proposed improvements of the regulatory framework

1.3.1 Ongoing review of MiFID II: objectives and timeline

A regulator indicated that MiFID II introduced many improvements concerning the functioning of the markets and the further strengthening of investor protection. However, an ESMA report on the impact of MiFID II's transparency requirements on equity markets concluded that, 'MiFID II can be considered unfinished business.' An additional report on non-equity markets is expected to be released by ESMA in September 2020.

A policy-maker explained that the Commission has been in a 'listening mode' on MiFID II so far. The full MiFID II review will come no earlier than the third quarter of 2021, once all the input needed has be collected and considered, including ESMA's report on the transparency of non-equity markets and contributions to the public consultation on these proposals. One element that needs to be considered is that there are very different views on how to improve the transparency of European capital markets. The impacts of Brexit and changes to the market structure when it comes to the biggest pools of liquidity must also be considered.

The pandemic has also pushed delivery of the MiFID II review into two separate stages. One is the Capital Markets Recovery Package, which was tabled in July and aims to help businesses to access capital markets with targeted adjustments to prospectus, MiFID II and securitisation rules. The rest of the review will come in a year's time. MiFID I and II have improved the situation of capital markets, but more needs to be done notably regarding transparency. The Commission's ambition in this area is to identify the best possible approach in a holistic manner, both in terms of pre and post-trade transparency for equities and non-equities, taking into account the differences in the market structures.

1.3.2 Non-equity transparency: specificities and improvements proposed

An industry representative explained that a number of steps have been proposed by ESMA to address the scarcity, quality, timeliness and accessibility of post-trade transparency data. ESMA has recognised that very few off-venue transactions are subject to post-trade transparency so it has outlined a number of options to make the post-trade transparency framework more comprehensive and to ensure a level playing field between on and off-venue transactions. Secondly, both the Commission and ESMA have recognised that inconsistent and excessive deferrals undermine post-trade transparency. Rationalising the deferral regime offers great promise. In the US markets for example, for corporate bonds, mortgage-backed securities and OTC derivatives, post-trade transparency regimes were put in place with deferrals that do not exceed 15 minutes, even for large transactions and illiquid instruments.

A regulator agreed that the measures proposed by ESMA may alleviate the observed problems with MiFID II transparency requirements. However, these quick fixes are not enough to solve all of the issues. Differences between equity and non-equity markets need to be more carefully considered in particular. The lack of liquidity is a given in the current fixed income markets. Many instruments are tailor-made, OTC and not designed with the intention of being traded on secondary markets. This means that simply replicating the transparency requirements in place for equity markets is counterproductive. Improving the functioning of non-equity markets with more liquidity and higher and sustainable levels of transparency can only be achieved by addressing market fundamentals e.g. incentivising the standardisation of instruments, improving the trading structure and the level playing field between bilateral and more transparent multilateral forms of trading, creating more regulatory certainty. This also requires a cultural change. Regulation can support these changes, but other evolutions are needed.

An industry representative considered that the quick fixes proposed by ESMA will add value, but beyond this a more strategic end-objective needs to be defined and implemented for the market. One of the key differences between equity and fixed income is the method of execution. In fixed income, execution is a three-phase process including the identification of liquidity, price formation and execution and each phase is equally important. Whereas in equity transactions the identification of liquidity and price formation steps are less relevant, because they are correlated to the omnipresence of that information by virtue of the use of central-limit order books. This is why the request-for-quote protocol is so important for fixed income markets, because it facilitates the identification of liquidity and the price formation element, as well as the act of execution. Robust fixed income post-trade transparency data is of most benefit in the identification of liquidity and price formation, hence the recommendation to focus on post-trade.

A market observer agreed that there should be careful consideration of market structure and of the differences between equity and non-equity markets. Whatever approach is taken, there has to be clarity about the economic benefits and incentives provided for the market.

1.3.3 Consolidated tape implementation challenges

A policy-maker mentioned that the implementation of a European consolidated tape, which would solve many aspects of the current transparency problems, is being considered closely by the Commission. The cost of data and its evolution as a result of MiFID II are another important element being assessed. The challenges of implementing a consolidated tape however also need to be taken into account. Ensuring a sufficient quality of data is essential, as well as defining an appropriate governance and remuneration model.

An industry representative stated that the establishment of real-time post-trade consolidated tapes ensures that investors can efficiently access transparency data. This is true for both equities and non-equities, but is particularly relevant in the non-equity space. The key features of any post-trade consolidated tape are that it is comprehensive, with a mandatory contribution from trading venues and for the activity conducted outside trading venues, that information is disseminated immediately upon receipt and that it features a targeted and limited deferral regime for larger block trades.

A regulator added that best execution is also important in the context of the consolidated tape. Best execution and smaller spreads are key features both for institutional and retail investors and currently are not delivered.

Another industry representative stated that the consolidated tape is a matter of implementation rather than of objective. The market agrees on the need for a consolidated tape and the transparency that it affords. A market observer added that the CMU HLF had not been able to achieve a consensus position on the consolidated tape. That is because there are different views on the detailed measures needed for implementing it and there are also significant economic interests involved.

2. Enhancement of the EU securities and derivative market structure

2.1 Ongoing changes in the post-trading regulatory framework

A policy-maker explained that the Commission's priority is to implement all of the legislative changes that have been agreed and adopted over the last 18 months concerning post-trading market infrastructures.

There are many legislative projects underway in the clearing and settlement areas. The EMIR Refit Level 2 delegated acts on fair, reasonable, non-discriminatory and transparent (FRANDT) contractual decisions will be adopted in the autumn. The report on postponing the clearing requirement for pension funds will be sent to EU institutions this month. The three delegated acts under EMIR 2.2 on tiering, fees and comparable compliance are awaiting agreement from Council and Parliament. A new CCP Supervisory Committee is being set up within ESMA. The EU CCP Recovery and Resolution framework was also agreed in Council and will be voted in Parliament in a few weeks.

The Commission is also required to prepare 16 reports to the European Parliament and Council over the next 24 months, covering a wide variety of issues. Some examples include the EMIR reports concerning issues such as central bank exemptions, pension funds, exchange-traded derivatives (ETD) reporting calculations, aligning clearing and trading obligations, post-trade risk-reduction services and interoperability. There is also a report on whether ESMA should be dealing with the supervision of EU CCPs, beyond systemic third-country ones.

The Securities Financing Transactions Regulation (SFTR) will also be assessed in order to evaluate whether it works and whether the fees are appropriate. The Settlement Finality Directive and the Financial Collateral Directive will also be reviewed, as well as the CSDR taking into account input from the member states and other stakeholders, the policy-maker added. Concerning the CSDR, elements such as the authorisation process, the cross-border service provision, settlement internalisers and settlement discipline rules will be discussed in particular. The coming into force of the settlement discipline measures has been delayed to the beginning of next year in view of the issues observed during the beginning of the pandemic, and ESMA was asked to draft Regulatory Technical Standards (RTS) postponing its implementation further to 2022. The Commission is also working on options for equivalence decisions in this area in order to mitigate the issues linked to Brexit.

An industry representative noted that one additional important, non-policy element from a CSD perspective is the discussion around the EU recovery package, which means that there will be mutualised debt issuance by the Commission in the future. This is an important change for CSDs, because usually sovereign debt is issued in national CSDs. The question will therefore be where this supranational debt is issued and whether this will be in more than one CSD.

2.2 Progress made in terms of financial infrastructure

An industry representative stated that progress has been made with the regulations implemented in the post-trading space. In the current Covid crisis and other past crises, financial infrastructures have risen to the challenge: for example, massive increases in volume in terms of securities transactions in the last few years and the recent move to working from home experienced with the Covid crisis. Concerning post-trade derivatives reporting, the position now is 'lightyears away' from that of 2014. Volumes have increased massively, costs have decreased in equivalent scale and the quality of the data and the frequency of reporting, have greatly improved. All of that has been achieved seamlessly, which is partly due to the regulations put in place since the financial crisis that have given a structure within which to work. The regulations have also evolved over time to become more efficient and relevant. The question is however whether 'sufficient' progress has been made. By any measurement, there is still plenty of room for improvement in the post-trading area, the speaker believed.

A market observer agreed that more progress is needed particularly for the CMU. The efficiency and safety of market infrastructures, which is a key element for CMU, still needs improving. Some of the fragmentation issues raised by the Giovannini group in the settlement space twenty years ago are still being debated. There are still concerns on the prudential side regarding CCPs. One question is whether the recently adopted recovery and resolution framework for CCPs and the default waterfall that is part of it can work in all circumstances.

2.3 Proposals made by the CMU High Level Forum (HLF) for reducing fragmentation

An industry representative considered that there are common themes running through the High-Level Forum report, the first and second Giovannini reports, and the European Post Trade Forum report that was published during the previous stage of the CMU: harmonisation of tax, harmonisation of corporate actions, harmonisation of data standards and provision of access to data. It is hoped that Covid and Brexit will be catalysts for making progress on these issues, which are key for the CMU. The HLF is also a stronger basis than previous reports for moving forward in these areas. In CMU the key word is 'union' and it means all working together to create one single solution. There have been talks about the move from directives to regulations to support the implementation of a single rulebook, but the recently adopted SRD II (Shareholder Rights Directive) is a directive, leading to potential variations in its transposition into local law, which is not helpful. Another priority is the better integration between the individual pieces of regulation and better coordination between regulators.

A market observer explained that concerning market infrastructures, the High-Level Forum had concentrated on three areas where further harmonisation is needed. First is the fragmented provision of settlement services discouraging cross-border trading. The Commission is urged to come forward with a proposal mid-2021 with targeted improvements to CSDR measures aiming to facilitate settlement across borders (with a more harmonised application of passporting rules, enhanced supervisory convergence). The ECB and national central banks are also invited to consider facilitating access to non-domestic central bank money within the EEA. The second proposal is to alleviate problems relating to the cross-border exercise of ownership rights. Proposals were made concerning the harmonised definition of shareholders and the clarification and harmonisation of interactions between investors, intermediaries and issuers and also the use of technology The third aspect relates to cloud services, for which the development of standard contractual clauses was proposed in order to facilitate effective supervision and the monitoring of risk and to make sure that cloud service customers are aware of the legal implications. These are feasible recommendations that will make a difference. A key aspect of the CMU is however that all the actions proposed are inter-dependant. Unless the full, integrated CMU package including all the infrastructure points discussed are implemented, the expected results will not be achieved.

Another industry representative was supportive of the proposals of the CMU HLF but suggested two further areas of work. First, it would be beneficial to assess the open-access provisions included in MiFIR, EMIR and CSDR and to identify whether they have effectively met their goals, considering the co-existence of horizontal and vertical infrastructure models in the EU. One issue is that these provisions have been scattered across these different regulations, which makes the stock-taking exercise more difficult. A second point is the upcoming CSDR review. The industry representative believed that this review should be limited to the cross-border elements of the regulation such as cross-border settlement and passporting, which have regressed with some unnecessarily burdensome measures. But there is no need for a significant overhaul of the CSDR. There is for example the intention to determine whether the settlement discipline regime needs revision, although it has not yet been implemented. In addition, examining the mandatory buy-in requirements in case of settlement fails is more a request made by investment firms.

2.4 Further areas of improvement

2.4.1 Enhancing supervisory coordination and convergence

An industry representative suggested that moving towards a single securities regulator is a clear and easy target to hit and should be a priority for the EU, although there are tensions between this proposal and the powers of individual member state regulators.

A regulator confirmed that some domestic authorities are very much in favour of further European integration and perceive the added value of the European Supervisory Authorities (ESAs) including ESMA. Supervisory convergence is very important and efforts to increase central supervision at the EU level should be pursued. This capacity at central level should be used in particular for advising those who need to make the decisions at the EU level, be it the Parliament or Council, or at the national level, and to have this capacity in-house within ESMA. Less fragmentation and a better-functioning European market is in the interests of all member states and all citizens within Europe.

2.4.2 Improving data collection and management at EU level

A regulator noted that data collection is an area that can be far better organised in a central place. Europe has to improve data quality and the exchange of data between regulators, and needs more centralised data collection. This concerns pre-and post-trade data as well as central reporting with, for example, the single access point to company financial and ESG data at EU level proposed by the CMU HLF previously mentioned. At the very start of MiFID II, there was a huge investment in data-collection capacity. Some member states for example Norway, Sweden, Finland, Denmark and the NL worked together on building and testing a common system. In terms of cost and performance, very satisfactory results have been achieved. Therefore more European centralisation and supervisory convergence are worthwhile objectives.

An industry representative agreed that data can be much better organised in a central place. Data collection and storage are at present fragmented within the EU and also on a global basis with the US and Asia. There are differences also in the form in which data is stored. That fragmentation makes it difficult for the regulatory community to achieve the stated goal of the 2009 Pittsburgh Summit, to bring greater cross-border transparency to the OTC-derivatives market in particular. Transparency within regions has improved but, between regions, it still needs to be worked on. Moreover, the goal of the EMIR derivatives reporting piece was transparency and usability, and not to achieve a competitive reporting landscape within the EU, which is not a helpful outcome. That regulation could be looked at in a different way. ■

How to address key CCP outstanding issues?

1. Lessons from the Covid crisis: strengths and weaknesses of EU CCPs

A regulator suggested that the March-April Covid crisis was a real-life stress test of the resilience of CCPs. CCPs showed resilience, complying with regulation throughout the crisis, and also played their role as shock absorbers. However two questions can be raised. One is about how margin calls fluctuated during the crisis and whether the anti-procyclicality measures (APC) mandated by EMIR[1] for handling the inherent procyclicality of margin calls, especially variation margins (VM) and intra-day margin calls, were effective. A second question concerns the capacity of CCPs to manage the clearing process and possible events such as defaults in the specific stress situation of the lockdown.

1.1 Margin models and anti-procyclicality measures

Two speakers, representing major CCPs, considered that their margin models and the EMIR anti-procyclicality measures worked as designed during the first phases of the Covid crisis.

An industry representative explained the concepts of Variation and Initial Margins (VM and IM). VM represents the marking-to-market of losses or gains in any asset class. With participants providing VM daily through the CCP, there is a mechanism that prevents the build-up of credit exposures and undue systemic risks, which was an objective put forward following the 2008 financial crisis in order to make financial markets safer. The IM is there to cover future market moves and to allow the CCP to be in a position to withstand even dramatic shocks to the markets, such as the Covid crisis. The size of margin swings is specific to each asset class. In addition, models make margin fluctuations quite predictable, depending on the magnitude of anticipated market swings. Market participants can thus anticipate the amounts of cash that will be needed in a transparent way, without 'draining liquidity' from the market. The speaker felt that, from a CCP perspective, the scenarios anticipated and used as the basis to determine the need for and size of VM and IM had worked well in cleared markets during the Covid crisis and the anti-procyclicality measures built-in proved to be adequate.

A second industry representative explained that during the Covid crisis, their institution, a major CCP, experienced a single-digit increase in margins. This is probably because they use conservative risk policies (including risk models and EMIR anti-procyclicality measures), above EMIR standards. These risk policies had been tested during fire drills and worked well throughout the crisis. This shows that CCPs have helped the market to better approach and face these difficult circumstances, the speaker considered. VM helped to cover market volatility and movements and contributed to protect the CCP membership from the effects of the market stress, by making sure that there was no sudden need for increasing margins.

A third industry representative pointed out issues with the number of breaches seen during March and April, and the subsequent size of margin increases. For the whole of 2019, there were 40 margin breaches across the contracts tracked. For just 9 March 2020 there were more than 250 margin breaches. What was concerning also was that the increases in margin were larger than in 2008, showing the unprecedented volatility that the market faced. Potential lessons can be learned from comparing the performance of margin models across different asset classes, and at different clearing houses, because the margin models differ in the way they are constructed. One way is through the margin period of risk, which is significantly longer for OTC contracts than for futures and other exchange-traded derivative (ETD) products. OTC contracts saw less significant margin increases than the ETD, which is something that needs to be further assessed. In addition, an evaluation of how the three possible anti-procyclicality EMIR measures that can be used by CCPs performed during the crisis would also be useful. Europe has been at the forefront of these measures and there may be room for further refinement in order to avoid excessive margin increases that may add stress to the system.

The first industry speaker stated that there has to be caution when comparing cleared and uncleared markets. Margin models are more stable in the uncleared space because they are only reviewed once a year. But without marking-to-market, potential exposures are not precisely evaluated. Much better disclosure would be needed in the uncleared space for such comparisons to be valid.

The regulators on the panel also considered that the margin system and anti-procyclicality measures of EMIR generally worked during the Covid crisis.

An official identified some possible unintended consequences of these measures. To have less steep increases in margining at times of stress, there will have to be more margining in normal times. Secondly, it was observed that intra-day margin calls were quite substantial late in the day certain days. At that time, the chances are that the payment will have to be made in US dollars, which raises two issues. Clearing members have to source the dollars and secondly, this may create a problem for the CCP in terms of what to do with the dollars received quite late in the US day. There should be a discussion with the US Fed about how this situation may be handled, the official suggested. The US authorities may however not be willing to open their accounts to allow an EU CCP to park extra liquidity overnight.

[1] Procyclicality of margin refers to the fact that margin requirements for the same portfolio are higher in times of market stress and lower in calm conditions. The anti-procyclicality margin measures under EMIR seek to establish consistent, efficient and effective supervisory practices and to ensure a common, uniform and consistent application of EMIR in order to limit procyclicality of CCP margins. The adoption of the guidelines should enable national competent authorities (NCAs) to better supervise their CCPs in this respect. CCPs may also need to adapt their models and processes to the guidelines. CCPs are required to monitor and account for procyclical effects of margins including to make disclosures on its risk management practices such as the models used for the calculation of margins. These guidelines promote consistent supervision of such requirements including: monitoring of the procyclicality of margin requirements; implementation of anti-procyclicality margin measures; and disclosures to facilitate margin predictability.

A regulator stated that the CCP system was designed from the beginning to be safe and to cover the positions. The proportion between the IM and the VM can be analysed, but it should not be assumed that, since there were huge costs to be borne to make it workable, the system has to be changed altogether. The issue of procyclicality will always be present.

Another regulator noted that VM calls reflected the volatility of the market, from one day to the next. The margin calls were met, despite significant increases and IM increased moderately. Some models experienced breaches but this was not unexpected given the market volatility. The default fund contributions in place would have been enough to cover these market moves, should a default have occurred. Only in one instance did an EU CCP have to increase its default fund size. The shocks experienced during the period showed that the scenarios used in the EU-wide CCP stress test exercise were quite plausible.

1.2 Resilience of EU CCPs during the Covid crisis

Several panellists emphasized the successful way in which the Covid crisis had been handled by EU CCPs and market participants, which demonstrated the essential role played by CCPs in ensuring market resilience. The fact that this was new territory and that potential issues had had to be anticipated in a work-from-home environment was noted. This constituted a test of business continuity arrangements for the staff of CCPs and clearing members. An industry representative also stressed that clearing remained resilient despite unprecedented volumes and volatility and that the authorities had stepped in very quickly, with liquidity and monetary stimulus. A regulator also pointed out that EU CCPs did not face any defaults. There was one default in the US and one in a non-CCP clearing house in the EU, but both were successfully managed.

Two speakers however stressed that there should be no complacency, because the Covid crisis was just one scenario and a rather specific one: it was a public health and not a financial crisis. Work has to continue on enhancing CCP resilience and anticipating different recovery and resolution scenarios.

Such real-life stress tests are a good opportunity to identify potential areas of improvement, an industry speaker suggested. On the operational side, there were consecutive days during which volumes were three times the usual daily averages. That created challenges for certain operational processes that are performed manually and where it is difficult to scale capacity up quickly. The industry is considering ways to address this issue by streamlining and automating some of those processes in order to make the system more resilient.

2. EU CCP Recovery and Resolution (CCP R&R) framework: possible areas of improvement

A regulator emphasized that the new EU CCP recovery and resolution regulation recently adopted raises two questions. First is the relevance of the regulation for handling potential systemic risks. Paul Tucker and the Systemic Risk Council (SRC) indeed recently criticized the global CCP resolution guidance proposed by the FSB with which the EU regime is consistent, due to the fact that it neither prescribes the full elimination of owner's equity before entering into resolution, nor the issuance of bail-in bonds in the way required for banks. A second question is the extent to which the EU framework reinforces or weakens EU CCPs in the global competition.

An industry representative believed that although the EU CCP R&R regulation was significantly improved compared to the first drafts, it does not go as far as desired. Some elements of the SRC response need to be considered, in particular those mentioned by the previous speaker regarding the treatment of equity and bail-in debt, which both relate to incentive alignment. It would be a strange outcome for a CCP to go through resolution to essentially fail and yet equity has a no-creditor-worse-off claim against the Resolution Authority. That does not exist in other financial resolution frameworks. Regarding bail-in debt, there is also a potential upside in terms of the CCP putting up resources ex ante to deal with losses that could crystallise during a resolution, thus facilitating the recapitalisation of the CCP and its continuity.

There are also a number of areas where further enhancements to the framework could be made, the industry speaker felt. A first area is non-default losses which should normally be covered by the CCP, since it is the CCP management that is responsible for managing the risks that may lead to such losses. A second area of improvement is increasing skin the game commitments. The industry representative's institution, a major clearing member, is satisfied that the EU regulation includes a second layer of skin in the game, i.e. a requirement that CCPs commit a second tranche of their own capital to absorb potential losses in the event of a default[2], considering that it should be fixed 'towards the higher end of the scale'. This demonstrates Europe's thought leadership role globally in this area, given that many regulators do not even require a first layer of skin in the game. This mechanism should be considered more as an incentive alignment than a loss absorption tool, the speaker added. A BIS report from earlier in 2020 analysed the levels of skin in the game at CCPs and then looked at the robustness of IM models at those CCPs. A positive correlation was found between the two, i.e. the more skin in the game there is, the more robust those IM models are. Engagement with ESMA on this question at Level 2 is anticipated positively. Cash calls are a third issue that merits consideration. For recovery and resolution tools to actually achieve their goal they need to be reliable and non-procyclical. This is recognised to a certain extent in the regulation by putting a cap on the number of resolution cash calls that can be made. It is a two times cap, and to go beyond even a one-time cap the regulation indicates that the Resolution Authority should assess the potential impact on financial stability, which seems relevant. However, there are other areas of the recovery and resolution toolkit which could potentially be procyclical and are not capped or limited, such as recovery cash calls and VM gains haircutting. Limitations similar to those for resolution cash calls should be put in place in these other areas.

An official doubted that 'wiping out the equity' or 'issuing bail-in liabilities' would really improve resolution. The official also felt that the European solution for non-default losses needs to be improved, because it would mean that an additional cash call is being brought in on the clearing members. This may distort the incentives, because non-default-related losses are

[2] At present CCPs contribute a single tranche of capital that would usually be tapped once the defaulter's initial margin and default fund contributions are depleted. Instead, the second layer of so-called skin-in-the-game would sit near the bottom of the waterfall, after the various clearing member resources are exhausted but before any recovery tools like variation margin gains haircutting can be used. (Source ISDA July 2020).

the responsibility of the CCP and clearing members should not be affected by them.

An industry representative considered that the EU CCP R&R framework is generally appropriate and balanced. Increasing the capping of certain commitments does not seem necessary. Going back to the SRC comments, the speaker felt that incentives are important, and that it is key to not introduce anything in the waterfall that may reduce the appetite of participants to come in early and to help in the recovery phase. Having a 'carrot' for example at the end of the waterfall by which participants may ultimately have equity compensation and become the owners of the CCP does not seem appropriate, because it may distort the incentives.

3. Implementation of EMIR 2.2 and temporary Brexit measures

3.1 Implementation of EMIR 2.2 delegated acts and recognition of UK CCPs

A regulator stressed that the end of 2020 would be a pivotal moment for CCPs in Europe with the implementation of new EU regulations and temporary equivalence measures due to be put in place for UK-based CCPs.

A second regulator explained that EMIR 2.2 has applied since the beginning of 2020 and was prepared the previous year. The Delegated Acts were adopted by the Commission in July and are now in the non-objection period with the Council and the Parliament, so the framework should be available soon. EMIR 2.2. includes some organisational and governance changes that are currently being prepared. A CCP Supervisory Committee will notably be introduced, which will lead the work on CCPs going forward. Regarding third-country CCPs, EMIR 2.2 introduces a significant change with a tiering system based on the systemic relevance of these CCPs for the EU and a specific supervisory regime for each type of third-country CCP. This includes a new comparable compliance framework for third-country CCPs, as well as supervisory fees. The regulator noted that UK CCPs will be the first use case for these new EMIR 2.2 measures. The Commission has indicated that it plans to take an equivalence decision regarding UK CCPs. There have been preparations with the relevant authorities for the recognition process to be conducted in order to allow continued access following such a decision, taking into account the new EMIR 2.2 provisions. As soon as the decision of the Commission has been taken, which should be a matter of weeks, the process will be put in place.

A third regulator noted that when the equivalence system is complete it will have a little more flexibility, but perhaps not all the flexibility sought. The other task that will be given to ESMA together with those related to third-country equivalence, is ensuring comparable compliance, which will be important in the future system because it will ensure that in day-to-day practical life, a CCP stays in line with EMIR requirements.

An industry representative explained that a programme has been put in place over the last 3 years to allow participants using the existing venues in the UK to split their books between UK and EU-based venues. The profits made are shared between the CCP and the market participants involved in the programme. Close to 20% of the euro Interest Rate Swap (IRS) market in notional outstanding (out of a total of about €100 trillion) is now cleared in this alternative liquidity pool in the EU, which is deepening. Three years ago 99% of that amount was in London. A level playing field is however needed between EU and UK based CCPs for competition to develop on equal terms, which means granting equivalence only if regulations, including recovery and resolution frameworks, are equivalent. Another market participant agreed that this move is market-driven and may potentially benefit those who are participating.

Another industry representative stated that the clearing service operated in the UK includes 26 currencies and as of today represents about 90% of the flows around the world, providing customers with a great deal of efficiency. There was no particular pressure from customers to change the current system, but now the decision has been made, clarity is needed regarding the equivalence process and the timing of implementation of EMIR 2.2 because designing a different process has a cost.

3.2 Temporary equivalence measures in the context of Brexit

A regulator mentioned that what is on the table in the short term for UK-based CCPs is temporary equivalence. To some extent temporary equivalence could be considered to be at odds with the principle of equivalence and the new tiering framework, since an equivalence decision can normally be removed, but an official felt that this was why the Commission has insisted on the temporary nature of this recognition, which is meant to be a political signal.

The official added that with the concept of equivalence the UK in effect is tying its fate even more strongly to the EU than at present in this area. Indeed, the very moment UK CCP regulation starts to deviate, the EU will have to re-assess whether the preconditions for granting equivalence are still in place. The official added that given the dominant position of the UK for euro clearing, a direct supervision of the UK-based CCPs concerned, not only by the Bank of England but also by ESMA seems to be the right solution. However, this is a solution only as long as UK rules remain consistent with EU ones. There is a risk that the UK decides to go in another direction in the future and therefore that euro clearing business may be required to relocate to the EU. This risk needs to be mitigated by clearing members by allocating part of their euro clearing to CCPs based on the continent.

An industry representative stated that regarding equivalence and recognition, there is a need for a balanced approach and for predictability and transparency, so that market participants can prepare for the possible outcomes. As regards Brexit, the sooner there is full certainty about the equivalence and recognition of UK CCPs, the better for market participants, clearing members and CCPs. Concerning the risk that equivalence may be withdrawn at any time for UK-based CCPs, the larger global clearing firms are prepared for that possibility and have connections to a large number of CCPs that allow them to provide clients with access to the venues they need for clearing. ■

How to relaunch securitisation in the EU?

1. The recent measures were not supportive enough of the securitisation market

An industry representative indicated that there is now general recognition that recent measures were not supportive enough to truly relaunch the securitisation market. It has been said for years that the measures are too complicated, not transparent and not simple. The subject being revisited in the context of the relaunching of the capital markets union (CMU) is welcome. The industry has to be listened to because they are practitioners and know what is working.

An official explained that last year the level of issuances diminished. Europe is only issuing 140 billion compared to 800 billion in the US. The extension of the Simple, Transparent and Standardised (STS) label to synthetic securitisation is welcome in this regard.

2. The development of the low interest rate and zero interest rate environment, and the amount of liquidity coming through, have also weighed on the securitisation market in Europe

An official noted that central bank liquidity is one of the issues. There was a significant amount of liquidity coming into the system over the last several years, particularly with the COVID-19 packages. It is a good way to move forward and boost the STS. The expansion of the synthetic to all types of asset classes underlying loans would be an important amendment to bring forward, particularly for SME loans because they need a quick and efficient way to bring securitisations. The package has to get through Council and Parliament, ideally before the end of the year, to maximise its benefit.

3. Other geographies teach that a well-functioning securitisation market is necessary to help banks to reduce risk-weighted assets in order to contribute further to the financing of economic growth needs

An industry representative noted that the urgency is growing, because having a well-functioning securitisation market and helping banks to reduce their risk-weighted assets by selling out their risks is a prerequisite for Basel IV. In the US, everything which is low risk is securitised and sold out. Mortgages are sold to the Government Sponsored Enterprises (GSE). The prime or near-prime consumer loans are securitised and sold out to investors. That is not possible in Europe, where everything is kept on balance sheets. As a result, the balance sheets are bigger in Europe, but the density of risk is lower. As soon as Basel IV comes in and puts in floors, erasing the difference between highly risky assets and less risky assets, the less risky assets need to be sold in order not to be penalised.

An official noted that green securitisation is also a priority for France. There is room for more ambition, and that is why there should be more than a quick fix. A green STS label could be worked on first to have enough harmonised collateral.

4. The STS framework contributed to addressing the political stigma provoked by the US subprime market

The Chair noted that there is an argument that there is a stigma for securitisation and that the STS framework is needed. It appears that the market would develop much more quickly if not for the cheap money from the ECB.

An official agreed that there have been many positives with what has been achieved with the STS regulation. With the framework and its due diligence, transparency and confidence have increased. Unfortunately, volumes have decreased.

An industry representative noted that securitisation is instrumental for building the bridge between the Banking Union and the CMU. Securitising or SRT-ing RWAs from the balance sheet creates new landing capacities for the real economy.

Since the financial crisis there have been a number of helpful developments on regulations, given that there is a ban on re-securitisation, which contributed to stability in the securitisation market, and the implementation of the retention rule and of STS. There is also the obligation for setting up mandatory due diligence meetings for the investors.

5. EU investors feel that securitisation is reliable but complex and unaffordable

An industry representative stated that European securitisation has always been reasonably safe. Even in the US, the crisis occurred because sub-prime mortgage loans started to be securitised, which was a very specific segment of the market. That does not exist in Europe and never has. The market is ready to buy good securitised products.

The issue is less the stigma than the prudential treatment because the target is to be able to unload assets from the banks' balance sheets. A prudential treatment is needed which relieves the risk-weighted assets calculations from the banks that are securitising, so it is a framework that is not too severely penalising banks or investors.

If the load is securitised and different tranches are sold to different banks, the addition of these different parts should not be much higher than the risk-weighted assets of the initial loan. The current situation is that by securitising there is roughly a doubling of the risk-weighted assets associated with the same loan.

The benefits, in terms of risk-weighted asset transfers, should be measurable and reliable. The current rules, which are not working, have not taken the issue in the right direction. There has been insistence on the processes, complexities and rules instead of the creation of avenues for a market of risk-weighted assets.

6. Benefitting from a securitisation market to relaunch the EU economy demands not delaying the regulatory evolutions outlined by the High-Level Forum

A policymaker noted that the European Commission listens carefully to what the industry has to say. Securitisation can be a very useful refinancing tool for banks, allowing them to create capacity on their balance sheets. The Commission agreed that, following the adoption of the STS framework, securitisation is not picking up sufficiently. This has to be addressed, especially in light of the COVID-19 crisis, which should lead to doing whatever can be done to facilitate lending to the economy.

An official stated that with Europe's banks there is a zero-interest rate environment and decreasing comparability. There has to be consideration of what measures can free up capital to provide lending into the economy. It comes back to synthetic structures and giving beneficial treatment to the senior tranches. That is essential for bringing the lending through to the real economy and for leveraging what member states have done. All member states have brought forward guarantee schemes to support companies in the move into the post-COVID-19 and recovery stages.

An official explained that during shutdown periods many businesses saw a collapse of revenues. Support mechanisms were being brought in everywhere. SMEs' ability to generate capital organically has been impacted, and it was already under pressure prior to the crisis. Banks have to be able to patiently use their capital, to ensure that there is funding available for the real economy.

Changes are being made to Prospectus and MiFID, but SMEs need to be able to access capital markets and securitisation. The ability of banks to securitise those exposures is one of the quickest approaches.

An industry representative noted that there has now been a High-Level Forum to address the issue, and five main game changers have been identified. The High-Level Forum has done a very good job and their recommendations should be implemented promptly.

For practical reasons, the Commission is isolating a number of measures, but this is very selective, covering perhaps a quarter of the proposals underlined by the High-Level Forum. For the full result, all of the measures have to be implemented as quickly as possible, so work on them has to start rapidly. Even if the work is split into two packages for legal or regulatory reasons, the urgency of the second package is as great as that of the first.

An industry representative stated that numerous adjustments remain necessary. One concerns the punitive treatment of securitisation in the liquidity coverage ratio (LCR), which hinders the market from becoming more liquid. This needs to be improved. Another is extending the STS to synthetic transactions, which is underway. There are smaller items, such as relief from ESMA templates and private securitisation requirements. The requirements from the ESMA templates are so great that many originator issuers will not be able to facilitate private securitisation.

An official noted that the High-Level Forum report shows that Europe can do much better, and should seize the opportunity to introduce more changes, especially regarding the clarification of the significant risk transfer (SRT) test. When it comes to non-performing loan securitisation, the EBA report must be built on.

An official added that there are always comparisons with the US, but there there are government-sponsored entities. The STS will have to evolve going forwards. What happened with UCITS can be considered. There were numerous iterations of UCITS but it is now a globally recognised brand.

The package needs to be targeted and to go through both Council and Parliament quickly. There will be the amendments on Prospectus and MiFID, and what matters is the combination of those changes, as no one part stands alone.

There could be greater ambition than what the Commission has brought forward. However, the Commission has been good with the expert groups it has facilitated, resulting in a well-developed package for the Council and Parliament. Nonetheless, there are other things that can be considered, some of which are in relation to transparency on private deals and cashflows on synthetic structures.

A policymaker pointed out that the Commission has identified two issues it considers sufficiently mature to move forward with. First is the securitisation of non-performing exposures (NPE), which is particularly relevant in the present context because there will be a rise in the number of NPEs. It is important to ensure that the securitisation of non-performing exposures becomes a more viable alternative for banks. The Commission hears the industry saying that it and the Basel Committee have not gone far enough, so the subject matter is currently being discussed.

Following work from the supervisors in the EBA, so-called synthetic on-balance-sheet securitisation has been identified as having a strong case for a review of prudential treatment. It is hoped that adoption can take place very soon so that the new rules can come into force towards the end of the year.

In a few days the Commission will provide its official reaction to the High-Level Forum report in the form of an action plan. Securitisation will be an important element. However, there is a need to do things properly. A fundamental review of the securitisation framework is planned for next year. It will be a fairly fundamental examination of what is in place and what can be done. There are markets where securitisation functions well, and the drivers behind that have to be understood.

The Commission will issue its CMU paper soon. There will be no surprises therein, insofar as what comes from the High-Level Forum should be adhered to. A root and branch review is planned for early the following year.

The issue of significant risk transfers is very important for improving the framework, and there is a desire to look very closely at the feasibility of a framework for green securitisation. The points on the liquidity coverage requirement are understood. The preference is to remain close to the Basel standards. However, there is work within Basel Committee to make progress on the Commission's priorities. It is then up to the legislator whether alignment with Basel is confirmed or not.

An official noted that there was little data available in 2016 when working on the STS regulation, because the market collapsed. A policymaker remarked that since STS the supervisors have been looking at the issue more closely, so it is hoped the position will be better, but they should be checked with to ensure they are able to feed policy-makers with sufficient data.

An industry representative stated that the US securitisation market can be looked to for inspiration on how it works, and the way banks are using securitised products, which may be more effective than just going through the Basel Committee. It would be better for this to happen at the beginning of next year rather than at the end. As long as the five game changers identified by the High-Level Forum are not all completely solved the market will not take off. Insurance companies are needed as investors, and one item is related to Solvency II. The banks are needed as investors for the senior tranches, so the LCR is key as well. The private issue is needed.

An industry representative agreed that all five were needed. The market has to be kept liquid. To have a sustainable recovery from the ongoing crisis, it is vital to have liquid markets, and hindering liquidity anywhere in the entire value chain cannot be afforded.

An industry representative agreed that all of the ingredients are needed at the same time; they interact with each other and then the market is created.

An official noted that there are many aspects to the five points raised at the High-Level Forum, such as the LCR and the transparency side, especially with private deals. Regarding how many of the five should be adopted, there is a need for realism. There needs to be ambitiousness in the review of STS next year and quick adoption.

Much was done in the previous version of the CMU. Calls for a reform of the European long-term investment funds (ELTIF) structure are very important, particularly for the SME side. For non-listed debt equity in that sector, ELTIF has an important role to play. The retail aspect needs to be boosted, as there are pools of cash there.

There will be aspects of the CMU that are multiple Commissions, so prioritisation on that basis should be in the action plan. The work from the High-Level Forum is heading in the right direction, some of which is in relation to investor education and more money going into funding pensions. These different changes will all help to develop out capital markets, without which Europe will be put at a disadvantage.

Some changes in the quick fixes are important for supporting what has been done at a state level. The next stage is to see what is possible more quickly and what can be addressed in the timeline of this Commission. Insolvency and other issues will not be dealt with in one Commission, but there is a need to be ambitious and to ultimately deliver on the objectives in the coming years.

An industry representative indicated that corporate loan securitisation and consumer lending securitisation are being addressed currently, but together only represent about 20% of the market. 80% of the market is about mortgage lending securitisation. Those are the proportions in the US market. To fully align with the US market structure the issue of creating conditions for mortgage securitisation will have to be considered, which implies a setup including government-sponsored entities like those in the US.

An industry representative added that the US has a big advantage over Europe in terms of its agency structure. In the financial crisis, almost from one day to the next, the American banks were reset. It is unclear to which extent Europe can implement that, but ideas like it are very welcome. Before a crisis comes, Europe needs to be prepared and that can only be done if every condition is carried out.

A policymaker stated that there will likely be further legislative negotiations on securitisation. The ground needs to be well prepared. Member states, the Council and the Parliament should have objective and unemotional discussions about securitisation, because on the previous occasion there was still a stigma attached, given what happened in the 2008 crisis. In order to achieve things, that has to be left behind, while still ensuring there is a robust framework, given what happened in the past.

7. Success factors for a green securitisation

The Chair asked what is expected from green securitisation. Sustainable finance is still in development. The taxonomy has just come out and benchmarks are needed.

An official replied that the key issue regarding sustainable finance is the quality of data, without which the green products on the market cannot be relied on. There is therefore a great deal of work needed to help make the green STS label mean something real. It must be possible to trust whether a green product will be very green or greener, but that it is not greenwashing. There is a need to have some common standards at the EU level.

The Chair suggested that there are not many truly green products out there, at least not verified by the taxonomy, and queried whether securitisation can help.

An official indicated that it is important to start the work on green securitization as soon as possible, without necessarily waiting for the publication of the delegated acts on taxonomy. However, it will be very important in the long run to ensure full consistency between the stabilized taxonomy and the new framework for green securitization. European common certificates, such as European energy performance certificates, can be relied on. There has to be a wide pool of assets and a common harmonisation of those assets so the market can be very liquid. ■

NEW TECHNOLOGIES AND PAYMENTS

How to support an effective digitalisation of EU finance?

1. Main impacts of digitalisation in the financial sector

1.1 Benefits of digitalisation

An industry representative explained that digitalisation has radically changed the cost structure of retail banking. Fully digital banks operate a cost structure that is a tenth of a traditional bank and thus are able to provide retail banking products at a much lower price point, offering their customers better value for money and increasing competition in the market. The lower fees charged by digital banks also increase returns on investments for retail customers. Technology moreover facilitates the access of customers to banking and investment services with convenient apps, allowing a wider proportion of the population to create future wealth.

Another industry representative stated that the banking business of the future will be technology driven. Technology can improve the profitability and cost-income ratio of all types of financial institutions, increase their flexibility and also facilitate the fulfilment of regulatory obligations such as anti-money laundering and know-your-customer rules (AML and KYC). With digitalisation, financial institutions can also provide customers with better value for money and develop their activities more easily on a cross-border basis.

A third industry representative emphasized that technology can 'democratise' the access to the financial market and allow smaller financial institutions to compete with the larger ones. There is however the need for a level playing field in the market for all types of institutions to be able to compete.

An official suggested that demand factors also need considering. Digitalisation is changing behaviours and needs in the whole of society. The demand of customers is evolving and the way financial services are provided also needs to change as a result.

Another official added that technology helps to improve customer service and also the agility of the sector, with the development of fintech companies. There are also huge opportunities for digital inclusion and financial literacy that need to be considered, because more vulnerable sectors of the population should not be ignored in digitalisation efforts.

1.2 Technology as a driver of innovation and performance

An industry representative explained that the cloud is a major driver of digitalisation in the financial sector. Their company, a digital bank, has run its activity entirely on the cloud since its outset and this has enabled it to scale up. More generally technology has moved from being a cost factor to a key success factor for the financial industry. In 10 years' time, the banks with the best technology will win. Traditional banks are aware of this but have not yet fully implemented technology-based solutions because they still have many traditional customers and legacy systems.

Another industry representative agreed that, with the evolution of technology and financial institutions becoming more familiar with technology and cloud services in particular, the focus concerning the use of IT in the financial sector has moved from cost optimisation to leveraging technology for innovating and increasing resilience. Moving their activities to the cloud allows financial institutions to re-think their operating model, implement cost-saving measures and increase security. This enhances their ability to innovate, improve end-user experience and adapt to market changes. Cloud services also help traditional financial institutions to address the challenges raised by their legacy systems, which prevent them from using effectively machine learning (ML) and artificial intelligence (AI) technology and obtaining appropriate insights from data. Implementing these new technologies can lead to significant improvements in the end-customer experience and to differentiation with competitors, which is why they may be so transformational for the financial sector. These developments are however still at an early stage.

1.3 The prospects of future technological developments

An official asked if there is a new technology still in development that might bring a significant change to the world of finance and banking in the near future. An industry representative suggested that quantum computing could be a possibility, but it is still in the early stages of development. Quantum computing could notably improve performance agility and allow ML and AI to be used in a faster and more cost-effective way. Blockchain is another technology with strong potential, but it is already in use.

Another industry representative felt that finding the new technology with the most potential is not the issue. Although quantum computing might accelerate analyses even more in the future, high-performing technology is already available. The question to address is rather whether currently available technologies are appropriately used in retail banking and how to do so effectively in the present regulatory environment. The industry should not wait for the great technology likely to radically transform retail banking or financial services. Companies need to work with the technologies they have at their disposal and regulators should develop the frameworks that may support the use of these technologies. Many pending issues can potentially be addressed with existing technologies. This includes AML and KYC for which video and photo solutions have been available for a long time. Card fraud is another major topic in Europe for which there are solutions. Through knowing the geolocation of a smartphone and the location of a transaction, a multitude of frauds can be avoided. The industry needs to provide regulators with more data and information on these systems, which are not really high tech, in order to demonstrate their effectiveness, the industry representative suggested.

2. Digitalisation partnerships

An industry representative stated that financial institutions need to establish partnerships with technology providers and platforms, as other industries have been doing for some time. This is the condition for enhancing and accelerating the digitalisation of the sector and implementing effectively AI and ML solutions in particular. The Covid crisis also shows that the trend from ownership to consumption is due to accelerate. This is a challenge for financial institutions, which are used to managing their own developments, and also for their regulators. However financial institutions have demonstrated their capacity to react quickly and adapt to other challenges, such as low interest rates or the situation created by the pandemic. In addition, banks should focus on their core financial activities, serving their customers and helping companies to implement their future business models rather than on developing new technologies.

An official agreed that partnerships and importing technologies will be essential for the successful digitalisation of the financial sector. Building everything in-house is indeed impossible and innovation is happening now in the technological sector rather than in banks. As a result financial business models will need to evolve towards more openness, and financial regulation will need to be adapted. This may also put some pressure on the revenues and profits of the financial sector. The increasing role of third-parties may also create new risks that need to be clarified and carefully monitored. This issue is being addressed by the Commission in the Digital Operational Resilience Framework for financial services currently being prepared.

The industry representative suggested that some resources could be shared across industries and countries for supporting digitalisation. For example, a cross-industry and cross-country digital identity system leveraging technology could be developed. All industries, including the financial sector, are indeed faced with frauds such as attempts to hide identities or execute fake payments that require AML, KYC and CFT (combatting the financing of terrorism) verifications. These could be shared through the use of a common utility and shared identity verification system, which could cover both individuals and corporations and reduce duplicate investments by multiple organisations in these capabilities.

3. Policy priorities put forward in the new Digital Finance Strategy for the EU

A policy-maker stated that digital technologies are a key driver for rebuilding the European economies and ensuring a transition to more sustainable growth. A policy paper on how to shape Europe's digital future[1] was issued earlier in the year by the Commission, covering all sectors of the economy. Additional targeted initiatives are being prepared for implementing this overarching strategy in different industry sectors. Concerning financial services, a Digital Finance Strategy[2] will be issued by the end of September proposing measures for supporting the digitalisation of the sector in 4 different areas. In doing so, the Commission will pay particular attention to the provision of new opportunities for consumers and to their protection and also to the international consistency of the standards developed.

- **Tackling the fragmentation of the Digital Single Market for financial services:** The objective is to make it easier for European financial firms to operate cross-border and scale up their digital operations and for European consumers to access cross-border services digitally. This will require a harmonisation effort building on previous initiatives conducted notably in the banking sector for harmonising prudential requirements or centralising supervision. Further work is needed on AML in particular. Differences in consumer protection approaches across member states remain a challenging area and are unlikely to be addressed in the short term, but should be considered for the future.
- **Ensuring that the EU regulatory framework facilitates digital innovation in the interest of consumers and market efficiency:** EU financial services legislation and supervisory practices must be regularly examined to ensure that they remain relevant with rapid digital innovation. Additional rules are also needed in certain new areas. One is crypto-assets that qualify as financial instruments, for which interpretative guidance on the application of existing rules will be provided. A pilot regime will be designed to support the uptake of financial applications based on DLT (digital ledger technology). The use of other technologies such as AI in the financial sector will also be considered. The general policy framework proposed for AI[3] earlier in 2020 will serve as the basis for more targeted rules in the financial sector.
- **Creating a European financial data space to promote data-driven innovation:** This action will build on the cross-sectoral European data strategy[4] proposed at the beginning of 2020, with measures for enhancing the access to and sharing of data within the financial sector. Progress has been made in the payments area, where the EU has led the way in opening up data sharing, but the objective is to go further and foster more data-driven innovation in the financial sector. The aim is to facilitate real-time digital access to all regulated financial information and to encourage business-to-business data sharing, as well as the implementation of innovative IT tools for facilitating reporting and supervision.
- **Addressing new challenges and risks associated with the digital transformation:** This area focuses on the measures needed for mitigating potential risks associated with digitalisation, notably cybersecurity and data protection. A new legislative proposal on operational resilience is being prepared. Adaptations that may be needed to existing financial legislations in order to take into account the impacts of digitalisation are also being examined. Particular attention will be paid to the principle of 'same business, same risk, same rules' in order to safeguard the level playing field between existing financial institutions and new market entrants.

4. Views expressed on the policy priorities for supporting digitalisation in the financial sector

Several speakers suggested that the actions of the EU authorities concerning digitalisation should focus mainly for the time being on the gaps left in regulation and on addressing regulatory fragmentation.

4.1 Addressing regulatory fragmentation across the EU

An industry representative stated that EU banking regulations allow digital banks, such as theirs, to operate throughout Europe, but they still face many domestic obstacles, which impact their competitiveness. Harmonisation efforts are being made in the EU, but differences subsist across domestic requirements and the way they are executed because supervisors tend to consider that their market is specific. One

[1] https://ec.europa.eu/info/publications/communication-shaping-europes-digital-future_en

[2] https://ec.europa.eu/info/publications/200924-digital-finance-proposals_en

[3] https://ec.europa.eu/info/sites/info/files/commission-white-paper-artificial-intelligence-feb2020_en.pdf

[4] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52020DC0066&from=EN

example of this is KYC requirements that differ significantly across EU member states. Another example is IBANs. The intention of the IBAN system is for EU citizens to be able to use the same IBAN for payments and transfers throughout Europe, but at present German IBANs are not accepted in France for instance by large mobile phone companies or cannot be used for receiving a salary. This means that it is very difficult to scale up a company to being a large tech player in the EU, unlike the US, where fintechs can more easily market their products across the whole country and leverage economies of scale, even though regulation also differs to a certain extent across US States. The problem is that at present there are a limited number of institutions operating cross-border in the retail space, therefore domestic regulators do not see the need for changing their rules. In addition financial regulations are based on detailed rules that apply to financial activities or entities and each country has a different way of approaching these. More flexibility would need to be built into the regulation, e.g. with a stronger focus on targeted outputs or principles, and more consideration should be given to the opportunities associated with the development of cross-border financial services across the EU.

Another industry representative agreed that there is a need for further harmonisation of European regulation and that regulation should be as much as possible principles-based in order to allow more flexibility and innovation. The delay of regulatory approval is another issue that needs to be considered because time is of the essence when launching new products or services. It is hoped that initiatives such as the Capital Markets Union (CMU) can reduce market fragmentation and support the diversification of financing in the EU. Digitalisation can also play a role in supporting these integration efforts.

4.2 Ensuring security in the context of digitalisation

An official noted that security is also an important consideration in the context of digitalisation. Cyber-security initiatives are in development in the EU but there is less discussion about the potential systemic risks related to the development of technology. Regulation and supervision are very sector oriented, but the financial sector is interlinked with telecommunications and energy networks for example. Cross-sector aspects should be further considered in legislation, as well as in crisis management arrangements and non legislative actions such as joint testing and scenarios. The Digital Operational Resilience framework for Financial Services proposed by the Commission is also extremely important in this perspective. Cooperation and information exchange between all levels of authorities should be included in this approach. Financial infrastructures should also be considered as critical infrastructures in EU frameworks, which is not always the case at present. It is also important to reflect crisis management arrangements in the Digital Finance Strategy now being prepared.

Another official asked if there is a need to respect national specificities in this context, given that by nature digital risks are borderless. The first official replied that although incidents can happen in many places at the same time it is difficult to have a 'one* size fits all approach', because there will be local consequences as well, so local authorities should be involved in the preparations and they also need to consider their own national security issues related e.g. to their geographical location. However, these national considerations should not be used to hinder cross-border business or competition. A balance between national and EU-level issues should therefore be sought in this regard.

A third official stated that the approach to risks such as the potential misuse of data and cybersecurity has to be flexible because they interact with many social norms and other legislative areas that may differ across the EU. The policy framework should also retain appropriate protections for consumers.

4.3 Balancing risk mitigation and innovation objectives

An official emphasized that the pace of development and innovation is very fast in the digital space within and outside the financial sector and that it is very difficult to predict how digitalisation will develop in the financial sector. The aim is to provide a sound regulatory framework that is able to evolve over time. In setting out priority issues for the coming years, the Commission has recognised that it is an evolutionary process. Whether the appropriate legislative and regulatory frameworks are in place should be constantly questioned. Another important point is that an appropriate balance should be sought in regulation between risk mitigation and customer protection objectives and the encouragement of innovation. Innovation must not be stifled indeed, because the most agile companies with the latest developments in technologies are essential for providing a fast response to adverse changes in the economy such as the one experienced with the COVID crisis. Engagement between the public sector and industry are particularly important in this perspective and tools such as the innovation hubs that have been introduced by several member states can help. Supervisory architecture should also ensure a level playing field across the member states and across different sectors of the financial industry.

An industry representative agreed that the innovation cycle is accelerating. Putting in place the appropriate policies for supporting this development is essential, as well as ensuring their consistent implementation throughout the member states. Exchanges of views between the digital industry and regulators are important in this context and should be further developed. ■

Is the EU policy approach on cloud and data up to the digital challenges?

1. Progress of cloud adoption in the financial sector

An industry representative stated that Europe is moving in step with the rest of the world in terms of cloud adoption. Many European banks and insurers have moved beyond the testing phase and are fully investing in cloud-based solutions. The same is true more generally for the digitalisation of the financial sector, as demonstrated by the innovations happening in the European fintech space in particular. These evolutions are building on the collective progress that the financial and tech industry and the authorities have been making over the last few years in better understanding how cloud solutions can support the financial industry and adapting the regulation accordingly.

Another industry representative confirmed that cloud usage is progressing in banks, both in terms of the breadth of use cases and in the depth of implementation. Initially experimental, use cases started emerging in areas such as data analytics and artificial intelligence (AI). Their bank, for instance, has its mobile bank, big data analytics and AI capabilities fully on the public cloud. An increasing number of organisations are now moving towards more critical public cloud use cases, such as data centre replacement and the hosting of core products and systems in the public cloud. Banks are however not yet moving their entire operation to the cloud. This trend is due to continue and is dependent on well functioning public cloud services.

A regulator emphasized that European supervisory authorities are very supportive of the digital transformation and the leveraging of data which are happening in the financial sector, as that will help to improve customer service and the competitiveness of the sector. EIOPA for example has been monitoring the digital transformation of the European insurance sector for some time. It is clear that the insurance sector is moving ahead, adopting at a fast pace new types of tools, such as the cloud, which facilitate new developments based on AI and big data analytics. The COVID 19 crisis is likely to further accelerate the pace of digital transformation, requiring close attention from the supervisory and regulatory side. For implementing these new developments, it is essential for the financial institutions to conclude partnerships with specialized third-party providers in order to have access to the highest degree of innovation. This on-going evolution is mutually beneficial to insurers and technology providers such as cloud service providers (CSPs).

An industry representative confirmed the relevance of cloud-based solutions for the insurance industry in particular, which is and has always been, a data business with data being fundamental to how insurers analyse, underwrite and price risk. For this speaker's company, a global insurance company, there has been a significant shift to cloud particularly over the last 5 years.

A policy-maker stated that more broadly the whole financial system is increasingly dependent on the use and development of information and communication technology (ICT). There is a growing demand for digital solutions provided by third party services such as CSPs in the sector, for reducing manual operations, putting in place new remote working processes and facilitating new channels of communication with and amongst stakeholders.

2. Benefits associated with cloud usage in the financial sector

2.1 Supporting product innovation and cost-effectiveness

An industry representative stated that innovation and agility are among the main benefits of the cloud, which helps financial institutions to bring new products to the market and reach out to new customer segments faster and in a more cost-efficient way.

Another industry representative explained that insurers for example are increasingly building their new generations of products using cloud infrastructure, not just because of the cost advantages but also because of the benefits in terms of customer experience. Both traditional players and new fintech players are moving to simpler product designs that are leveraging the data storage and analytics capabilities of the cloud, as well as the capacity to speed up development and marketing processes. A trend that is due to continue particularly on the retail level is the use of parametric triggers[1], offering an entirely new kind of customer experience because contracts using them are quicker and easier to subscribe and underwrite than traditional indemnity-based products and claims can be paid in a matter of minutes.

A regulator agreed that digital transformation supported by the cloud will be fundamental for the insurance industry in a number of new areas, including the internet of things, which may provide the insurance sector with a much higher level of data availability, open insurance concepts, which are likely to develop in the coming years, as well as parametric insurance. These changes are in their infancy but will become increasingly relevant in the coming years. Europe therefore needs an ambitious programme to ensure that cloud solutions develop in a safe way and that they benefit customers as well as the industry in terms of cost efficiency.

2.2 Reducing operational risks

An industry representative emphasized the risk reductions offered by cloud technology. Cloud services firstly provide increased stability, reliability and security for financial institutions since the outages that regularly happen with traditional data centres are far less frequent. There are also significantly fewer successful hack attempts that may jeopardise consumers' data. This is due to the fact that CSPs have a core expertise on security because their business model depends on it and they employ large teams of security experts solely focused on cyber protection. Secondly, cloud services provide a means for financial services firms to exit the legacy IT infrastructure that they have been using in some cases for up to 40 years. That sort of old infrastructure creates

[1] Parametric insurance is a type of insurance that covers the probability of a predefined event happening instead of indemnifying actual loss incurred. It is an agreement to make a payment upon the occurrence of a triggering event, and as such is detached from an underlying physical asset or piece of infrastructure.

various risks for financial institutions in terms of safety and business model that public cloud-based solutions can address with improved resilience, costs and scalability.

Another industry representative noted that there was initially a great deal of concern over cybersecurity when the use of cloud was first discussed. Such risks cannot be completely eliminated, but the major CSPs are tackling them in a very effective way, investing in state of the art tools and monitoring capacity at a level that significantly outstrips the ability of any individual financial company.

2.3 Improving fraud detection and facilitating compliance

An industry representative explained that cloud services support dramatically improved fraud detection systems, utilising AI and integrating different data sets for spotting patterns that cannot be identified by manual processes. This allows a significant improvement of detection rates, which are typically under 1% (of fraudulent transactions) when they are conducted manually on separate data sets, and also a decrease of false positive cases.

Another industry representative added that cloud-based compliance tools allow global financial companies to pool easily relevant customer and transaction data on a large scale so that AI can be applied. This supports the tackling of money laundering, international sanction, suitability and fraud-related issues in a much more effective way, which constitutes a game changer for large insurance companies that spend significant resources and time on dealing with these issues.

A regulator agreed that cloud services may play a role in improving risk management, in addition to enhancing process automation and customer service. The ability to deal with data in a much more efficient way supports progress in terms of compliance and fraud detection in the insurance sector and has allowed for example the reduction of the levels of fraud related to motor vehicle insurance claims.

3. Challenges posed by the development of cloud services

3.1 Issues related to the underlying data regimes

An industry representative emphasized that many jurisdictions are increasingly requiring all data to be kept locally for data protection purposes, which could be at odds with one of the objectives of cloud usage, which is to generate benefits from scale. This needs to be considered in future cloud and data regulation developments. There are also many uncertainties concerning who has jurisdiction over cloud data. Contractual provisions to this effect can be overwritten by legislation, which can lead to sovereignty and national security questions. Certainty and clarity in this area would be welcomed by private sector actors. The industry speaker also mentioned the European project (GAIA-X) aiming to develop a cloud infrastructure and data ecosystem in the EU based on European standards. While their firm supports this project which may increase competition in the cloud market, it is important to consider that the cloud market is global and should remain so without geographic segmentation. Global users indeed want to be able to choose from the whole range of providers available at the international level.

A regulator considered that the regulatory approach needs to ensure that consumer data is used in a fair and transparent way, with the highest ethical principles. This needs to be done from inception, because digital transformation must be embraced in a way that best serves consumers and service providers.

An industry representative added that the geopolitical risk related to cloud provision also needs to be considered. There need to be appropriate rules and regulations in place in terms of how data can flow or be used across geographical boundaries.

Another aspect is that the ability to perform the administration of assets in the public cloud space could be compromised if the cross-border control infrastructure is unavailable or impeded. This issue has been identified by some of the main public CSPs, who are working on building capabilities to allow for country-based administration. In this area, legislation and policies could potentially speed up and harmonize such developments and hence reduce risk.

3.2 Operational and market structure challenges

A regulator underlined some challenges related to cloud implementation that concern both financial institutions and supervisors. For example, there are difficulties with the cultural changes needed to implement digital solutions, which can be a significant challenge for certain organisations. There is also the question of the appropriate management of the shared responsibility model between the CSPs and financial service companies. Financial services companies also face potential lock-in risks with CSPs, which is why a number of financial companies are deciding to implement multi-cloud approaches and further work is needed on the reversibility of cloud contracts.

The regulator was also concerned by the possible concentration risk in the cloud sector, because an excessive concentration in the market around a few major CSPs could potentially create financial stability and systemic risks.

4. Existing cloud outsourcing guidelines in the EU

A regulator stated that the guidelines issued by the European Supervisory Authorities (ESAs) on the outsourcing to CSPs are an important first step in facilitating the dialogue between supervisors and market stakeholders. The guidelines have also contributed to improving market practices and transparency with a clarification of contractual arrangements for example.

An industry representative confirmed that significant progress is being made with the implementation of these guidelines, which are an adequate basis for further improving the European cloud framework. The work on harmonizing requirements for cloud services in the EU should nevertheless continue, because there are still duplicative or overlapping requirements that need to be eliminated for these measures to remain manageable for the industry. In the definition of guidelines, the right balance also needs to be struck between risk mitigation objectives and ensuring that customers can reap the benefits of the cloud.

Another industry representative stressed that there is a very strong common interest between regulators, cloud users and the CSPs in getting the approach right on cloud guidelines. Standardisation needs to be improved in the cloud market, but in a pragmatic and progressive way. The guidelines on outsourcing provided by EIOPA and the other ESAs are well thought through and make a very strong basis. There are also many advantages in having a European-level agency that works in close coordination with the local authorities on these issues in order to ensure that harmonisation progresses across Europe. This will simplify the terrain for all the players. One objective of this harmonisation work is to ensure that there is a level playing field between CSPs and their users in the current context where market power is largely concentrated amongst a handful of CSPs. Standards can indeed help users to better negotiate sufficient reversibility of cloud contracts and adequate audit rights for example.

5. Measures proposed for mitigating digitalisation risks

5.1 Proposed Digital Operational Resilience framework

A policy-maker acknowledged that the current financial regulation needs updating and completing in order to take into account the changes brought by digitalisation. A new Digital

Finance Strategy for the EU (DFS) will be proposed by the end of September, aiming to ensure that the EU financial sector embraces the opportunities offered by the digital revolution[2]. Concerning the risks associated with digitalisation the Commission proposes adapting the existing financial services legislative framework with respect to consumer protection and prudential rules to the new digital environment and also implementing a new EU framework for strengthening digital operational resilience in order to take into account the new challenges that the increasing dependence on ICT and data are creating[3]. This cannot be done entirely through the existing regulation, and so the Commission is considering some new legislative measures that would allow the enhancement of current cyber-resilience approaches in the financial sector, as well as an oversight mechanism of critical ICT third-party service providers, potentially including CSPs[4].

An industry speaker considered that direct oversight may be an option for addressing some of the challenges associated with a broader adoption of cloud services in the financial sector. Another industry representative however emphasized that direct oversight should not absolve cloud users of their monitoring and auditing responsibilities in the context of cloud arrangements[5]. The first industry speaker also stressed that potential oversight arrangements need to be manageable for all stakeholders and that there needs to be an element of proportionality so that small and medium-sized companies can continue to benefit from cloud services in this new regulatory and supervisory environment.

A regulator stated that the direct oversight over the critical CSPs needs to be undertaken at the European level by a single European supervisor. A fragmented oversight of these providers by different member states would make no sense given the international coverage of CSPs. The regulator also agreed with the importance of proportionality for allowing the small and medium-sized entities to also embark upon the digital transformation.

An official agreed that these issues need to be addressed at the EU level. European approaches also need to have a broader international perspective, because cloud services are an area where Europe can take a lead in embedding the measures proposed globally.

5.2 European data frameworks

A public representative mentioned that the European Commission and the European Parliament are addressing the issues of risk reduction and trust associated with digitalisation also with new proposals regarding data. The new European strategy for data proposed at the beginning of 2020 is due to complete the General Data Protection Regulation (GDPR) and the E-Privacy Directive that have been effective for protecting the data of individuals. However standards concerning access to data do not always seem to be properly applied, because customers in some cases are not able to access in a practical way their own data that is held by some big tech companies. Further consideration needs to be given as to how the data regulations can be applied in a practical way because such issues with access to data potentially undermine consumer trust. In order to achieve a well functioning internal market, there also needs to be a balance in the legislation between the interests of European citizens and of the industry, and the expertise of academics and researchers also needs considering in these innovative areas. The data that financial institutions and digital companies collect from European citizens should be used to their advantage, and not just to the advantage of financial service providers.

This issue led the public representative to comment on the taxation of the profits made with digital services. A strong view of the Parliament is that taxes should be imposed where profits are made, even if tech companies operate globally. Changing tax regulation with regard to digital services in order to make this possible will help to convince European citizens that they are receiving the benefits arising from the usage of their data and that these activities are properly regulated.

5.3 Enhancement of the EU cybersecurity framework

A policy-maker stated that a growing reliance on digital processes and third-party providers requires increased cybersecurity and the capacity to adapt to fast evolving risks and challenges.

A public representative explained that the Parliament is constantly working to improve cybersecurity regulation, which is one of the key topics related to digitalisation. Legislators and regulators need to adapt to the speed of development of technology. In order to earn customers' trust, cyber-resilience standards need to be applied both to the financial institutions and the CSPs. To this end, a cybersecurity certification scheme is currently being developed by the European Union Agency for Cybersecurity (ENISA) and should be shortly implemented.

A regulator stressed that standardisation is important in this area. Harmonizing cyber-risk taxonomy and incident reporting at the European, if not at the global level, is essential. The current fragmented system is inadequate because it obliges providers to report incidents to multiple authorities using different sets of requirements. ■

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[2] https://ec.europa.eu/info/publications/200924-digital-finance-proposals_en
This framework pursues 4 main objectives : (i) Tackling the fragmentation of the Digital Single Market for financial services; (ii) Ensuring that the EU regulatory framework facilitates digital innovation in the interest of consumers and market efficiency; (iii) Creating a European financial data space to promote data-driven innovation and (iv) Addressing new challenges and risks associated with the digital transformation.

[3] The increasing level of digitalisation of financial services coupled with the presence of high value assets and (often sensitive) data make the financial system vulnerable to operational incidents and cyber-attacks.

[4] The Commission is proposing a new framework for strengthening digital operational resilience built around five pillars : i) a coherent baseline for ICT risk management requirements, hinging on the cyber-risk management concept and which would be shaped and built upon internationally agreed standards guidance; ii) a cyber resilience testing framework to periodically assess financial institutions' cyber vulnerabilities; iii) a comprehensive framework for reporting cyber accidents, which would improve the flow of information between sectors and between the industry and supervisors; iv) an oversight mechanism of critical ICT third-party service providers, potentially including CSPs and aiming to strengthen outsourcing requirements and provide for a direct oversight of activities at individual levels; and v) the encouragement of financial institutions to share information about cyber threats amongst themselves, as well as, possibly, with the regulators.

[5] In the shared responsibility model used in the context of cloud outsourcing arrangements, security, risk management and compliance responsibilities are shared between the CSP and the financial institution, but the latter institution retains the ultimate liability for its own operational resilience and business continuity.

Will AI be a game-changer in the financial sector and under what conditions?

1. Applications of artificial intelligence (AI) in the financial sector

A regulator stated that AI is a key driver for innovation and change, not just in the financial services industry but in many other sectors as well. In a data-driven industry like financial services, AI applications can potentially play a significant role, but there are still ongoing discussions as to whether AI is hyped or under-exploited and whether it is an opportunity or a threat in certain circumstances.

An industry representative explained that there has been a great deal of experimentation of AI in the banking sector. There are now applications across different parts of the sector such as retail and wholesale banking and different activities including product development, marketing and risk management (e.g. for anti-money laundering (AML), fighting financial crime…). Further due diligence of these different applications is however needed before full-scale deployment can be effective.

Another industry representative emphasised that their firm, a major insurance company, is looking at AI with a high degree of enthusiasm. While it is true that some AI uses can be detrimental to consumer protection, such as facial recognition technology, there are a number of applications that can improve the relationship with the customer and, ultimately, provide them with a better value proposition. Examples of this include AI systems using language processing and geo-localisation for accelerating roadside assistance, or the use of computer vision for identifying the damage to a car and the repairs and parts that are required and for evaluating the cost of repairs in a matter of minutes.

A third industry speaker added that AI allows the provision of customized services, such as individualised advice based on client data and their needs in a much more effective way, on average, than human-based advice which is very dependent on the knowledge of individual advisors.

The regulator concluded that these use cases show that AI applications are driven by a range of needs including client service and logistics improvement, which go far beyond more traditional back-office efficiency improvements.

2. Data access and sharing issues related to AI

2.1 Data quality challenges

Some speakers on the panel stressed that what is often labelled 'AI' is actually more like machine learning (ML), which is about processing large volumes of data in order to infer patterns or achieve certain outcomes such as identity verification or fraud detection.

An industry representative felt that consequently the quality of the data used is a key success factor for achieving appropriate use cases and outcomes. At present however, although data is the basis for conducting many financial activities, the financial industry does not have in most areas the high level of data quality that one might expect. In addition, financial data is generated in silos such as payment or credit activities and is hard to aggregate or combine across these silos, making it difficult to identify patterns on a wide scale and therefore limiting AI use cases. In comparison, 'modern' technology companies such as big techs, have built huge 'data lakes' from which they are able to draw insights more effectively.

Going forward, the industry speaker suggested that financial players need to adapt their data infrastructure in order to improve data gathering and management. This will allow them to improve the training of algorithms and the identification of statistical patterns and thus broaden the use of AI. Data quality, storage and management do not need to be perfect on a perfectly integrated infrastructure for progress to be made, but ultimately, the better the infrastructure, the better the data, the better the use cases and the higher the quality of the outcome is likely to be. If financial institutions do not develop the right data infrastructure, they will always be at a competitive disadvantage compared with the big tech companies, the speaker believed.

2.2 Data-related competitiveness and level playing field issues

A regulator noted that AI use and related issues regarding data flows raise questions in terms of competitiveness and level playing field. There are two dimensions of level playing field to be considered. One is between financial institutions and tech companies, and the other is between Europe and the rest of the world. The former issue that was already debated in the context of the second Payment Services Directive (PSD2) relates to whether access to data is asymmetric between financial and non-financial companies. The latter dimension is whether there is a risk that Europe could miss some opportunities because of overly stringent ethical standards, applying to AI models or the underlying data, that may hamper the speed of innovation.

Concerning the level playing field in terms of data flows, an industry representative considered that if data is not allowed to flow across organisations – i.e. not only from the financial sector to other sectors as provided by PSD2 but across industries – that means that there is no level playing field and there will always be certain players that have a significant competitive advantage because they can lock-in the data from clients. That is why access to data and how it is regulated is so important. Ant Financial, for example was able to become such a successful financial institution because it has preferential access to Alibaba's data and algorithms, the speaker claimed, and it is likely that some other financial institutions with the same access to Alibaba's data could have been as successful. However, without the same access to data, they have no chance to compete.

The regulator asked whether PSD2 should be updated with provisions forcing non-financial companies including big techs to provide open access to their data for all financial institutions.

The industry speaker felt that the General Data Protection Regulation (GDPR) already contains all the core ideas that are needed for managing data sharing properly and making this possible. GDPR already provides users with the right to ask for their data and thus allows data sharing across organisations. The problem however is that, unlike PSD2, it does not define any standards for providing the data, therefore companies that hold data, such as big techs, are currently able to release it in a way that is impractical and unhelpful if they are asked to do so by users. Every industry should therefore be asked to comply with a set of common standards regarding the movement of data, such as those provided by PSD2, in order to lift those obstacles. This would allow competition to develop on equal terms based on the trust of clients i.e. the most trustworthy companies would be the ones that get the most access to customer data, which would then lead to the desired results. The speaker added that Europe has a real chance to build a unique selling proposition (USP) around data standards in this context, potentially becoming the region on the globe where institutions will want to store their data because they know it will be handled properly.

In terms of the competitiveness of the financial sector vis-à-vis tech companies, an official stated that the odds are not in the financial sector's favour with regard to data analytics, even though financial firms are increasingly utilising non-financial and non-balance sheet data such as images, social media or geo-localisation information in their decision processes. Technology companies already have the edge in this area with many more data points from which insights can be drawn. Previously, financial firms could count on their superior understanding of the needs and economics of their customers for making marketing or risk decisions, due to their proximity with them, but now technology firms could potentially develop better insights based on data analytics. Referring to the comments made by the previous industry speaker, the official agreed that data and having the appropriate rules for it is important, but it is not the only factor. Data is an input and the learning algorithm is also essential. In some cases, the algorithm has achieved such a level of sophistication that it is very difficult to catch up with it. Thinking that GDPR is sufficient to preserve a safe competitive environment may be 'wishful thinking'.

The regulator remarked that financial services institutions can purchase AI capabilities from tech companies and that data analytic capabilities do not necessarily put tech companies in a favourable position for entering the financial sector. The official confirmed that technology firms are currently not venturing into the financial space because of the regulatory and prudential requirements and that financial institutions are using tech third parties to develop ML algorithms rather than just relying on in-house engineers. However, in doing so, financial institutions should take care not to become too dependent on tech third-party providers.

An industry representative emphasized that customer experience will be driving the embedding of these technologies in financial services, the opportunities for new product development using AI, such as a further personalisation of products, and thus the competitiveness of financial institutions in this area. However providing more personalised products, as requested by customers, will also require that financial institutions put an increased focus on data privacy. The data element will be as important to manage vis-à-vis customers as the technology itself for financial institutions. Willingness to invest will also determine whether financial institutions can compete in an AI-based environment. It is not just about investments in technology and data, the speaker believed, but also investments in skillsets and people. Those institutions that successfully capture and achieve a positive outcome on these challenges will gain the competitive advantage.

3. Challenges associated with the use of AI in the financial sector

3.1 Explainability

A regulator remarked that while some of the challenges discussed in relation to AI are similar to those concerning digitalisation in general, such as cybersecurity or the measures needed for safe cloud outsourcing, some are more specific. The explainability of predictive models, which is a key challenge for the successful implementation of AI systems is one of these. Explainability for supervisors is not about being able to fully analyze or replicate any AI algorithm, which would be impossible. Rather, it is about being provided with a sufficient level of auditability of algorithms - e.g. being able to understand what are their key drivers for providing results or test the algorithms with samples of data - in order to ensure that they do not create excessive risk or bias. In addition, the level of explainability that is needed for each type of use case needs to be defined jointly by the financial institutions, the developers of the algorithms and the supervisors concerned. The French ACPR (Autorité de Contrôle Prudentiel et de Résolution) has published a recent study on the governance of AI algorithms in the financial sector that is currently under consultation and will help to develop a framework for analysing how AI use cases can be supervised.

An official considered that the level of development of AI should not be over-estimated. It may be that at some point in time AI developments may become so sophisticated that humans can no longer understand how they are reaching their insights. If and when regulated firms start using this technology en masse, supervisors will need to have a deep understanding of the technology and how it is used. However, so far, applications are mainly seen at an experimental level and the use cases that have been referred to by the previous speakers are not making up a large proportion of the balance sheet or risk capital of financial institutions.

A regulator referred to an academic who had stated that strict insistence on explainability and documentation could stifle AI innovation. An industry representative agreed with the academic, stating that this issue is often handled incorrectly at present. Indeed a human decision-maker is not judged by trying to understand how decisions are made, but by the results produced i.e. the decision itself. Applying this reasoning to an algorithm, the focus of potential policy guidelines or supervisory monitoring should not be on the explainability of the algorithm or understanding how it is built, but rather on the explainability and the relevance of the results provided and acting upon them if needed. To what degree the company using the AI system is checking whether the results produced are in line with the initial objectives defined and acting on possible divergences should be verified in particular. For example, if it is discovered that certain groups are systematically discriminated against by the results of an AI algorithm or that some social media algorithms result in the spreading of fake news, this needs to be acted upon.

Another industry representative agreed that explainability is essential and should be focused on the output. For example, their firm makes sure that it can explain the results of AI and ML-based models, not just to itself but also to its customers and also checks the stability and consistency in the outcomes. Consideration is also given to whether the technology is utilised to the benefit of customers and the financial markets as a whole. This is part of a more general focus on the responsible deployment of AI and ML in which model risk management and data governance play a key role, alongside explainability and accountability principles. Technological changes, in the context of the competitive landscape with the big tech companies, indeed need to be responded to by banks in a sustainable, pragmatic fashion.

Another industry representative concurred with the importance of a responsible use of AI and of explaining end results to customers, as well as within financial institutions; technology is a means, not an end. Thinking about the responsible usage of AI is important for example when AI is used for enhancing personalisation. Indeed extreme personalisation, potentially customising proposals for individual customers may be attractive, but would go against the principle of diversification and pooling, which is the basis of insurance and may undermine the possibility for insurers to serve specific customer segments in a non-discriminatory way.

3.2 Accountability

A regulator emphasized that the results of AI not only need to be explainable for the institution's supervisors, but also for the governance of the institutions i.e. the board and senior management who are held accountable for the resulting decisions. Ultimate accountability should indeed lie with the supervised entity, regardless of whether they choose to develop knowledge internally or via a third party. This means that the senior management needs to be aware of the implications of using these instruments and should also be able to understand the outputs produced.

Another regulator concurred that accountability and liability risks need to be considered with regard to AI. There is currently a significant gap in terms of knowledge and understanding between the data scientists, who are building the scenarios and the AI models, and the bankers, insurers and asset managers, who are managing the business and are accountable for the decisions made. This means that it is difficult for the latter managers to make sure that the risk models that are built are adequate. The solution for financial institutions, concerning IT developments, has been until now to hire engineers or work on a long-term basis with third-party providers, who can develop this knowledge internally, but it is uncertain whether this can be achieved with AI.

3.3 Bias

A regulator explained that there are risks of bias or of amplification that exist with AI and that require extreme caution because non-representative data can lead to undesired outcomes. This is related to the quality of the data and also to the infrastructure that is used for managing the data. For example, risk models considering features such as age, credit history or the origin of name could lead to excluding some parts of a population from banking services if other elements of client knowledge that may require human interaction for collecting them, are not taken into account.

Another regulator agreed that there is a risk of undue bias with the use of AI algorithms and techniques. There needs to be ex ante clarity over these risks and ex post adjustment if those biases were to arise in order to enhance the confidence in these systems. Consideration also needs to be given to consumer protection and privacy issues. Consumers need to be aware of how their data is used as an input for the outcomes produced.

3.4 Skills and knowledge

A public representative emphasized the challenges in terms of skills and technological knowledge raised by the implementation of fast-developing technologies such as AI for the public authorities and also for the financial institutions. It is difficult for regulators and supervisors in charge of controlling these systems to adapt quickly enough to these fast technological developments and for firms it can also be challenging to control and use the data and technology properly. The provision of appropriate training and constantly updating qualifications for people connected with AI systems is essential in this context.

An industry representative agreed, noting that for example one of the first proposals of the Advisory Council of the German Ministry of Finance was to make it easier for people with a tech background to become a board member of a financial institution. Initiatives such as these are essential for ensuring that sufficient people with the relevant background are present in the financial industry.

4. Policy approach recommendations

Some regulators on the panel stated that, to address the aforementioned risks, it is first necessary to determine what constitutes 'sound' AI. A first regulator considered that a small number of key technical principles need to be identified relating to the performance of data management and the stability and explainability of predictive models and their results. A second regulator added that elements such as the quality of data and cybersecurity are also important. From the regulatory perspective, the key element to be borne in mind is the need for trust to be built around AI technology in order to be able to use it on a much higher scale. Controlling that the criteria mentioned previously are fulfilled is essential for building trust and ensuring that all stakeholders are comfortable with using it.

A public representative noted that there has been a high level of policy activity in the area of AI. The European Parliament has issued an ethics guideline on AI. The European Commission also published a White Paper on AI earlier in 2020 that echoes some of the principles that have been mentioned above. Consultations with the member states are ongoing with a view to then drafting relevant regulations. The common agreement so far is that the regulatory framework should be focusing on three main aspects: the economic; the social; and the ethical. The right balance needs to be struck between these areas. Ultimately, it is not the technology that is a problem. The issue is rather how it is used, implemented and regulated. It is also important to make a clear distinction between ML and AI. The industry has realised this distinction but this needs to be better reflected in the regulatory framework that is being prepared.

The public representative also stressed that AI rules require not only EU harmonisation but global harmonisation as well. Europe has a unique chance to be at the forefront of regulating this technology, and it needs to get it right. A great deal of input from people with a technical background is required for achieving this properly. ■

Key success factors for delivering an effective and viable EU retail payments area

1. The most significant shifts and trends in the European payment area

A Central Bank official outlined that technological innovations, regulatory adjustments and the increased digitalisation of daily life have permanently altered the payment landscape in Europe and will continue to shape it into the future. The COVID-19 pandemic is fuelling the ongoing technological shift transforming society, making daily life much more digital than before.

1.1 The COVID-19 pandemic is fuelling the ongoing technological shift, but cash still has an important share in the EU

An industry representative stated that Europe has historically remained a heavy user of cash compared to many other regions. In the last three or four years there has been a significant growth in digital payments. COVID has accelerated that change. However, it is still not at the level of penetration in some economies around the world.

1.2 Trends and challenges in digital payment developments

1.2.1 Unprecedented growth in e commerce across most European countries

An industry representative considers there has been tremendous growth in e-commerce. Visa has seen a 25% growth in e commerce across most European countries. Contactless payments as part of the use of cards have also increased significantly. There has been a harmonisation of contactless limits across Europe. Most countries in Europe, partly as a result of COVID, have moved to a €50 limit.

1.2.2 Ever-increasing cross-border fund transfers

An industry representative considers that the financial remittance industry has been recognised as an essential service. During the pandemic most Western Union locations were able to stay open and to serve customers because cross-border payments were considered essential. Digitalisation has been a big step. In 2020 there has been triple-digit growth, and in the last three months the company's digital growth has accelerated at about the rate that would have usually been seen in the next two or three years, because people have more and more need to transfer funds electronically by downloading the mobile app.

There is a different digitalisation phase across Europe, especially in the remittance sector. It is essential that there should be innovation in order to have a seamless way to transfer funds and allow for electronic identification. Electronic ID is much more developed in northern Europe and the UK, while in other countries in southern Europe it is less developed. That did not allow many consumers to leverage the opportunity of the digital online remittance cross-border payments.

1.2.3 Technological disruption, data ownership and control challenges, varied and numerous new players in the payment landscape as well as new forms of risk

A Central Bank official considered that there are two main trends. The first one is the digitisation of the economy. It is important to underline the introduction of disruptive technological innovation that could have a strong impact on the payment landscape and also on the economy. The development of distributed ledger technologies has made it possible to transfer value through cryptographic digital tokens and also paved the way for the creation of a new form of virtual assets, like bitcoins, stable-coins, and global stable-coins. This development could be disruptive, both for European payment players and international players.

The second trend is about the arrival of a crowd of new players. European regulation with PSD1 and PSD2 encourages the arrival of new players. It is a very positive trend to allow Fintechs to enter the market, but it has also resulted in a greater footprint of large international players and tech giants.

The current COVID-19 crisis acts as an accelerator of these trends; they carry substantial benefits for customers, who now have access to a wider array of payment solutions at a lower cost. It is also very important to take new risks into account which is why regulation needs to be adjusted over time. Operational risks also exist, such as cyber risks, fraud, anti-money laundering, and privacy.

An industry representative stated that it is important to understand how data is being used. Visa does not use data in any way that some other platforms do. One of the important things is that consumers are actually aware of their data, how their data is being used, and what the value is of their data.

1.2.4 Payment schemes add value and competition by attracting and cooperating with additional and new participants

An industry representative stated that when the European retail area is examined it would be a major achievement if there was a truly effective payments area. The Interchange Fee Regulation (IFR) report that was published in June states that the major four-party schemes either kept their market share or even gained market share, which was not the intention.

An industry representative considered that competition is good, which Visa pursues in terms of its open network strategy. It welcomes new players onto the network, but all participants in the ecosystem need to work to ensure that safety, security and resilience are maintained. AML/KYC remains something that every participant in the industry needs to be aware of. Competition is a good thing. Visa has a very close partnership with Western Union. Around 45% of small businesses in Europe today either still do not take card or cannot sell their services in an e commerce environment. Visa has just launched a major campaign across Europe called, 'Where You Shop Matters'.

An industry representative does not see American Express as challenged; it cooperates with many players in the markets and is also cooperating and investing with fintechs so that it has a good portfolio of legacy systems and new systems.

2. EU pro-competitive policies need to follow an ongoing adaptation process

2.1 Competition policy should lead to more interoperability between more players and fintechs regarding a broader range of services than is necessary today

An industry representative would look forward to more competition in the European payment arena, which could come by giving more interoperability to more players, fintechs, or firms that could offer consumers even more than open banking. In the future it would be beneficial if people could access insurance services or any other service and then look into where the best products are offered and make this space much broader than it is at present. EPI cannot just be left to Europe.

2.2 The EU payment landscape is governed by certain regulations and competition enforcement

A policymaker stated that the Payment Services Directive is a very good step and has reshuffled the logic of business models. It regulated new services and new business opportunities. The interchange fee regulation established caps for debit cards and credit cards for interchange fees within the EU. That was complemented later on by case law with the Visa and Mastercard cases last year with respect to inter-regional fees. GDPR is about the processing of data, the free movement of data and portability.

When it comes to the application of legislation, beyond compatibility and checking whether the letter of legislation is strictly respected, implementation also has to be conform. Industry standards also need to be pro-competitive.

2.3 Competition is part of the deepening of the internal market and compatible with financial stability and other important objectives

A policymaker stated that the Commission has a variety of tools to preserve competition beyond traditional enforcement action, e.g. advocacy. It is surprising to hear people saying that legislation, policy and competition are silos which are separated. Competition is embedded in the internal market policy, cohesion policy, and interacts with financial stability. Financial services legislation and competition enforcement in that sector are complementary

2.4 The EU's competition framework feeds into legislation and consists of various tools in addition to traditional enforcement activities

A policymaker explains that experience gain through competition cases can feed into legislation. The Payment Services Directive, the Interchange Fee Regulation, and many other pieces of legislation have been built precisely on the basis of experience based on competition law. Enforcement is not simply investigating and imposing sanctions, including important fines, but there are much broader tools at the Commission's disposal. Beyond sanctioning established projects, the Commission examines projects in the making, such as Libra and Calibra or advises on projects like the EPI.

2.5 The EU's competition policy and the Central Banks, support the idea of European projects when combined with further innovation and market openness

A policymaker highlights the advocacy and advice to facilitate projects in the making. The European Payments Initiative is precisely something that the Commission has been facilitating; it supports the idea of a European project, but it is important to ensure that the governance of the project is fair, open and does not close the market for other competitors.

A Central Bank official stated that the market is still highly fragmented. Due to this characteristic it is very difficult for European players to reach the same level of profitability and economies of scale compared to the very large players Central banks want to have competition but also want to have some European players in the field.

An industry representative commented that there are currently some very strong, dominant card schemes in certain countries in Europe such as Carte bancaire and Girocard.

A Central Bank official considered that there are three major challenges. The first one is to be able to support technological innovation which brings real benefits to users, i.e. innovation that will not lead to the creation of monopolies, innovation that will not lead to an even greater fragmentation and innovation that will not increase financial exclusion.

The second challenge is to preserve European sovereignty. It is not to have a less open economy. Payment services are crucial services; they are critical for the economy and critical for society, so they cannot only be delivered by non-European providers.

The third challenge is that Europe needs to preserve the role of central bank money as a settlement asset, not only for the financial stability of the wholesale market, but also as an anchor of stability for the retail payment market.

3. Policy priorities, ambitions and possible trade-offs

3.1 Making compliance duties consistent throughout the EU is an essential area for progress

An industry representative applauded what has been built, because the Single European Payment Area (SEPA) is quite unique. SEPA has been a great platform. It needs to be built on, because it requires additional intervention in order to facilitate financial inclusion to make payments seamless, but also particularly in the area of compliance since currently there are 27 specific requirements each time enforcing EU legislation.

3.2 Ceasing digitalisation opportunities requires that regulation has consumer convenience as a starting point

An industry representative considered the open finance piece important because American Express would like to look at it from the consumer side, the small business side, and offer services and products that they really appreciate. In every market small business are really suffering. Hard work is needed to get strong customer authentication (SCA) over the line by the end of the year. The consumer and small merchants' businesses will suffer because they will not be able to transact. More data is something that small businesses would really appreciate.

3.3 The EU must improve its agility to cease all the opportunities open by technology beyond existing legacy infrastructures

An industry representative commented that being the most advanced countries and economies is not always an advantage. A more established market like North America or Europe has a legacy and an infrastructure in place and is therefore slightly behind on new technology. In Africa Western Union has made agreements with mobile operators, and it is impressive what can be done in respecting the rules and always operating within the correct environment.

3.4 Combining financial inclusion, affordable costs for customers and AML policies require further adjusted trade-offs

An industry representative stated that the payment and cross-border industry is important for financial inclusion. Some of the regulations that are needed sometimes cannot be compatible with achieving all of the same objectives. The first is financial inclusion. The second is having AML compliance rules at the maximum standard. The third is a very affordable cost for consumers. There are some trade-offs that regulators should try to understand that are not possible.

3.5 Symmetric access to data; interoperability and portability of data; competition concerns raised by network effects and potential exclusionary conducts of certain cooperation arrangements, as well as fair access to technology, are some of the main points of attention in the field of competition policy

A policymaker stated that there are four main areas of focus: access to data; interoperability and portability of data; network effects stemming from platforms; and potential exclusionary conduct.

Companies need to have the capacity to access large amounts of data, and big techs have a significant advantage. One issue which has been brought to the Commission's attention is the alleged asymmetry in access to data between banks and Fintechs/Bigtechs. This is something that should be discussed and fixed to regulation, but any response should be proportionate, precisely in order not to create other bottlenecks. It also has to be calibrated to the specific niche and the specific area and service.

Data interoperability and portability is another issue; various ecosystems need to be able to cooperate with each other. There needs to be fluidity between those ecosystems. That can relate to licensing conditions or pricing conditions of the relevant data.

Network effects can scale businesses, but network effects can also raise competition concerns. Monopolies are not bad as long as the market power is not leveraged precisely to impede the operation of other participants or the entry of other participants in the market.

Exclusionary conduct is another issue, which means stopping innovative third parties entering a market or implementing an innovative solution. The Commission is closely examining collaboration and cooperation among market participatns. As an example, cooperation between card schemes can be beneficial for consumers but should be adequately designed precisely not to exclude innovative solutions.

3.6 EU Central Banks will focus on cash, instant payment, central bank digital currency and pay particular attention to set the appropriate balance between central bank and commercial money to achieve safety and confidence, as well as competition and innovation

A Central Bank official considers that central banks can and should support innovation in the retail payment field but that cash should not be forgotten. Central banks have to be neutral; their role is to ensure that customers have access to all types of means of payment in a secured and effective way. Therefore, central banks are providers of several types of payment solutions or infrastructures. It is important to support technological innovation in a way that provides real benefits. That is why the TARGET Instant Payment Settlement Project (TIPS) has been implemented by the Eurosystem. Instant payment use-cases have still to be developed, but that will come with digitalisation. Work has also started on the potential benefits, costs and challenges of a central bank digital currency (CBDC). As cash is a central bank money offer to the general public, the question is whether central banks should continue to provide an access to central bank money for the wider public in case of a move towards a cashless society.

When providing these kinds of services or means of payments, it is important to keep an appropriate balance between the private and the public sector. For centuries, there was central bank money on one side and commercial bank money on the other, and they co-exist. When central banks are thinking about the possible creation of a central bank digital currency, the objective is not to crowd out the private sector. a CBDC should be considered as complementary to commercial bank payment solutions. Actually, central banks are not eager to provide directly central bank money to the general public as it would require overcoming all compliance issues that need to be thought through. Central banks are very conscious that it would be not be good value to duplicate this work.

4. The European payments area five years from now

A Central Bank official hopes that the EPI project will go live and that it will be well adopted by European customers, as it would mean that a number of stakeholders and other players have agreed on the way forward. CBDC could also be in the landscape.

A policymaker stated that going cashless is unavoidable. The question is whether Europe is going to move from card-based to other types of payments. More incentives need to be examined in order to have parallel competition and other types of payments.

An industry representative was of the view that there will be more competition. There will be new entrants coming into the payments market, which is a good thing, and therefore there will be better outcomes for consumers. Digital wallets will start to play a larger role as Europe sees the growth of new payment types. Instant payments will start to play a larger role. There will hopefully be more cooperation between all participants, as it will ultimately give better outcomes for all participants.

An industry representative considered that in five years' time there will be an increase in digitalisation, but cash will still be part of the economy, with around 25% or 30% of total consumer expenditure.

An industry representative commented that consumer choice should always be protected. The goal is an ecosystem with multiple touch points where people can transfer funds electronically to a bank account, mobile wallet, or cash, but in a way that is facilitated, seamless, flexible and accessible at a very low cost to different operators.

An industry representative hoped that in five years' time Europe will have more players, more innovation, and the two dominant card players will have less than a 90% market share. ■

Does the EU need to build its own payment system?

1. The evolving payment landscape

1.1 Dematerialisation, disintermediation and fragmentation

A policymaker outlined the significant pace and scale of innovation of the dynamic payment sector. The act of paying has become less visible and increasingly dematerialised and disintermediated. With digitalisation and changing consumer preferences, cashless transactions are increasing. The COVID 19 pandemic has further accelerated the shift towards digital payments.

Despite substantial improvements provided by the Single Euro Payments Area (SEPA) and the harmonisation of national payments legislation, the EU payments market remains significantly fragmented along national borders.

1.2 The influence of big tech companies

A policymaker highlighted the dominance of global payments players in European cross-border payment transactions, reinforced by the entry of big techs into the payments sector. By benefiting from significant economies of scale and network effects, as well as vast access to their consumers' data, these tech companies are challenging established providers. Moreover, with the advent of asset-backed cryptoassets, they may soon be offering disruptive payment solutions based on encryption and distributed ledger technology, which can present risks for consumer protection and financial stability if not properly regulated.

Apart from large global players, such as worldwide payment card networks and big technology companies, there is virtually no digital payment solution that can be easily used across Europe to make payments in shops and in e-commerce.

2. The European Payments Initiative (EPI)

2.1 Aims

An industry representative explained that 16 banks are currently involved in the EPI, which is aiming to promote independence and sovereignty in payments. At the moment, there are different payment habits amongst European countries, which are exacerbated by the influence of domestic schemes. The EPI is intended to bring about convergence and to create a unified method of paying throughout Europe. The European Central Bank (ECB) and the European Commission are helping the EPI thrive, and this influential support from regulators and policymakers will need to continue.

A public representative underlined the importance of addressing the fragmentary differences between local markets across the EU and of creating a global player that could challenge the incumbent companies. In that regard, the EPI is a step in the right direction.

A Central Bank official stated that a pan-European solution should be usable in various payment situations and via various initial channels, such as cards, smartphones, and so on. It should also have a pan European reach and European governance.

2.2 Status

A Central Bank official stated that, with the press release in early July the EPI reached an important first milestone, but there is still a long way to go. There are still questions about whether the initiative will succeed in developing a viable business case based on a solution that is suitable for card-based as well as smartphone-based payments, and whether it will achieve a real pan-European reach.

In terms of common payment routes the use of instant payments, which are already built on the pan European SEPA routes, are recommended. With the addition of a mandatory connection to the TARGET Instant Payment Settlement (TIPS), the European Payments Council (EPC) in cooperation with the euro system, closed the last gap has been closed in the pan-European reach by 2021.

2.3 Membership

An industry representative and a Central Bank official stressed that, while the EPI is a private bank-led initiative, it is certainly not a closed and exclusive club. They hoped that more organisations from different countries will join it, especially smaller banks, non-bank acquirers and payment service providers (PSPs). At the same time, it is important to ensure that no weak links are onboarded into the process that would compromise the robustness of the EPI.

2.4. Centralised versus domestic aspects

An industry representative stressed that the EPI is currently construed as one central entity but that the processing will not be centralised. The EPI will not act against the local processors.

Another industry representative stressed the need to find a smart solution and a combination between national processing items and the centralised aspect. It is clear that national systems need to be migrated to a common European system. This is a question about the infrastructure and its migration into something bigger; it is not only about cooperation. The easiest way to convince all the customers and the banks to migrate and to cooperate with other players in Europe is to base it on standards and common infrastructure methods in a centralised space, which also needs to be invested in collectively. Centralised investment, combined with the infrastructure and standards coming together from a national starting point, will allow for the migration to a centralised solution. This will help Europe develop world-class players.

An industry representative warned that market participants and banks in each country will need to accept the consequences on their domestic schemes that the EPI will bring. The EPI is not about the interoperability of domestic schemes but rather it is a pan-European scheme. Resources and talent currently applied to domestic schemes will need to be redeployed to ensure that the EPI becomes a reality in each country.

3. Competition

3.1 The need for a level playing field

A public representative stressed that payment systems are evolving very quickly. Digitalisation is completely changing the experience for retail investors and the EU should be proud to act as a pioneer of open finance with the Second Payment Services Directive (PSD2). However, these welcome innovations should not be at the expense of the protection granted across Europe. In its recent capital markets union (CMU) report, the European Parliament underlined that a level playing field between traditional and innovative players is crucial to protect European sovereignty and European citizens. Similarly, Europe needs to build its own international payments system. Dependency on non-European actors is detrimental to the independence of European foreign policy decisions and Europe's strategic autonomy.

3.2 The importance of consistency and cooperation

An industry representative stated that his organisation's strong national position would not be enough to secure its future and it would need instead to become a pan-European player. More cooperation with all the other banks in Europe is therefore required. The EPI aims to achieve this, but it needs help. A fair playing field is essential to compete against the oligopoly of the big techs and the international card system (ICS). These players have greater access to customers within closed ecosystems and they are able to generate a great deal of money that can be invested into marketing and product development.

The banks by themselves do not have the same opportunity to make the investments necessary to develop pan-European players. Help is therefore needed in terms of a fair playing field. The situation is even more challenging because of the interchange regulation, which has resulted in all the players in the value chain increasing their profits with the exception of the banks. Those that have increased their profits have done so to a significant degree and are accumulating more power and are creating a stronger oligopoly situation while the banks are losing their profits. The banks want to invest in the EPI but they need help in the form of legislation to do so.

A Central Bank official called for pan-European solutions for retail payments. A healthy amount of competition in the market is beneficial for the customer, and the initiatives in question should apply a holistic approach.

An industry representative stated that the EPI is still at the beginning of its journey. A level playing field versus the ICS is required to ensure that the initiative can come to fruition with no barriers to entry for newcomers.

Consistency is required in terms of industrial policy. There has been a great deal of noise about central bank digital currencies, which could compete as an alternative to the EPI. Fortunately, a number of central banks have said that they would not apply this to retail.

3.3 The concern over additional regulation

An industry representative stated that the announcement from the Directorate-General for Competition regarding the interchange will help finance the investments that are required to make the EPI happen. There is still some concern, however, over the regulatory 'creativity' that is still possible. Banks are currently having to cope with the impact of PSD2 in terms of customer identification and so on, and they do not wish to spend more money and energy in coping with a potential PSD3 or other 'creative' ideas.

3.4 The impact of tech companies

An industry representative stressed that banks are dependent on mobile devices from international companies in accessing their customers because these devices are now essentially 'remote controls' for the lives of the customers. These big tech companies may allow large banks with strong market shares to provide services through their devices, but this is not necessarily the case with the smaller banks. It is important to ensure that these mobile devices are open to everybody.

The big technology companies are also using artificial intelligence, machine learning and data collection in order to deliver better customer experiences and to create better business models. Financial institutions have to knock on their door to ask whether they are allowed access to that knowledge. This makes it very difficult for the banks to build better business models and to generate profits. The only solution to this is cooperation between European banks on standards in order to attain scale at the European level, alongside legislative support.

4. The Commission's priorities regarding the EU retail payment strategy

A policymaker stated that the Commission will unveil its retail payment strategy together with the digital finance strategy. As the retail payment sector is at the forefront of innovation in finance, the Commission believes that it requires specific and targeted policy measures that go beyond the horizontal scope of the digital finance strategy. The Commission's aim is to create an innovative, integrated and more competitive retail payment sector in Europe. It is hoped that, in due course, there will be homegrown European payment solutions that can be used globally. The capacity to drive cutting-edge innovation, with European solutions able to compete with global players, will determine Europe's autonomy. European sovereignty is a major strategic objective for the Commission, and payments have a major role to play in this respect.

Instant payments are an important area of the strategy in order to support the emergence of pan-European solutions. The Commission is teaming up with the ECB in their role as payment system operator and catalyst. Currently, even the strongest European operators have to work with large non-European operators if they want to offer pan-European payments. The Commission is determined to change this and intends to do so by leveraging the opportunities offered, in particular, by instant payment systems.

Beyond cross-border instant payment solutions, the Commission also wants a vibrant payment services market where fintechs, such as those providing payment initiation or account information services, can thrive. All efforts are being put towards ensuring that PSD2 produces its full effects, in particular with respect to open banking.

The Commission also plans to address important restrictions on the access and use of certain technologies enabling contactless payment, such as near-field communication, which can undermine the development of the retail payments market and jeopardise the level playing field between banks and big techs.

Ultimately, it is hoped that this strategy will provide an opportunity to boost the international use of the euro and contribute to the global efforts to improve cross-border payments.

5. The role of legislation and regulation

A public representative stated, with reference to the Wirecard scandal, that European leaders in the field of payments will not be developed if trust is not rebuilt in the capacity of EU supervisors to spot clear breaches of law. Consideration needs to be given to the supervision of all areas related to payments, financial reporting, financial innovation, audit, anti-money laundering and countering terrorism financing.

A policymaker stated that the Commission believes that the Wirecard affair needs to be looked at closely. Building on the inquiry initiated by the European Securities and Markets Authority (ESMA), the Commission plans to take a stance on the issue in the CMU action plan. The scandal raises a number of complex corporate governance, audit and supervisory issues that need to be properly addressed.

A public representative stressed the importance of aligning the regulatory approach on payments with the broader picture in Europe, including the Digital Services Act and the ongoing debate on reforming competition policy.

There have been discussions with the Committee on Economic and Monetary Affairs (ECON) on the best approach to move towards more European integration while respecting nuances across Europe. A balanced view on this sensitive topic will be provided in the final own-initiative report on the CMU.

On one hand, cooperation between national authorities and European authorities is crucial, particularly with payments where several authorities are involved in every country. On the other hand, Wirecard shows that national regulators tend to protect their national champions. Reform of the governance of the European supervisory authorities (ESAs) is therefore needed, particularly by way of independent voices on the boards of the ESAs. It is hoped that Wirecard will be the 'last wakeup call' on this issue. In order to develop global leaders, true European supervision is required, which means that national sensitivities need to be put aside.

A Central Bank official explained that the current direction of travel is towards what is required for pan European projects like the EPI. There are many good proposals on the table but what is needed now is political action.

6. The role of central banks

A Central Bank official stressed that central bankers recognise the importance of the EPI project as it feeds into the promotion of European champions that are able to compete with global legacy and emerging actors. That does not mean that central banks have no role to play, however. The payment system has been built on a set of important principles. One of those principles is the coexistence of settlement assets with, on the one hand, private settlement assets dominated by commercial bank money and, on the other hand, central bank money. Central bank money plays a vital and anchoring role in ensuring the stability of the payment system. Central bankers therefore acknowledge the importance of understanding the dynamic and the technological evolution.

This is the rationale for the review of the conditions and the challenges of the introduction of a retail central bank digital currency. The review is currently underway by a number of central bankers across the world, looking into the ways to provide central bank money in the retail field.

Fragmentation, sovereignty and stability are the most significant challenges currently being faced. Addressing those challenges requires adapting the legal framework to disruptive technologies and actors with the triple objective of covering all legal and financial risks, sharing a level playing field with legacy actors and maintaining good financing conditions.

Europe does not host global social networks, which means that European authorities will need to develop a coherent and comprehensive European payment strategy in order to create a stronger, more independent and more innovative financial sector and payment system. ■

ESG AND SUSTAINABLE FINANCE

Have the prospects of global and EU ESG policies changed with the COVID crisis?

1. Facing the challenges of COVID 19 and sustainability

1.1 The need to react

A public representative stated that Europe has to react to save its economy after the COVID crisis and it will probably also need to react in the future, because of the 'long tail' of impact from the crisis.

1.2 The reaction will either further increase the risks or improve both the economic and sustainability situations

A public representative described how €1 trillion is being pumped into Europe's economy for the COVID 19 recovery. If this money is used to support 'walking dead' industries in the fossil economy, Europe will end up with financial debt, environmental debt and out dated and uncompetitive industries. However, if Europe adheres strictly to its principle of 'do no significant harm' by committing to investment in green deal aligned economies, there will be a huge impact on Europe's economies and their ability to develop through the creation of new industries and increased innovation and digitalisation.

An industry speaker agreed. There is alignment between current thinking about COVID 19 and sustainable finance. There is a $10 trillion opportunity for the private sector to invest in sustainable finance. There will be a huge opportunity until 2030 for companies to invest, create jobs and create growth.

1.3 The economic response to the COVID 19 downturn and the green transition are complementary

A public representative observed that there is political division about economic policy following the crisis. In a finely balanced situation, a slight nudge can make a difference. The public representative emphasised that the COVID 19 response and the green transition are entirely complementary.

A policymaker described how the Commission views the crisis as an opportunity to accelerate the green transition. There are tremendous opportunities for investing in more sustainable economic activities, given the yearly investment gap of €470 billion on climate and environmental goals.

A regulator reiterated the importance of enabling a recovery that also supports the sustainability agenda, highlighting the fact that investors are also clearly viewing the recovery in this way.

1.4 The financial sphere is necessary to leverage the €750 billion Next Generation EU package

A public representative expressed their belief that, given the importance of the financial markets to the real economy, the financial community needs more than a small nudge to make it move in the right direction.

An industry speaker suggested that there will be no medium or long term trade offs between the recovery from the COVID crisis and the green transition. The industry speaker's firm has seen a record inflow into ESG aligned ETFs. One of this firm's products saw record inflow in March, which was the beginning or peak of the COVID crisis in many countries. Furthermore, a recent survey of high-net-worth individuals indicated that a majority of investors are focused on investing in sustainable finance.

A policy maker stated that the private sector must play an important role in Europe's transition to a more sustainable economy, but the public sector can play an important role as a catalyst. The €750 billion Next Generation EU package will not be sufficient. With its sustainable finance action plan, the Commission has tried to incentivise and facilitate the participation of the private sector. The appetite is there, and investors' expectations are moving in this direction. It is now for European policy makers to create a regulatory framework in which sustainable finance will be facilitated and incentivised.

1.5 Key success factors

1.5.1 A generalised use of the EU Sustainable Finance Taxonomy

A public representative stated that the taxonomy must be used for both private finance and public funding. If there are different metering systems, it will be impossible to define 'green' and 'harmful'.

An industry representative stressed the importance of designing the EU recovery fund with both the taxonomy and the sustainable finance principles in mind. Otherwise, there will not be a level playing field between the private and public sectors when investing in corporates. This would result in weakened resilience in the economies that Europe is attempting to strengthen. Achieving a robust economy will only be possible if all investor stakeholders apply the same sustainable finance principles.

Noting that the EIB was active in the working groups which defined the EU taxonomy, an IFI representative supported the remarks made by the industry representative on the importance of public sector institutions also applying these standards.

A public representative emphasised that politicians must be lobbied on the fact that taxonomy alignment is in the interest of public finances, which has not been made sufficiently clear.

1.5.2 The importance of a broader sustainability agenda

An industry speaker reminded participants of the importance of the broader sustainability agenda and the UN's Sustainable Development Goals within any green recovery, while also focusing on growth, jobs and issues such as gender and diversity. One of the most powerful aspects of the discussions on ESG issues is the idea of incorporating these issues into the taxonomy and its future strategy.

1.5.3 It is essential to consider the different situations in different countries

An industry speaker highlighted the importance of considering the different positions of different countries. As the world determines how to transition to a low carbon economy, it is important to acknowledge that there are different situations in, for example, Belgium and Bangladesh.

2. Corporates with robust governance and sustainability frameworks are better positioned to generate long term shareholder value

An IFI representative noted that companies with robust ESG frameworks have outperformed their benchmarks in recent years and queried whether this is a result of improved performance in such companies or whether it merely reflects current investor preferences.

2.1 Improving shareholder value through better management of emerging risk

Another industry representative explained how their firm considers the question of ESG factors in terms of shareholder value. The companies with robust governance and sustainability frameworks are better positioned to manage risk in their business, which enables them to generate long term shareholder value.

An industry representative agreed, citing the fact that corporates with strong scores on E, S and G metrics have suffered fewer financial losses in the COVID crisis and hence have outperformed. The industry representative's firm is now seeking a link between performance on its proprietary ESG metric and financial performance. It is also becoming increasingly apparent that the individual E, S and G factors are interlinked.

2.2 A focus on "value and risk" avoids an emotive discussion of "values"

An industry representative observed that the conversations their business has with its clients are less about values and more about value. When the discussion of ESG performance centres on values it can become emotive, and there can be disagreements about the composition of these values, but everybody can focus on the importance of generating shareholder value.

2.3 The COVID 19 crisis has further increased the importance of ESG for shareholder value

An industry representative described how ESG factors have gained importance during the COVID crisis as a result of increased thinking about labour force practices, access to supply chains or simply something such as dealing with a crisis situation. The industry representative explained how ESG factors contribute to investment analysis and research. Traditionally, research into a company centres on the analysis of financial statements and considerations of industry trends, growth strategies and competitive advantages; increasingly, however, ESG factors are also important. Understanding the factors relevant to different industries is becoming increasingly important for investment research.

Another industry representative stressed how much the COVID crisis has accelerated the focus on ESG. There is a need for corporates, economies and governments to embed ESG criteria in their investment process and there is increased investor awareness of the correlation between ESG factors and financial performance.

2.4 Anticipating and communicating ESG impact requires a distillation of the relevant data into a limited number of key performance indicators

An industry representative emphasised the importance of the role played by data, the amount of data, and how it can be crystallised into a usable form for clients, investors and investee companies. The industry representative's company has developed a proprietary tool to do ESG analysis, the purpose of which is to collate the most relevant information on individual companies. This information is then utilised in discussions with companies and clients. Another industry representative highlighted their own firm's proprietary ESG rating tool, which is used to assess investee companies on ESG KPIs.

3. EU initiatives supporting green finance

An IFI representative turned the discussion towards the EU, querying the EU's principal achievements in supporting green finance work streams and asking how Europe can ensure adequate levels of investment in climate action and environmental sustainability.

A policy maker noted that the European Commission's 2018 sustainable finance action plan rests on two key pillars: the EU Sustainable Finance Taxonomy and the disclosure regulation.

3.1 Pillar 1: the EU Sustainable Finance Taxonomy

Noting that the taxonomy regulation was adopted in June 2020, a policy maker stated that the Commission is now preparing the implementing rules to make the taxonomy fully operational. The Commission is working internationally, because the taxonomy must not remain solely an EU instrument.

A regulator agreed on the need for standards to be internationally aligned. Wherever possible, Europe should try to work with the international community to come to a common agreement. The standards should also be consistent across the financial sector and the entire investment chain.

The policy maker noted that this international work started in autumn. The Commission engaged with a limited number of companies as part of a platform on this issue. The policy maker agreed on the importance of applying the taxonomy broadly, including in the private sector.

An industry representative praised the policy development undertaken by the European Commission and other bodies, noting how extremely helpful this is for both the supply and demand sides of the economy. The taxonomy is a step in the right direction, because the demand side can further develop the definition of ESG factors. On the supply side, the taxonomy will guide asset managers when they offer fund products and effectively streamline the criteria which the public sector wants industry to focus on.

3.2 Pillar 2: the disclosure regulation

A policy maker outlined how, through the disclosure regulation, the Commission is seeking to promote investments in a more sustainable economy. The disclosure regulation covers all the environmental, social and governance aspects of sustainability. Additionally, work is continuing on a review of the Non Financial Reporting Directive. As a result of the crisis, the openness of member states to pursue an ambitious project here has increased.

An industry speaker reiterated the importance of data. There has been much focus on data disclosures within the financial sector. It is important to move this into the real economy now to enable financial actors to take decisions based on that data.

3.3 The global dimension is essential

An industry speaker praised the leadership shown by the European authorities in developing the taxonomy. This shared set of standards will drive future growth in sustainable finance. The COVID crisis, climate change and capital markets are all global, so it is important for the world to drive forward this agenda.

The industry speaker underlined the fact that capital markets are global, just like the challenges around COVID and climate change. This means it is important to adopt a single set of standards across the industry. Ultimately, the goal of the work on sustainable finance is to create green and more sustainable growth across the globe. Europe is not an island: climate change will happen as a result of global emissions, and 90% of the world's emissions happen outside the European Union.

3.4 The sequencing of actions is very important

An industry representative highlighted the importance of the sequencing of action on climate risk. Europe must ensure its ambitious programme is delivered. There are worrying elements in the level two proposals on disclosure, particularly around an overly granular or one size fits all approach for entity level reporting on adverse impacts.

3.5 Improving green bond markets can introduce flexibility without 'greenwashing'

3.5.1 Green bond issuance is down

Another industry speaker highlighted the importance of green bonds. The issuance of green bonds fell significantly during 2020, while issuers and investors are increasingly interested in other types of ESG bonds such as social and sustainability linked bonds, the issuance of which appears to be growing. The industry speaker's firm ascribes these trends to the fact that these bonds offer issuers greater flexibility on the use of proceeds, which means they can issue larger sizes. However, it is important to avoid 'greenwashing'.

3.5.2 It is necessary to find a better balance between flexibility and sustainability

The industry speaker reiterated that the challenge is to find flexibility without undermining the objectives of the regime. For example, some bonds allow a degree of flexibility in how issuers may use the funds raised. To minimise risks of green washing, these bonds have overall sustainability targets issuers need to meet. In the instance issuers do not meet the targets, they must compensate the investors. This creates a financial incentive to meet broader sustainability targets without imposing restrictions on proceeds. To solve this problem, the industry speaker suggested that, as mentioned in work by the Commission, bond verifiers could confirm that the activity being financed will broadly contribute to environmental sustainability.

An IFI representative noted that the German government recently issued green bonds with great success, which is a major step in the development of the green bond market.

4. Improving the comprehension of climate, environment and public health risks, requires improved disclosures at the entity level and product level, underpinned by a consistent framework

A regulator opined that investors should be enabled to judge things for themselves. To do this, there must be an underlying basis of disclosure supporting the financial sector. In this regard, the ESAs have been empowered to provide technical standards to define the presentation and content of taxonomy related disclosures by market participants. The ESAs are also developing technical standards for the disclosure regulation. At its core, disclosure can happen at the entity level or the product level and it can involve pre contractual disclosure and public disclosure around a relevant product. There is a consultation out at the moment on both the taxonomy regulation and the disclosure regulation. The aim is to deliver the relevant technical standards in the coming months, taking into account the feedback from this consultation.

The regulator considered the Non Financial Reporting Directive another crucial pillar. Europe must ensure there is better ESG disclosure, and that any ESG disclosure is consistent. This comes back to the issue of data and the availability of information. The regulator highlighted the fact that several of the panellists from the industry spoke about their firms' proprietary ESG metrics. It is vital to develop a common method of considering these factors and to connect non financial and financial reporting.

An industry speaker praised the development of a comprehensive ESG framework. The financial industry is seeking a clear and consistent disclosure regime in all sectors and across the entire investment chain, which will foster greater transparency.

A public representative reiterated the importance of data. Europe must create an 'ESG IFRS', potentially using the IFRS framework. At the European level, there should be a single entry-point for data and integrated reporting.

5. Consumers should be empowered rather than having restrictions imposed on their investment decisions

An industry representative stated that clients are indeed interested in ESG. Clients are a key stakeholder in the development of ESG. The industry's customers should be at the heart of any action on ESG. Consumers must have confidence in what is happening. Disclosure will contribute significantly to this. Consumers should be empowered instead of having restrictions imposed on their investment decisions. Aligned to this idea, the industry representative suggested that a principle based approach would enable the further expansion of ESG. Collaboration on this topic is not finished, however, and it will not be finished for some time.

A public representative agreed that there should be leeway for investors to choose how they combine, for example, a biodiversity target with a different social target. Currently, there is no acceptable answer for this issue. ■

Will tackling climate risk still be a major priority post COVID 19 crisis?

1. The COVID 19 crisis opens a window of opportunity to leverage a win win policy paradigm by combining the relaunch of the EU economies while aligning them with the Paris Agreement and broader sustainability objectives

A Central Bank official suggested that the COVID crisis provides an opportunity for governments, financial institutions and regulators to create a paradigm shift and harmonise two different goals: re establishing global economies and aligning them with the goals of the Paris Agreement. The Central Bank official commended the European authorities for their ambitious strategy to align Europe's economies with the goals of the Paris Agreement. Europe is making this journey together, and it is something that governments, financial institutions and regulators must achieve in close harmony.

An industry speaker considered that action beyond financial assistance will be required to create a recovery consistent with the Paris Agreement. This might be a clear roadmap for the phasing out of fossil fuel subsidies or the introduction of a requirement on price externalities. In any event, it will be vital to establish a roadmap with a clear timeline and an explicit scope. This will help maintain the balance between incentivising businesses to transform and/or be resilient while not tipping the 'economic cart' over the edge. The COVID crisis demonstrated that numerous real economy businesses have vulnerabilities, which underlines the importance of not exacerbating their position.

2. The COVID crisis demonstrates how sustainability challenges are real and interlinked; creating better assessments of those risks is a policy priority

A Central Bank official noted that the COVID crisis has been a stress test of societies' preparedness for unpleasant but nevertheless foreseeable events. The world should not consider finance, health and environment as different silos but tackle these problems as one.

A Central Bank official explained some of De Nederlandsche Bank's work on shaping policy around the risks stemming from climate change and the broader area of sustainability risk. Tackling climate change will be a major priority after the COVID crisis. The threat of climate change is imminent; it is the same. The COVID crisis is a real life example of how exogenous shocks can impact the financial system.

An industry speaker stressed that the world cannot afford to deprioritise climate risk post COVID. If anything, COVID 19 is a lesson about the dangers of what can happen if the world fails to act on the warnings it is given. The industry speaker described how green investments comprised 16% of national stimulus programmes following the previous financial crisis. In today's crisis, this would be €550 billion. The European Commission estimates the gap in sustainable investment to be around €250 billion per year until 2030, which suggests a need to increase the green component in these stimulus measures.

A Central Bank official highlighted a recently published book called The Green Swan . Taking the analogy of the 'Black Swan', the book demonstrates that the consequences of climate events could be even worse and less predictable than a 'black swan' event. The world knows that the climate crisis will probably happen, but there are also solutions to be found and there is a degree of positive impetus.

An industry representative noted that climate change is a top priority for their firm and described how, in advance of the COVID crisis, research by the World Health Organization discovered that climate change could contribute to an increase in the severity and frequency of pandemics. The industry representative described how European policymakers were busily working on the sustainable finance agenda before the COVID crisis. The taxonomy published in March provides guidance on exactly which economic activities policymakers are considering green, transitional or enabling. The industry representative explained that climate change is already at the top of their firm's agenda, but this is mostly driven by clients rather than policymakers. Increasingly, institutional clients ask the industry representative's firm to integrate these factors into the distribution process. The industry representative added that their firm has developed a proprietary ESG rating system which scores investee companies on E, S and G factors.

A Central Bank official recommended the report Indebted to Nature published by De Nederlandsche Bank, noting that the report applies current thinking on climate change to other types of sustainability risk. De Nederlandsche Bank took the ideas of physical risk, transition risk and reputational risk from climate risk and discovered that they applied equally to the loss of biodiversity. Currently, De Nederlandsche Bank is working on how to apply this knowledge to supervisory frameworks.

A Central Bank official noted that agriculture could be massively impacted by the loss of biodiversity. The intensive consumption of meat and other agricultural products can damage habitats, but the agriculture industry might also be the first industry to be affected by this damage.

An industry speaker emphasised the need to consider the broader landscape of sustainability risks, because these risks are interconnected. It is important not to solve one risk and exacerbate another as a consequence, so the industry must consider the landscape holistically.

A regulator agreed on the importance of broadening the topic beyond climate risk. This process began with the EU's green taxonomy. The financial industry must work on a single methodology and try to broaden it slowly but steadily into other sectors. The regulator highlighted the global nature of climate risk. The speeds at which these sensitivities have been transported across the world have been very different.

3. Financial institutions confronting sustainability challenges face both credit and reputational risk

An industry speaker described how banks often state that they must address productivity and other issues before addressing climate risk. Overall, banks consider climate risk a priority, but they do not seem to want to do it immediately in full scope.

An industry speaker considered the three key risks of the COVID crisis for banks to be credit risk, cost management and consolidation. The crisis is not yet over, and the peak of additional loan losses is forecast to occur in the third or fourth quarter of 2020, or in the first or second quarter 2021 for SMEs. The industry speaker suggested that tackling climate change could help banks from a reputational point of view, however. One of the opportunities created by COVID 19 is the chance for banks to improve their reputations. For banks, being green could be beneficial. Clients are increasingly interested in banks' green credentials. Most banks do not consider climate risk as their highest priority, however, because they are focused on surviving the crisis. A Central Bank official noted that tackling climate risk is also about survival.

4. The financial sector must produce qualitative and quantitative harmonised data on climate change and develop forward looking and future proof risk frameworks

A Central Bank official observed that there is an emerging need for qualitative and quantitative data on climate change. Real economy companies should abide by TCFD standards. Financial institutions must disclose their data, and there should also be access to non financial information. In general, Europe needs more comparable and harmonised data. The Central Bank official stressed that the world does not need a plethora of different initiatives operated by global and local institutions; the world needs a harmonised set of comparable data so that forward looking and future proof risk frameworks can be developed.

An industry speaker described how their firm has received many requests for advice on sustainable finance in the past few weeks. It is easy to say that data is important, but acquiring it is a different question. The industry speaker compared the situation to mortgage loans. A lender can request information from their customer on energy consumption, but the lender cannot force the consumer to provide it. In practice, the problem is about data quality. The industry speaker noted the importance of ensuring that banks use relevant KPIs when providing loans. Banks must include all the main risks in their risk management frameworks. The industry speaker described how their firm uses a proprietary tool to value assets on the basis of climate impact.

A regulator stressed that the challenge here is broader than climate; it is about ESG overall. There are problems, but these are not reasons to stop tackling the crisis. There are data problems, but climate change is a bigger problem. Data is simply an instrument, and it would be incorrect to think that the problem does not exist simply because the instrument to measure it does not exist.

An industry speaker explained how banks are also establishing ESG committees to define their own ESG criteria according to their own perspective, because there is no common view on ESG. Banks who have established an ESG committee also using it as "second vote". The EU has developed the taxonomy, but it is difficult to understand and will take time to finalise. The industry speaker suggested that the good work being done by supervisors, regulators and politicians is somewhat like building a wonderful car and then asking banks and other market participants to drive it when there is no engine. The engine is the data.

An industry speaker praised the ECB's recently published guide on climate change and environmental risk, which focuses on business strategies, risk management, governance and disclosure. However, the document is only for banks in the eurozone; there are other banks in other parts of the European Union. Additionally, the world is not on a level playing field here. These policies are right for Europe and the world in general, but in other regions not very much is actually happening. Other countries' financial industries say they will take action, but there is no political or regulatory pressure to do so.

A Central Bank official described how the NGFS has founding members from the global south such as Morocco and Mexico, along with China, and suggested that there is some movement here. Europe can develop benchmarks and tools that other countries and regions can use. Europe should never forget that many of the countries impacted by climate change are beyond its borders.

5. Policy priorities: improving the taxonomy, managing the contribution of rating agencies, designing forward looking risk assessment tools and reshaping climate risk management

A regulator considered it essential to improve the taxonomy going forward. The EBA will issue a consultation paper at the end of the year, in which it will provide more detailed taxonomies for assessing risks and suggestions for how to measure these risks. These assessments must be built into banks' risk monitoring and implemented into adequate risk measurement models. These models will be difficult to create, and they will be necessarily imprecise and heterogeneous across the industry. However, the industry must experiment. Only experimentation, further work and a strong institutional culture will produce progress. The industry will have to change how it measures and assesses these risks. This assessment will not be based on historical information, because there is no historical information. The industry will have to produce markers, perform scenario analysis and possibly utilise counterfactual analysis.

An industry representative noted that there is an academic debate over whether ESG issues are a return factor or a risk factor, but their firm considers ESG in terms of what is possible to predict. When measuring ESG, it is important to consider what a company is doing in the future, what their rating is, and whether the overall ESG rating covers each of E, S and G. The 'G' is simple to measure, but the 'E' and 'S' are more complicated. This type of assessment will be more successful than trying to prove that sustainable companies are a better investment over time. The industry representative disagreed with his fellow panellists, suggesting that the numerical proof of this is not yet '100% there'. However, during the COVID crisis, companies with high ESG exposures performed better than companies with lower ones.

An industry representative highlighted the importance of data. There should be a sustainability report which defines data standards. Market participants are already doing this in different ways. It is often possible to find proxy measures for many metrics. The industry representative suggested that it is better to develop a standard using reliable historic data than to predict the future. The industry representative concluded his remarks with a note of caution: the rating agencies are an oligopoly, and there is considerable room to improve the scores they currently publish.

An industry speaker emphasised that it is essential for the financial industry to make forward looking projections rather than relying on historical data. Where possible, these results must flow into policymaking. These data points will be extremely relevant in areas like building resilience.

6. Europe should not wait for the world to catch up

An industry representative highlighted the importance of global acceptance, noting that Europe should not wait for the rest of the world to catch up. If Europe waits for the rest of the world, it will achieve nothing. The industry representative noted that the European UCITS product is one of the best products available around the world and suggested that the European financial industry should be ambitious and set a similarly high standard for ESG products.

A Central Bank official considered the global nature of climate risk highly significant. If Europe wants to maintain free trade, open markets and the movement of capital, it must also protect openness.

7. Ongoing work in the EU: developing a climate related vulnerability assessment and mitigation tools for banks

A regulator described the EBA's active engagement with a subset of volunteer banks to test their climate vulnerabilities. This is a way for the EBA to understand how banks are thinking about climate risk, how they are measuring it and what horizons they have in their operational timeframes. There was a positive response in terms of volunteer banks. Although the EBA expected the COVID would cause a number of these banks to withdraw, in fact they continue to be very engaged. The regulator outlined the EBA's priorities: to ensure climate risk is embedded in the culture of banks and to enhance risk measurement and disclosure within banks. The EBA will produce guidelines on pillar 3 disclosure for banks in terms of climate risk. This will entail broader guidance rather than being excessively prescriptive on the issues that banks should disclose. Additionally, as better risk management develops, the EBA will be able to consider prudential requirements or prudential measures.

8. Redirecting capital flows to sustainable investments requires further client engagement

A regulator outlined the aim of the sustainable finance agenda of the European Commission: to ensure the adequate refinancing of capital and the redirection of capital flows towards sustainable investments. This will ensure the industry manages the financial risk of the green transition properly and fosters transparency around disclosure on the industry's progress. The financial industry must enhance its disclosure.

An industry representative described how their firm has realised that corporates with strong ESG scores have suffered fewer financial losses in the COVID crisis, which means they have outperformed. There is increasingly more evidence of the correlation between ESG factors and financial performance. The industry representative's firm gathers data on the ESG KPIs of corporates on a forward looking basis. The industry representative emphasised that climate change will be even more important after COVID. It is important to increase more investor awareness about climate issues. Only when investors have a greater understanding of the importance of these criteria can they make fully informed investment decisions.

An industry representative highlighted the fact that for the UK public authorities it is now standard to have carbon emission scores for portfolios, suggesting that the use of these standards is working well.

An industry speaker reiterated the important role of data and queried how the industry could access the data it requires. The industry needs a clear dataset on climate risk, but it currently does not have one. Financial market participants believe that the disclosure regulation which comes into force in March 2021 is not workable at this point of time because there is no data, though these data points should be held within banks. The industry speaker stressed that the banks would need time to solve this issue.

An industry speaker described how one positive effect of the COVID crisis is that almost all banks have learned about the strengths and weaknesses of their business models. Some of the weaknesses in the sector concern the composition of portfolios. The industries most impacted by COVID 19 are passenger transportation, hospitality, entertainment and media, and non food retail businesses, many of which are not as green as was generally suspected. From a practical standpoint, next steps are that banks classify their customers into clients affected by climate change and clients responsible for climate change. Depending on the classification banks' risk management analyse risk margins and the composition of their portfolios. Banks must then consider whether to remove some of these clients because they are too risky. The industry speaker opined that banks should discuss sustainability and climate risks with them and seek to persuade clients to improve their energy mix, as one example. The industry speaker suggested that banks could even impose performance targets on clients and then remove them as clients if they do not adhere to these.

An industry representative stressed the importance of understanding the appropriate combination of actions needed from NGOs, financial regulators and supervisors. Establishing government guidelines and sharing best practice within forums like Eurofi contributes greatly to accelerating the financial sector's actions to tackle climate change. However, it is also critically important for financial institutions to engage with their clients and share perspectives on climate risk. The industry representative described how their firm shared a report with its clients on the recent Climate Financial Risk Forum guidelines on disclosures, risk management and stress testing.

An industry representative suggested that the COVID crisis had produced a greater awareness of the emerging risks on top of climate change and COVID. The industry representative is relaxed about the prospect of finding adequate ways to measure emerging risks from a risk management perspective. However, financial institutions must engage on risk management. It would be easy for lenders to unilaterally declare that they will not support a particular sector or country, but this could lead to 'sudden death' for these sectors or countries, which is not ultimately productive. The industry representative considered engagement with clients preferable to simple divestment, given an appropriate transition framework. This framework will require consensus among financial institutions and non financial institutions in both the private and public sectors. The industry should engage with all stakeholders and develop a consensus around a timeframe, the issues to be addressed and the initiatives to be taken forward, that reflect the particular situation of each country and region.

A Central Bank official queried whether this idea of consensus might delay progress on tackling climate risk.

The industry representative clarified that the financial industry should not postpone tackling climate risk. As a lender, the industry representative's firm requires some form of industry consensus in order to make progress on this issue.

An industry representative emphasised that the opportunity to take action on climate risk is now. Europe will need to rebuild after this economic crisis. It is essential to rebuild in a better, greener and more resilient way. Europe is also at a historic turning point. As of 1 January, the EU27 can speed up integration and therefore implement a recovery plan and a green deal more quickly. Finally, it is essential for the asset management industry to collaborate with the public sector on investment opportunities through, for example, the EIB FC projects, which are now also applying sustainable finance principles. ■

Sustainability disclosures: progress made and possible new challenges

1. Sustainability disclosures are essential for improving investment risks and impact assessments, triggering behavioural change in financial markets, participants and investors, and further involving citizens and retail investors in the transition

A policy maker outlined how correct disclosures of non financial information are critical for the EU's sustainable finance strategy, as financial market participants and investors need comparable and reliable non financial information to understand the risks of their investments. This is a key pillar of the European green strategy. The Commission aims to create, via disclosures, more incentives for a real behavioural change in financial markets to accelerate the transition towards more sustainable investments. In addition, this policy offers an opportunity to involve more ordinary people and retail investors in that transition.

The EU has already adopted a common taxonomy that defines sustainable economic activity, so that market participants can better focus their investment strategies. The Commission is going further with a legislative proposal to revise the non financial reporting directive (NFRD) to improve the availability, quality and reliability of sustainability disclosures by investee companies.

2. Policy challenges regarding sustainability disclosures

This panel took stock of the Commission's policy, its achievements, what is working and what remains to be done. The discussion started with the benefits of sustainability disclosures and whether they are on the right track. But even if all agreed that future policy is promising, there would still be some policy and regulatory challenges to be addressed for the transition to be successful.

A regulator congratulated the EU on its approach. When the transparency regulatory proposals were launched, this regulator was initially sceptical, as usually a taxonomy is the starting point to constructing a regulatory framework. Doing it the other way round worked this time, as now both are available at once, allowing disclosure requirements to commence. The second big task is to make greenwashing less possible. This mandates a harmonised and reliable approach towards sustainability.

An official described how corporate non financial reporting could be seen as an opportunity rather than a challenge. Without corporate reporting, investors cannot be provided with reliable information in order to pave the way for the ESG transition. But these requirements can also be a challenge, so any approach to building European reporting must be pragmatic, harmonised and reliable. The official recognised that there is an emergency here, and it is essential to improve the resilience of both financial institutions and investments to master the financial risk induced by climate change and ESG factors. As a consequence, financial institutions should appropriate these risks in their strategy and their risk management. Legislation will help in that matter.

An industry representative pointed out that disclosure requirements had been voluntary for decades but, in recent years, there has been an increasing demand, both from clients and public institutions, for more granular, consistent and comprehensive data on ESG factors. Another industry representative agreed on the need for more reliable information, welcoming the European Commission's initiatives in that regard, and voicing their support for a pragmatic approach. In the official's view, there is an opportunity for reporting to cover the whole value-chain and hence incorporate suppliers' ESG information, but the cost must be reasonable and manageable for it to have value.

3. Regulatory challenges of the EU Commission in the global context

3.1 The EU should have a leading role in the definition of the much-awaited global standard

An industry representative reported that, in Japan, around 300 private sector companies from all sectors have voluntarily established consortia to follow disclosure guidance, supported by cooperation from government agencies. This is a valuable reference for the EU. Likewise, the systemically important global banks are endorsing a number of voluntary ESG guidelines covering investing and lending activities.

Another industry representative saw a great opportunity for the EU to set a global standard and become a global leader in this area. The taxonomy regulations show what can be achieved and, although steady progress has been made, this work is not yet completed. From these meaningful concepts, the EU has a real chance to become a global lighthouse. The general data protection regulation (GDPR) is a benchmark here, and gives cause for optimism in developing a consistent and aligned framework.

The first industry representative stressed the importance of global alignment, citing an IFI study that counted nearly 200 policies and regulatory measures on ESG disclosures, across nearly 40 countries. This is too many and only leads to inconsistencies. The various ESG disclosures and reporting guidelines have to be aligned and harmonised before integrating them into mandatory frameworks. The future for non financial reporting standards should ultimately cover all ESG topics, not only climate risk, and must avoid fragmentation in the scope of disclosures. It is essential to ensure that international voluntary ESG standards are complete and consistent, as they are vital for strengthening the sustainability of the financial system in the world's path to net zero.

The regulator (Pierschel) has full support for what the Commission is doing. When globalising its approach, it should not spend too much time convincing others. Pressure can be placed on other countries just by requiring the same standards of supply chains.

3.2 Building an EU harmonised sustainability database is necessary, while making firm specific strategic information available should allow a dynamic assessment of risk and investment attractiveness

An industry representative is planning an EU wide, centralised, open access and free database for sustainability and non financial information. This will enable the regulations to be used more widely beyond Europe. The official considered the NFRD a necessary step, since the way corporates are currently reporting makes it difficult for financial institutions to compare two companies' ESG approaches. In the current state, simple materiality expresses the financial cost of ESG risks on the corporate. Dual materiality is essential, both for corporates' and investors' analysis. This could help progress to an approach where economic players see how their actions impact their environment and how they can contribute to the improvement of ESG factors.

An industry representative focused on how disclosure information is currently used and opportunities around NFRD and sustainable finance disclosure regulation (SFDR) reforms. Consistent and comparable data is important but is not the whole story. More interesting are the specifics of how a company identifies, assesses and manages sustainability related financial risks, and how it determines if an issue is material and therefore characterises the risk reward profile of a firm.

3.3 The NFRD should help EU companies to navigate the complex reporting landscape

An investor representative described how companies with good or improving ESG characteristics are attractive to active investors. As the broader context is key, reporting on more strategic issues is preferred. Reporting frameworks, such as the integrated reporting framework and the Task Force on Climate related Financial Disclosures, are much more dynamic. Other reporting frameworks miss that forward looking strategic focus.

It can be frustrating for companies that there are so many different reporting frameworks out there, but which serve different purposes. The Sustainability Accounting Standards Board (SASB) looks at near term contingent financial risk, while the Global Reporting Initiative (GRI) and the Sustainability Development Goals (SDGs) have more of a public policy focus. With such a crowded field, the NFRD has to be welcomed. At best, it will help companies to navigate the reporting landscape, but there are risks of oversimplifying a set of complex and intertwined issues to the point of becoming a tick box exercise.

Before moving on to the challenges for future policy, a policy maker wanted to hear the industry representatives' views on what has already been agreed for the new SFDR on non financial reporting and whether they have detected any potential problems. A text should start to apply in the coming months.

4. Although transitioning is urgent, further attention should be paid to the current legislative process and planning in the EU, since sustainability disclosure regulations impact long term irreversible decisions and the investment-financing value chain is complex and international

The first industry representative (Bücheler) to comment perceives challenges with the timeline, particularly as the level-one regulations are applicable before level two is ready. More of a phased approach is to be preferred. This is a long term business as, when buying life insurance or old age provision, customers sometimes look 20 or 30 years ahead, yet sellers might only offer assurances about the sustainability of these investments here and now. The timetable between levels one and two for sustainable financial reporting and disclosure regulations is difficult. The NFRD is similar because, as good as its intentions are, it is currently only envisioned for 2023.

The industry representative gave the example of the 'do no significant harm' assessment, which is reflected in the SFDR, and the principal adverse impact assessment, which is in the NFRD. Both basically address the same issue that if, for example, a company is CO2 friendly, it does not do other damage to the environment. But their definitions are different. These things need to be nailed down if the European industry is to cooperate with the IFRS Foundation and other global players.

The policy maker described the issue with the timetable for implementation. The level one text was meant to be applied before the technical standards were ready. The regulator feared that postponement of the framework's entry into application is impossible. Participants will have to live with the framework as it is for now. As soon as the information is there to be used for disclosure requirements, it can be. If not, the financial industry should not be blamed. Financial companies are not exposed to sustainability risk per se. They carry a huge amount of reputational risk, which is already covered by solvency regulations, but an insurance company or bank is exposed indirectly via its loan granting, insurance and investment businesses. That is where non financial information is needed, and as soon as possible.

An industry representative thinks the moment should be seized to make society greener, where the EU could be a frontrunner for global ESG initiatives. Another industry representative fully supported the direction of the European Commission's activities here but cautioned that time is needed to properly align the EU taxonomy with the regulatory technical standards. For example, the 'do no significant harm' principle must align with the principal adverse impacts, and clarity is also required on ESG strategy products.

5. The scope of the NFRD should be widened for SMEs, which requires the adoption of proportional regulatory approaches

A regulator wants non financial reporting to be widened from the current arrangements, so that it applies not just to listed companies, but to all other corporates. Some SMEs may only comprise around 50 people, but have turnovers of €2 or €3 billion, because their factories are automated. To encompass those, a combination of number of staff and turnover figures might be applied, widening the scope of the NFRD. A policy maker stated that there has to be a trade off between such a widened scope and the burden that would then fall on small non financial corporates, which would call loudly for more of a proportional approach.

6. Designing an efficient sustainable-disclosure value chain in the EU raises many challenges

There is a sustainable disclosure value chain, which begins by gathering quantitative and qualitative data, then makes sure there are quick to understand indicators and ratings. The panellists were asked if the Commission should pay more attention to certain links in this chain or if all are equally important.

6.1 Incentivising individuals' sustainable financial investment requires making appropriate and consistent definitions available

One issue not touched on yet was the sustainability preferences being included in the suitability tests for MiFID and the insurance directive. An industry representative felt that it made sense to incentivise customers to take up sustainable products, but whether such products could be offered depended on reporting definitions. According to this speaker's firm information, all their life insurance products are currently sustainable, because investments are being monitored for ESG compliance. Following a channel approach makes sense and might help solve this reporting conundrum.

6.2 The provision of data raises critical issues, such as the relevant timeline of the project, the existing asymmetry of information, proportionality challenges and over concentrated data providers

An official contended that ESG data had already been seen as a strong lever for innovation in the market, but some think the market is not functioning well. There is an asymmetry of information and a high level of concentration, which results in barriers to entry for new players. There is a need for an EU regulation applying to all ESG data-related products and services on the market (e.g. ESG rating, scoring, etc.). The scope for this regulation should be wide and not too prescriptive. It should ensure transparency around the methodologies that providers have employed and must include some quality criteria. An industry representative commented on this that some data providers are supplying opinions, not facts. It might be difficult to determine that one piece of advice is better than another without an understanding of what methodologies and assumptions are going into the data and metrics they have provided. The Commission could make sure there is better transparency, giving users a kind of health warning.

A regulator advised first taking advantage of the taxonomy. This has to start now, mainly with qualitative information, and cannot wait for the perfect solution. Sooner or later, the picture will become clearer and shifts can be made to more quantitative reporting. The regulator pleaded for a publicly funded data pool, from which all ESG data can be drawn. That data should be as raw as possible to enable everybody to deliver the disclosures required. Proportionality had been mentioned, but the usability of data is another issue. It does not make any sense to disclose data if there are no possible comparators for it. Like their colleagues, the official also strongly believed in the opportunity of building a European open access database for ESG data. It would be extremely valuable for the development of a forward looking approach, allow for more competition on the market of ESG data analysis, and improve corporate data comparability in the ESG sphere.

6.3 The design of an efficient sustainable-disclosure value chain should leverage the stewardship of financial institutions by providing a longer-term view of the strategies of ESG firms

An industry representative saw that, although regulating the supply side of information is important, consideration needs to be given to what investors are doing with the data. There is a gap in Europe's regulatory agenda concerning stewardship, as the sustainable finance reforms being proposed are focused more on consumer protection and reallocating capital away from climate damaging activities, rather than on the active role that investors can play in driving positive change. Stewardship is the act of investors using their ownership rights to engage with companies where they identify risks and challenge them to do more with their capital expenditure and product design to shift from the unsustainable to the sustainable.

Another industry representative echoed those comments. It would be interesting to see how doing nothing affects a company's shares over time. They are strongly expected to go down. Some industries or companies that have a high polluting standard today can contribute a great deal to reducing it if they made the right investments and changed their business models now. This requires forward looking information from companies with 5 to 10 year pathways showing how they plan to reduce CO_2. Care needs to be taken around complexity, in this context.

6.4 A level playing field is needed between listed and non listed companies

An official thought a level playing field is first needed, in which listed and non listed companies would be placed on an equal footing, because the latter are also able to engage in non financial reporting. This is being demanded by clients, but employees also want to work for an organisation that pursues ESG goals. Second, many SMEs are already reporting voluntarily and are able to handle up to 100 ESG indicators. The Commission should study how to develop a proportional approach in providing a framework to SMEs in their reporting, not only on the E pillar, but also on S and G factors. After that, if companies wish to report more, this could be facilitated.

Most important is that a common EU approach is followed, which means standardisation, so that indicators for reporting are consistent with all the policies that already exist on ESG. The inputs of the industry will help to build consistent reporting, while the existing frameworks used by many corporates provide a useful starting point. Many of the panellists are optimistic about the ambitions of a revised NFRD. ■


The Eurofi
BERLIN

SPEECHES

Dr. Jörg Kukies

State Secretary, German Ministry of Finance

Economic and financial priorities for fostering growth and innovation in the EU

Ladies and gentlemen, first of all, I would like to express my gratitude to David, Didier and their team – without their extraordinary efforts, this event would not have been possible. Many thanks also for acknowledging the work and organisational assistance of my colleagues to get this event going. I think it is an important signal that we are able to hold this conference with less attendees and at heightened health, sanity and security levels and I would like to warmly welcome all of you. I have to admit that it is a new experience for me to speak to such a large room with so few people in it, but if this is the precondition for holding gatherings like this, I will gladly get used to it for the foreseeable future.

Traditionally, this event takes place in the context of the meetings of the Eurogroup and the ECOFIN, so I would like to say a few words on political priorities by the German Presidency to be discussed during this week and beyond. As already mentioned, the key topic that will accompany us through our Presidency is recovery and resilience. The top priority is to implement the €1.8 trillion agreed by the EU leaders. The main task during our Presidency will be to take the 67 pages of the EU leaders' agreement and translate them into actual funds flowing. Our serious ambition is to start the process of recovery on 1 January and to get the package agreed upon at the highest level into action and start implementing recovery and resilience.

This agreement and the finance ministers' agreement on the €540 billion recovery plan in April is signals that the European Union is well equipped to face the corona crisis. This is a huge difference to the somewhat controversial response marked by dispute after the financial crisis. The European Union has shown resolve, unity and an ability to agree on massively important fiscal stimulus measures, both at Member State level and at Union level. These two components are extremely important. Not only did every Member State deploy the fiscal policy instruments at the national level, but afterwards, Europe as a whole decided to provide financial support. This decision avoided an asymmetric approach mirroring the fiscal capacity determining the response to the economic crisis. This is extremely important and a very clear signal to the markets, which have responded positively. Equally important is the good synchronicity between monetary and fiscal policy. In light of the abyss we stared into on 18 March and what we have achieved since then in terms of regained confidence and relaunching the economy, it is safe to say that the combined work of monetary authorities, fiscal authorities and the private sector has indeed strengthened us.

In this spirit, the priorities of the Finance Ministry will include three projects: number one is the Recovery and Resilience Fund. Number two is the Own Resources Decision, and number three is the multi annual financial framework. The Own Resources Decision is extremely important to make sure that the financing of the €750 billion RRF will actually happen and be implemented. It characterises the strength and resolve of the European Union to be a big capital markets player – hopefully with the AAA rating, as was mentioned – and hopefully with the strength of Europe's funding ability, that will be passed on in terms of growth-enhancing investments and spending. This will be accompanied by economic reforms, because this is the other part we are going through at the moment in the actual governance of the RRF, to ensure that our spending programmes will propel Europe to a higher growth path. It is important to mention that this is not an arbitrary measure. Europe is not transferring money to Member States to spend at their own discretion, but is agreeing to arm the European semester – the country-specific recommendations – and all of the European policymaking that we have come up with, to make sure that the money is implemented in a pan-European manner.

Finally, the MFF is an important topic for us, which is in the responsibility of our foreign ministry friends. Of course, we are working closely with them because everyone understands that the three elements of policymaking are intertwined and the debates with the European Parliament are extremely important in the context of a package deal. We are looking forward to achieving Council conclusions and decisions at the ECOFIN as early as October so that we can start the formal trialogue process with the EP with a view to getting funds flowing by the end of the year. The complexity of it all and the requirement to ratify Own Resources in each Member State shows that time is scarce. I can reassure you that this year, the unspoken rule of all of Brussels going on holidays in August did not happen. We worked extremely intensively in the last six weeks, essentially from the July Summit until today, with no break and no pause. Everyone was working hard to make sure that all the legislative work that needed to be done has actually been done and is going in the right direction.

However, these three pillars that have propelled themselves to the top of the agenda are not the only agenda items. There is another very important threesome, namely the Banking Union, the Capital Markets Union, and the Digital Finance Union. These have much more medium- and long-term perspectives, but no less urgency. On the Capital Markets Union, there has been a huge amount of positive energy, starting with the report of the Next CMU High-Level Group initiated by the Finance Ministers of France, the Netherlands and Germany. This was followed by the report of the High-

Level Forum on CMU in June. The 120 pages are an excellent compendium of specific, concrete steps, whether it is on post-trade, SME access to finance, or improving our pension system. We studied every single sentence of it and are very happy that there is willingness to move forward with concrete steps among the Presidency, the Commission and everyone I spoke with in the European Parliament. The goal during our Presidency is to achieve Council conclusions by December. This would be a strong signal by the Member States to everyone, particularly the Commission, that the legislative work on implementing the 120 pages into actual specific measures is strongly supported and endorsed. I am happy to see progress on this huge project during our Presidency.

The same goes for the Banking Union. We have made some proposals and there are many great ideas. We could observe that it was the right the lesson from the global financial crisis to enhance the resilience of the banking sector. Certainly, the strength of the banking sector has supported the response to the current crisis. This is something that also differentiates from the past crisis. Through the collaboration and combined work of the banking system and fiscal authorities, providing credit guarantees we were able to avoid the credit crunch we experienced in 2008-09 - which is a huge achievement. We went through the numbers for Germany with the Bundesbank and we actually had a credit expansion during the second quarter. Having a credit expansion when GDP contracts at double-digits is a rather unusual occurrence. The combined work of government guarantees, together with the activity of the banking sector and the strength and resilience of the rules we set in the Banking Union has really helped us.

We have witnessed similar experiences as the one in Germany all over Europe. The numbers from the ECB document that, as do the numbers from central banks. This is proof of its strength and resilience, but of course, our Banking Union is not complete. The lack of mobility of capital and liquidity stops us from being a truly competitive market for the banking system and financial services. This is an issue we have to address, along with the fact that risks will continue to build up. We are working on further steps towards risk reduction, but we also need to work on deposit insurance, prudential treatment of sovereign risk and cross-border mobility of capital and liquidity. Those elements are all components of a holistic Banking Union project that we intend to take further.

Digital finance is also hugely important, for which we need a European approach. In the last few months, we have witnessed how willing and able our citizens are to digitise their behaviour, and the financial industry lies at the core of that. We are also happy to report that we have been working with the Commission to take the Digital Union forward during our Presidency. This is a vital component of enhancing our European resilience. It also ensures that the European Union grows together and moves away from a fragmented landscape for digital banking business models, finding a response to questions of innovation of stable coins, cryptocurrencies and how to handle digital transformation in our financial system.

Germany is particularly proud to be moving our bond markets entirely to a digital world. This means that issuance, trading, settlement, custody, thus all parts of the value chain of the fixed income market, is at least optionally transferred to the tokenized world. There is huge willingness to engage in this transition. Our aim is to combine all these elements with sustainable finance, another big issue we are willing to take forward. Germany has just issued its first green bund and had quite strong demand for that, so we perceive the idea of sustainable finance as real, tangible, and effective.

The final project I would like to mention, closely interlinked with all previously mentioned ones, is the question of fighting money laundering. For this topic, have two main goals. One of them is to move from 'D' like directive to 'R' like regulation', meaning that we would like to reduce the amount of national discretion by implementing more harmonised anti money laundering rules in the European Union. Also, on the basis of a harmonised rule set, we aim at a single authority that will unify the supervision of anti-money laundering at the European level.

Please allow me to conclude by apologizing for only briefly touching upon all these topics; every one of them would have merited much longer speech time than I was able to attribute to them. However, my aim was to give you a high-level, quick overview and an outlook on the two days ahead. I look forward to lively discussions during this conference and would like to thank you all for coming here. ■

Felix Hufeld

President, Federal Financial Supervisory Authority, Germany

CMU 2.0

Ladies and Gentlemen,

About 20 years ago, the European Union gave itself a wonderful motto: "United in diversity."[1] Joining forces to advocate for peace and prosperity while perceiving the many different European cultures, traditions and languages as an asset – this combination is precisely what makes the EU strong. The motto is thus a very good fit for one of the EU's major projects: the European Capital Markets Union. To achieve this, we definitely need a closer union which still offers room for diversity. I very much welcome the fact that deepening the CMU has been placed on the political agenda of Germany's presidency of the Council of the European Union.

Completing the CMU is one of the most important regulatory tasks at the moment. Although we have already made significant progress, there is still some work to do. For instance, in terms of integration: in the EU, we still do not have a genuine single capital market but 27 national capital markets. As a result, those providing and those receiving capital are still facing unnecessary hurdles. There is also the issue of competitiveness: in this area, the EU's position is still too weak at the international level.

I expect considerable impetus for the development of the CMU to come from an action plan that the European Commission intends to release in the autumn. The action plan 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.

The action plan is set to follow a plan presented by the European Commission already back in 2015. The objective at the time was to eliminate regulatory and bureaucratic hurdles, promote EU-wide financial markets and reduce reliance on bank-based funding. Let's take a look at financing, for instance: 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. And Brexit has put even more pressure on the EU 27 to remain competitive internationally. If we achieve more integration here, we will be able to offer new, alternative and affordable financing options to many companies seeking capital, which is likely to offer more choice for SMEs in particular. At the same time, we would give these companies and the financial system as a whole new opportunities for diversifying their risks.

After the COVID-19 pandemic further weakened the already flagging economy, this endeavour has become even more urgent – despite the extensive state support packages. Brexit, too, has increased the pressure to act. Up until the previous year, we had a very large capital market hub within the EU: London. This hub is now at our doorstep, and we can play a part in setting the rules of the game there only to a limited extent. Another reason why the EU-27 must strengthen its own capabilities.

We should not be discouraged by the fact that we are now well behind the Juncker Commission's original timetable set in 2015. In my view, the CMU is and remains an ambitious long-term project. We will have to tackle a number of difficult tasks here and there. Some examples that come to mind include the harmonisation of minimum standards in the area of insolvency law, the simplification of tax law regulations, e.g. withholding tax refunds, the standardisation of company law provisions, the issue of investor education and building trust among retail investors in capital markets.

But let mention another point that is important to me: we not only need more "U"; i.e. more of a union – or to be more specific – more harmonization for markets in the EU. We also need more "M" – in other words: larger and deeper markets. To give an example, we still have a buy-side that is far too weakly developed compared to the US and other markets. And we still don't have a genuinely European investor structure, particularly with regard to pension funds. This includes the heavyweight EU countries of Germany and France.

In my view, an ideal starting point to counter this would be the strengthening of funded pension schemes within the CMU. I was therefore pleased to find out that the expert group I have just mentioned has dedicated an entire chapter to pensions. Given the forecasts made by various demographers, we would do well to examine every sensible-sounding idea with an open mind. And especially in times of low and negative interest rates, it is essential that savers are offered attractive investment products to build up additional pension savings across Europe. Longer-term investment opportunities in particular should be promoted. Initiatives

[1] https://europa.eu/european-union/about-eu/symbols/motto_en

in the private-sector industry could make just as much a contribution to this as the sort of big bang that could only be triggered by policymakers, ideally European ones.

For this reason, we also welcome the fact that the EU has laid the foundations for a truly European pension product. The Pan-European Personal Pension Product (PEPP) is set to be a simple, transparent and affordable solution to complement private pension schemes and would be primarily aimed at mobile individuals working in different countries. Insured individuals would then be able to take their pension entitlements with them from one EU Member State to another and continue to save up for old age with the same product. Even if PEPP does not really become a product for the mass market, which remains to be seen, I consider it a key pioneer, which marks an important milestone towards achieving a capital market union.

What I do not want is to create an insurmountable conflict between the capital market side and concepts that rely on a state-backed standard product. The simple matter of the fact is: given current and future demographics we don't have a choice and must do both. We have to leverage any and all opportunities that present themselves to reinforce each of the three pillars of pension provision to the best possible extent. And that is exactly what makes the capital market union a unique political opportunity and project: it serves obvious and urgent social policy goals on behalf of millions of current and future pensioners as much as it lays the foundation for a stronger and distinctly European capital market. What else could we ask for to mobilise as much political energy as possible to promote this important project.

In the EU, we will not be able to avoid having to take an even closer look at the issues surrounding digitalisation – which forms part of the much broader context behind the CMU project. We must give special attention to crypto assets in particular. Of course, technological progress and the rise in digitalisation are playing an increasingly important role on global capital markets, too. Blockchain technology should be mentioned in particular. It can be used both as an underlying technology for services and as a means of payment (e.g. stablecoins). It can therefore be assumed that blockchain applications will be a key driver of digital transformation. To allow this technology to unravel its full potential in the EU, trust is needed. Only a robust legal framework can guarantee this. Firstly, it should not stifle but should promote innovation. Secondly, it should have a protective effect on two fronts: protecting both financial stability and investors and consumers.

In August, the German Federal Ministry of Finance published a draft law on the introduction of electronic securities. Fruitful ideas for the CMU can be derived from this. Electronic securities allow companies to gain quick and affordable access to the capital market, which is likely to be highly appealing for SMEs in particular. Investors – including retail investors – have a wide range of products to choose from and can invest at a low cost and on a small scale – and thus diversify their risks.

We should set out the rules for this at European level, as this is the only way we can succeed in avoiding arbitrage and creating a genuine level playing field, while, at the same time creating a market of sufficient size to be efficient; of course in line with the proven mantra "same business, same risk, same rules". Speed is also needed here. If we do not rapidly set out clear rules for the further inclusion of crypto assets into the already existing financial market, then others will do that for us. And a financial market of the size and significance of the EU cannot and should not let this happen. For this reason, I again welcome the comprehensive report that the European Commission's expert group presented in mid-June. In this report, the group recommends incorporating crypto assets and blockchain technology into European financial market regulation for the purpose of further developing the CMU.

I am certain that this topic will play a significant role, also in the context of Germany's presidency of the Council of the European Union.

Ladies and Gentlemen,

Thank you for your attention. I am now looking forward to your views on the matter of this topic. ■

Valdis Dombrovskis

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

Implementation of the EU Next Generation package, what next ?

Ladies and gentlemen,

Unfortunately, I cannot be with you physically today. However, it is always a pleasure to address you – even via videomessage.

This pandemic has sent shockwaves through societies, economies and industries.

Some are hit harder than others. We now need a strong and inclusive recovery.

This is how we can rebuild our economy, meet future challenges head-on and make the most of new opportunities. It is exactly what the EU's massive recovery package aims to achieve.

The package is worth a combined €1.82 trillion - based on €750 billion from Next Generation EU on top of a reinforced EU budget for the next seven years.

For the first time, EU countries will borrow together on a large scale to face a common challenge.

Funding will flow in grants and loans to support countries in their reforms and investments, mostly from the Recovery and Resilience Facility: the driving force behind the package.

This money should get moving as soon as possible. I would like to see the Facility up and running by early January.

For the recovery funding to prove effective, it needs a strong and solid financial system to underpin it: deep integrated capital markets, stable public finances and a strong banking sector.

We will soon launch several initiatives to make sure these are in place.

Starting with Europe's banks: they are better capitalised and more resilient in terms of liquidity than during the previous crisis. We all worked hard to get to that point.

In this crisis, they can play a positive role - by continuing to lend to the real economy: to people and households, to businesses of all sizes. This is vital for our wider economic recovery.

The Commission has already facilitated an agreement on best practices between the financial sector, consumers and businesses to keep liquidity flowing.

These discussions will continue in the autumn.

While we can see the pandemic's effects on asset quality only partially in the initial first-quarter data, we can already see signs of a worsening situation regarding non-performing loans.

It has not yet led to a rise in these loans, but this is probably only a matter of time. There will be a certain lag before it happens.

We do not want this type of loan to build up again on banks' balance sheets. History shows us that it is best to tackle them early and decisively.

Now, we will work with EU governments, banks and investors to develop a comprehensive strategy as early as possible to prevent non-performing loans from accumulating and dragging on the recovery.

We will start this process this month with a roundtable with industry and Member States to begin mapping out its key elements.

Regarding capital markets, you are all familiar with the project to build a Capital Markets Union.

Today, it is more urgent and relevant than ever.

Fully functioning, integrated capital markets are essential to speed up the economic recovery, reach sustainable growth and facilitate long-term investments in new technologies and infrastructure.

They are vital for meeting the ambitions of the Green Deal and Digital Agenda. Later this month, I will present a new vision for the CMU in the form of an action plan.

It will have three main objectives:

First, to make financing more accessible for European companies, including smaller ones. For example - making information on EU businesses more visible to international investors, while reducing barriers that prevent smaller companies from accessing capital markets.

It also means supporting investment funds and institutional investors in channelling funding to long-term projects.

Second, to make the EU even safer for people to save and invest long-term so they can put a suitable income aside for their retirement.

Here, European savers need simple, clear and transparent information about financial products.

This is what our rules on retail investment must provide.

Finally, to integrate national capital markets into a genuine single market. The UK's departure from the EU makes this more urgent than ever.

We will aim to address barriers in taxation, non-bank insolvency and company law. Truly integrated and convergent supervision is also needed so that all market players can enjoy equal conditions for competition.

Ladies and gentlemen,

The strength of our economic recovery after the crisis will depend a great deal on financial flows.

We must use all available channels to get investments moving to where they are most needed. That is how we can best tackle the fall-out of the pandemic, build up economic resilience and embrace future opportunities – like the green and digital transitions.

As ever, the financial sector has an essential part to play.

Thank you. ■

Paschal Donohoe

Minister of Finance, Department of Finance, Ireland & President, Eurogroup

How to rejuvenate and rekindle growth in the EU?

Good evening, ladies and gentlemen. I am quite mindful, as I stand up in front of you all, that the day has been very long and you have participated, I am sure, in many, many seminars. You have heard many different speeches, and I am sure some of you will have events to go to this evening and other commitments, so I am just going to take four or five minutes of your time. In that time I want to give my perspective about politically where we stand, as Minister for Finance for a country that is very proud to be in the European Union, and sees our membership of the Eurozone as a critical building block of our economic success and our political freedoms. I also want to address this topic as somebody who has had the great privilege and honour of now being elected President of the Eurogroup by my peers within the Eurogroup. I want to address the topic that you have very correctly identified here this evening about how we rejuvenate and rekindle growth.

First, from the eyes of those that I serve, which is the citizens of the European Union, those within the Eurogroup, within the euro area, and of course those citizens that elect me in Ireland. As we do so – and as I acknowledged – it is so important to begin any economic analysis, any discussion of a policy framework and of different options with a very clear identification of the many, many great challenges that all of those face at the moment. When we saw the figures that are reported to us from Euro staff, the most recent figures that came out towards the end of July indicate to us now that we have 15 million citizens that are unemployed, 12 million of those within the euro area. The same study indicate that we now have nearly 3 million euro citizens unemployed who are under the age of 25, 2.4 million of whom are within the euro area. That is why I think the analysis and points that were made by Klaas a few moments ago are so pertinent and so powerful, because he posed the question about consent, and he posed a question about the level of political consensus that you need to support economic structures. At the heart of this great project of the European Union and at the heart of the great project that is the euro are economic institutions that rest on political consent, trust, and the idea that their continuation offers a way to a bigger and better future.

As we look at the crisis that we now face, we are dealing with a phenomenon that does not know what a border is, that does not see national boundaries as being in any way relevant to its existence. That phenomenon is of course the virus called COVID-19, and in many ways that surely reminds of what the rationale of the European Union is and what the rationale of the euro is, because that is something that also transcends boundaries. It is something that looks to say that we can achieve more together than we can individually, no matter how mighty or powerful we are as individuals. If the European Union is a project that also looks in its own way to make boundaries and national boundaries in some ways less relevant and to find ways in which we can transcend them, surely this is the point at which the many, many strengths of the euro and the European Union are called into play on behalf of our citizens when we confront something else in a biological virus that of itself knows no boundaries or no national promises either.

I therefore think that the great political challenge that we face at a time in which the great financial crisis for so many of our citizens still casts a shadow onto their families, business and lives is to demonstrate in the clearest way we can – for those of us in public life, for those of us who are politicians – the role of the euro and the role of the European Union in being an intrinsic part of the solution in responding back to such a great challenge, which is casting such darkness now and such shadow into millions of people, lives and dreams that I mentioned.

The foundations for what a recovery looks like at the moment are familiar to us; we know what they are, but they now have to be seen against a far more urgent context. The first pillar to this is how we can look at effectively implementing the new instruments and the new tools that were created by the European Council with the work of the institutions of the European Union just before the summer, in a way that delivers against a more sustainable future for all of us. It is about how we can have them implemented at a time when policy tools that may be available to national governments are no longer as powerful in the future as they are now, and in which those new instruments such as the Recovery and Resilience Fund and Next Generation EU can be brought to life in a way that is effective but also respects the fact that they are being funded by the European Union for very, very particular purposes.

The next pillar will be – particularly within the euro area – how we can ensure that budgetary co ordination and making the right budgetary stance at the right point in the economic cycle is of help to all. This challenges is so great – and it is a reminder back to the great lesson that we had a decade ago – that the technical language and the economic analysis of spill overs and externalities now mean so much in supporting individual member states and the people of the European Union in trying to pull through this great crisis. This is a great crisis which has at its foundation where we are with our private health and where we are with the public health of our countries and Europe. That concept of co ordination – something we are all too familiar with, in particular as we move into 2021 – will be a topic that will be so important to what recovery does look like.

The final area of it will be – and I heard much debate about it earlier on this evening – what the banking union looks like. It will be what kind of progress we can make in that, and in that, above all, the context for that debate and negotiation has changed. For me, the purpose of that debate and negotiation is how we serve and how we protect those who are at the heart of the European Union. How can we protect more capital for more jobs to be created? How can we create confidence about the deposits and their uses of those who are at times now feeling so vulnerable? How can we ensure – and I heard some reference to it this evening – that our banking systems and our financial structures play their part in a recovery that is resilient?

I want to end on a note of resilience and a note of inclusivity. Economic growth and a rebound in economic growth will of course occur in some statistical way at some point in our future. The great political challenge for all of us will be the nature of that economic recovery. Can it be inclusive? I am reflecting on the challenge that we experienced not so long ago, looking at economic recovery across a period of what was now a very moderate period. A political challenge for many of us is that kind of economic growth did not meet the needs of those who experienced it then, and what we now have to strive for is an economic growth as we emerge from this crisis that is inclusive, that benefits everyone, and one that is resilient. That is certainly the kind of economic growth that as the new President of the Eurogroup, working with all of my colleagues in the euro area, we will strive to create. Thank you. ■

Werner Hoyer

President, European Investment Bank

Policy proposals to relaunch growth in the EU

I have been asked two questions. One, 'Is the EU response to the current crisis fit for purpose?' The second: 'What are the challenges for the recovery?'

I have a clear answer to the first. I was pleasantly surprised that decisions were taken relatively quickly and with resolve, first on the national and then on the European level. As I sat in the Eurogroup alongside colleagues from the ESM, ECB and others, our dear friend Christine Lagarde called for a European response that is 'fat, fast and flexible.' Moreover, purely national responses represented a challenge to the integrity of the internal market, the cornerstone of the European project.

Of course, the contribution that national central banks and national governments could offer was very different. We had countries who really rolled up their sleeves and addressed the issues while others had to offer a more modest response. For the European internal market, this is a real danger, hence the imperative for a European response. And this is where our institution's value lies: in our ability to deliver and support such a European response.

So far, the EIB Group – namely the European Investment Bank and our subsidiary the EIF, the European Investment Fund – has responded via three main channels. Firstly, by promptly mobilising financing principally for SMEs and corporates, as well as supporting the public health sector impacted by the pandemic. Secondly, supporting the crisis response outside the EU, through what we call the Team Europe effort. I will come back to that later. Thirdly, we have responded through the pan-European European Guarantee Fund (EGF).

At the outset of the crisis we committed our resources for an urgent crisis response. In the first instance that meant we accelerated investment projects already identified to unlock additional financial resources for the real economy.

I insist on saying the real economy because this is the difference to the financial crisis 10 years ago. At that time, we had a crisis of national budgets and fiscal soundness. This time we have a crisis of companies in the real world, which are largely sound, healthy and able to survive if they can overcome a short period of liquidity shortage. This was the first thing we needed to do.

To complement the acceleration of our financing we increased the financing share of an investment project that the EIB could finance. Crucially we reinforced our financing activities in the parts of the economy most affected by the crisis, mainly by providing access to finance for SMEs and for healthcare and biomedical sectors.

Concretely, to give you an idea of the scale of this, since the start of the COVID-19 crisis response up to the end of August, we have approved investment projects worth €18.4 billion inside the European Union. The majority of operations are dedicated to SME and mid-cap financing with a 74% share, followed by the health sector.

Let me give you some examples of how the companies we are supporting alongside our partners at the European Commission are now in the forefront of our common effort to find cures, and treatments.

CureVac, is a highly promising biotech company developing a prophylactic against severe acute respiratory syndrome, and coronavirus too. Here we are providing €75 million equity investment.

Pluristem is a company active in cell therapies that could help address complications from COVID-19. We provided €50 million of financing.

BioNTech is perhaps the most promising development, together with Pfizer, a biopharmaceutical company at the forefront of developing next-generation immunotherapies and working on a COVID vaccine, which we are supporting with €100 million of debt financing. But, as I've mentioned, we are not limiting our crisis response to investment projects within the EU. We are a global institution, active in more than 160 countries around the world, including in many fragile and vulnerable states and of course in our immediate neighbourhood. As part of the Team Europe effort, led by the European Commission, we are providing around €6.7 billion euro in much needed support for developing countries in emerging markets in the fight against the virus and its impact: ensuring a unified EU response internationally.

As of today, we have approved more than 22 operations outside the EU, totalling around €2.5 billion euros supporting EU policy objectives.

The developing world is in many ways least able to cope with the impacts of this virus. But beyond our response to the pandemic, we must give more attention to these policies as a clear expression of EU external policy, strategy and values.

We need to act as Europeans, and as far as the EU institutions are concerned in the sphere of external policy, we should make sure that we are in the driving seat. We should not be at the mercy of partners who might veto for instance our ambitious EU decarbonisation strategy and climate goals.

The third element in our crisis response formed one of the three pillars of the European response package - the pan-European Guarantee Fund ('EGF').

EGF aims first and foremost to support solvent companies across Europe hit hard by the coronavirus pandemic. An off-balance sheet vehicle composed of up to €25 billion in guarantees by EU Member States, it will enable the EIB Group to support up to €200 billion in financing, allowing the EIB Group to go beyond its traditional financing activities and support companies who need it most. This does involve taking more risk. But this is the cost of having more impact. The implementation of the fund is now underway. The first projects have been approved. One example is the EIB portfolio risk sharing, a flagship product that will be fully delegated to financial intermediaries targeting SMEs and health entities through guarantees.

Let me turn to the question of the recovery. The Covid-19 pandemic has shown us the urgent need for a massive rollout of digital infrastructure – exposing weaknesses and highlighting opportunities for a growth in European competitiveness. The recovery needs to be digital, and it also must be green. We cannot afford to let ourselves be diverted from the challenge of tackling climate change and the environmental.

Last year we redefined our Energy Lending Policy to end support for fossil fuel related energy projects. Going forward we will ensure all our operations are Paris aligned by the end of 2020, devoting more than 50% of investments for green projects by 2025 and supporting €1 trillion of investment in climate action and environmental sustainability by 2030. We are about to roll out our Climate Bank Roadmap which will outline our climate policy on a sectorial level. Like the Energy Lending Policy last year, this has potential to be a real game changer for the market.

We need to think structurally. We need to increase European competitiveness to stimulate higher growth and investments. Digitalisation as well as investment in innovative climate action can help us to do this. I can only agree with Mario Draghi's recent statement that the big issue for the EU today is, more than ever, to channel funds into improving productivity. The reduction of productivity growth over the last 10 years – far before the coronavirus crisis – is a warning sign.

Building back better is now a widely, maybe overused phrase. But I truly believe that we have plotted a course, armed with truly European strategies that will, if we can act decisively and together, bear fruit and leave us more resilient and more competitive as a Union. ■

Klaus Regling

Managing Director, European Stability Mechanism

The EU response to the Covid-19 crisis

Didier Cahen

Didier Cahen introduced Klaus Regling, the Managing Director of the European Stability Mechanism and thanked him for being at Eurofi.

Klaus Regling

Klaus Regling stated that he would focus on three different items, which are all linked: the short-term outlook, some longer-term concerns in terms of the European or world economy, and the remaining agenda for Economic and Monetary Union (EMU) deepening.

In the short run, Europe is coming out of the biggest economic crisis of its lifetime. Given that it is such a serious crisis with so much economic, financial and social damage, Europe has done really well. The view from the markets in general on Europe today is better than anything he has seen in the last 10 years. The markets are impressed by the speed of the decision making in Europe in the last six months, the volume of action taken, and also the good, productive coordination between different European institutions, such as the Commission, the European Central Bank, the European Investment Bank (EIB), the ESM, the Eurogroup, as well as European institutions and national authorities.

In April and May, the Eurogroup decided on the first package at the European level, of €540 billion, put together with new facilities from the Commission, the EIB and the ESM. In July the European Council decided on the recovery fund of €750 billion. These are unprecedented amounts and it all happened very quickly. Markets are impressed by that. The European action comes on top of the decisions in different member states, which are in charge of their fiscal policy, so they do even more than what happens at the European level. When everything is added up at the national level support measures have been put in place that amount to more than 30% of euro-area GDP, which is unprecedented. Some countries are able to do more than others, but on average it is 30%.

This is a combination of automatic stabilisers that are working, amounting to, on average, 5% of GDP. In addition, there is another 5% of GDP in discretionary fiscal action. Additionally, there are liquidity measures, guarantees and tax deferrals that make up another 20% of GDP. Some of that will probably end up in higher deficits over time in the future, so deficits will be affected by that. Together, this is really quite striking. Without it, the economic damage this year would be much bigger.

For the euro area, the ECB recently came out with new forecasts. The ECB forecasts a decline this year of 8%, followed by 5% GDP growth next year and 3% in 2022. That would mean that in the second half of 2022 Europe would be back at 2019 levels. In the circumstances, that is probably not bad, but it requires all the action taken at the national and European level to get there.

Not every member state is able to take the same amount of action as others. All euro-area member states realise how important it is to protect the single market and to avoid excessive divergences in the monetary union. The facilities put in place at the European level were all deliberately designed such that they helped more those countries most affected by the crisis. That is a new approach and a new degree of solidarity, as well as a very positive result from what has happened this year.

However, not everything is well. In the medium-term there are four elements that could cause worry about growth in the longer term. First, potential growth will probably be lower after the crisis than before the crisis. That is a normal phenomenon after almost every crisis: potential growth is lower because physical and human capital is destroyed. There will probably be lots of bankruptcies this year and next year that are currently prevented by these guarantees and fiscal action. Capital will be destroyed, and unemployment will increase.

Consumer behaviour is changing. Savings rates are up in all member states by six percentage points on average. Different countries traditionally have different savings rates, but it is striking that all of them are up by six percentage points this year. That means less demand, which is understandable on an individual basis. People have more precautionary savings, given the uncertainty about the pandemic and employment prospects. For the economy as a whole, however, it is bad. That is one reason why governments have to step in. Investors will also be more reluctant, given the uncertainty. The same phenomenon took place after the global financial crisis, whereby investors were shocked and saw continued uncertainty, so they invested less than they had planned to do when talked to last year or in January this year. All of that is bad for longer-term growth.

Second, world trade is collapsing this year and has not done very well over the last five years anyway. Deglobalistion has been happening and it will continue. Supply chains are being shifted back to Europe, which may be positive for some countries that benefit from it in the long run, but less world trade means less competition, and economists know that less competition means less productivity gains. It is unavoidable. With smaller productivity gains, potential growth will be lower than before the crisis.

The third element is the European banking system. Christian Sewing was absolutely right to say that banks are stronger today than they were 10 years ago. They were not the cause of this crisis and, in fact, they are helping to overcome it. Compared to US and Asian banks, profitability is low. Provisioning will have to go up because non performing loans (NPLs) will go up with the collapse in GDP; this will not happen immediately but over time, when insolvencies are coming. This means that banks may not be able to provide the financing that is really needed to finance the upswing over the longer term, which is also not very positive.

Finally, fiscal deficits are very high. Public debt will go up probably by 30 percentage points, which is not good for future growth. There is enough economic research on that. It is unavoidable. These are the longer term worries and one should be under no illusion. It is all the more important that, against that background, Europe does everything possible to follow a reform agenda, to emphasise competitiveness and to bring up potential growth.

In that sense, it is very promising that the recovery fund agreed in July will be linked to reforms. It is not a kind of troika conditionality but, in cooperation between the Commission and member states, there will be agreement on the reform and resilience agenda. This is absolutely key, given the crisis, but in terms of these longer-term concerns this is the only way to bring up potential growth. The key point here is that all the money, which is more than has been available for a long time, is really implemented in a very productive way.

The final point is that Europe should not forget about all these problems and that it needs to implement the agenda for deepening monetary union. Europe has come a long way in the last 10 years, but the remaining agenda that Richard Gnodde and Christian Sewing already talked about is there. It is being discussed. The Eurogroup will discuss tomorrow the finalisation of ESM reform, which would bring in the backstop for the Single Resolution Fund (SRF), an important part of Banking Union. The other missing element is a deposit-insurance scheme, which is still controversial but under discussion. The backstop is important in terms of the question of whether Europe will bring this backstop forward from 2024 by at least two years, which it will try to do. Completing the banking union with the backstop and deposit insurance is one important item.

The other aspect is Capital Markets Union (CMU), which is high on the agenda. It is also a really important element to strengthen potential growth. Better allocation of capital could be a key element to bring up potential growth and finally move away from the 27 national financial markets to one unified European financial market. Another element that remains controversial is the fiscal capacity for macroeconomic stabilisation. This is one of the remaining elements to complete monetary union.

One element where Europe is making good progress is the euro safe asset. Following decisions taken in the last six months, the European debt issued by the Commission, the EIB and the ESM will go up from €800 billion currently to about €2 trillion. That is an important chunk of safe assets. Together with the sovereign debt of highly rated member states of the monetary union, the EU will have safe assets equivalent to 40% of euro area GDP, which is much better than the 20% it had in the past, but still far below the 90% found in the US.

David Wright

David Wright agrees that the progress has been remarkable. His article in the Eurofi magazine very much stresses that point. He asked Klaus Regling where he sees risks building up, whether he is worried about commercial property, and whether he thinks small tourist-related types of businesses, the collapsing of travel, and changing consumer patterns could lead Europe to a concerning macro situation.

Klaus Regling

Klaus Regling stated that certain sectors will be seriously hit and will not recover to their previous strength. The expectation is for GDP to be back to its 2019 level in the second half of 2022; that may well happen, but behind that is a strong distortion in that certain sectors will not be back to their old levels. Everything to do with tourism, travel, restaurants, hotels, hospitality, the culture industry and airlines will not return to their old levels in 2022. Other sectors such as IT will do well. There will be insolvencies in sectors and Europe will need to deal with that. They are unavoidable because there is a structural break and consumer behaviour is shifting in response to that.

With all the fiscal action, however, member states have found a good way to deal with that. It does not help every individual and every company, but the longer-term problems are more concerning, which are not discussed so frequently. They are beneath the immediate problems, but the concern is right that this leads to lower potential growth.

Didier Cahen

Didier Cahen noted that Klaus Regling rightly said that markets were impressed by the speed, volume and cooperation among EU institutions, and asked him to explain Europe's inability to move forward so rapidly on Banking Union and Capital Market issues.

Klaus Regling

Klaus Regling responded that Europe will make progress on Banking Union and CMU. In the area of CMU there are technically complex issues that need to be resolved and which cannot be resolved within a few months, such as harmonising certain parts of national insolvency parts. That is much more difficult than sitting together overnight with finance ministers and saying, 'We will now spend €300 billion.' That can be done quickly, but some of the complex technical issues of CMU require a lot of technical work. Some of it is not even politically very controversial but it is very complex, so it takes time. On Banking Union, the hope is that some progress will be made tomorrow in the Eurogroup on the backstop.

Didier Cahen

Didier Cahen noted that Klaus Regling said that member states would like to avoid economic divergence between member states, but with the crisis the economic divergences between member states are increasing significantly, given that they came to the crisis with different fiscal positions. He asked Klaus Regling how Europe avoids these increasing economic divergences, as can be seen notably in the fiscal position of member states.

Klaus Regling

Klaus Regling commented that divergences would have been much worse without the actions that had been taken. The decisions were right to focus on that. From the first decision in April, the euro area always said that it needs to design these programmes in a way that member states most affected by the crisis get more help. That needs to be implemented now, which requires good implementation in individual member states.

The same is true for the recovery fund. Countries will get a lot of money; Italy will get €206 billion over three years, and the Italian Prime Minister is fully aware of that. He spoke for 10 minutes at the Ambrosetti forum a week ago about the challenge for Italy in using that money, which has never been provided to Italy in such a volume by the EU, in a way that is productive and leads Italy out of this long period of low productivity gains. That needs to happen now. Up until now decisions have been taken that can make that possible, but implementation is key.

David Wright

David Wright stated that he had spent many years listening to Klaus Regling at the Economic and Financial Committee when he was its Director General, and he always admired his ability to be precise, clear, convincing and optimistic. He thanked Klaus Regling for his time. ■

Klaas Knot

President, De Nederlandsche Bank

Relaunching growth in Europe together

Ladies and gentleman,

More than six months after the outbreak of the Covid-19 pandemic, it is clear that the virus has pushed the global economy into deep recession. The European economy has not been spared. What I am particularly concerned about is that the ability to recover from this blow is far from equal across euro area member states. This crisis has thereby re-emphasized the challenges to our Economic and Monetary Union. Challenges that are posed by a creeping divergence in productivity growth, competitiveness and per capita income between member states.

Although many of you may share my concern, the urgency is not felt by everyone outside this room. Therefore, today I would like to argue why I think growth divergence in the euro area threatens to undermine the benefits of European cooperation. And I will outline how I think we can successfully overcome this challenge.

Challenges of the single currency

Indeed, the economic benefits of European cooperation are still convincing. Take the European single market. A wide body of research shows it has clear benefits for each and every member state, with small, open economies the Dutch one benefiting most.

Also, there are still strong economic arguments in favor of our common currency. A single market like the European market, where there is intensive trade between countries, benefits from the absence of exchange rates. The success of the single market is therefore built on the bedrock of the euro.

But we have seen that a single currency also brings disadvantages. Certainly for a group of countries that differ quite a bit from each other economically. Until now the euro has not lived up to its promise of bringing sustainable economic convergence. In fact, we have seen the opposite. As devaluations are no longer possible, countries with lagging productivity growth can only restore competitiveness through wage moderation. But even in competitive countries like Germany and the Netherlands, wage growth is already muted. Structurally undercutting German and Dutch wage growth is therefore easier said than done.

You could say that the euro always gives a little boost to the more productive, more competitive economies in the north. To southern economies where productivity growth is generally lower, the euro is a relative burden.

That is why the more productive and the less productive economies have a tendency to diverge. If this imbalance persists for too long, it will lead to problems like we saw during the 2011 European debt crisis, when several member states experienced major financial problems and all of us went through a deep recession.

The euro crisis taught us that we cannot just abandon struggling euro area member states to their own fate. So, as long as the phenomenon of divergent growth exists, more productive economies will occasionally have to step in to help the less productive ones. But it would be even better to tackle the root cause of this growth divergence. These differences between north and south are not after all a God-given natural phenomenon. It is an uncomfortable observation that in recent years, that some even characterized as euro boom years, many opportunities for economic reform have been missed.

Covid-19 crisis as a challenge to Europe

On top of this we now all have a new crisis to contend with, the Covid-19 crisis. What is particularly cruel about this crisis—and I might add hazardous for Europe—is that the most vulnerable economies in the euro area have been hit the hardest. Consequently, their government debt will rise even further. Market concern about their debt levels may force these countries to start cutting their deficits before their economy has been able to recover. Which could further exacerbate economic divergence between euro area member states.

In time, this could undermine public support for the euro. To this day, public support for the single currency remains high. But can we take it for granted that it will stay that way? Southern Europe currently reaps relatively little benefit from the euro. And in northern Europe, people often feel they are being called on to bail out their Mediterranean partners. Moreover, within the more prosperous member states the benefits are not always shared evenly. In my own country, for instance, businesses have benefited greatly from the single market and the euro. Due to lagging wage growth and an increasing tax burden, however, the benefits for households are less pronounced. If a large proportion of them start to see "Europe" first and foremost as a private party for businessmen, with scant benefits for their own pockets, then that will undermine support for the European project.

I think that is something we should all be worried about. Also, because Europe is about so much more than just the financial benefits. Take the shifting geographic balances of power, the refugee crisis, the climate crisis. You don't have to be a Europhile to understand that we can tackle these transnational challenges better at European level than at national level. These challenges call for European cooperation within a strong European Union. And this is inextricably linked to strengthening the foundations of our currency union. I am convinced this is perfectly possible. We designed our monetary union ourselves, including its flaws. And that means we can also fix it ourselves, if we want to.

Policy for Europe

There are three things I believe we need to do for that to happen. The first is to fight this Covid-19 crisis collectively and effectively. This summer, European leaders wasted no time in setting up a European recovery fund. An excellent initiative. What's very important is that the recovery fund is intended to support public investments that strengthen economic growth potential also in the financially more constrained member states. The recovery fund prioritizes investments in digitalization and a climate-neutral economy. That way, we can kill two birds with one stone: we narrow the gap between those leading the way and those lagging behind, and we invest in the sustainable growth capacity of the euro area. It is also important to note that the fund is temporary. There are no direct transfers between countries. Nor do countries assume responsibility for each other's debts.

While this fund is an important step, it is not enough. And this brings me to the second item on my list: we will also have to coordinate fiscal policy more closely. In recent years, European fiscal rules have been focused on the 3% limit for the budget deficit. As a result, the rules have been strict during bad times, and ineffective during the good times. I therefore think we need to pay more attention to public debt levels. The Maastricht Treaty's 60% debt limit must regain prominence. It is a recognizable benchmark, and allows member states the room to temporarily increase their debt during economic downturns. However, the pace at which countries are required to return to below this limit, must vary more than it did in the past. The individual economic situation of a country must be taken into account. During economic upswings, countries with higher debt levels should have to make greater efforts to reduce their debt than countries with lower debt levels.

In reducing public debt, we should put more emphasis on reforms that enhance economic growth. Rather than the spending cuts and tax hikes that often initially constrain growth. If austerity is unavoidable, fiscal rules should at least protect public investment.

The third point on my European to-do list is to improve coordination in other areas of economic policy. To effectively tackle the divergent competitiveness in the euro area, all member states must play their part. Less productive economies need to implement reforms and investments that increase their productivity and competitiveness. This has obvious benefits for exports, economic growth and employment. And it decreases the productivity gap with more productive economies. These reforms are, however, more likely to succeed if the stronger economies also do their fair share. Large and persistent trade surpluses often hide underlying problems, such as corporate savings retained for tax reasons, or stagnant wage growth. Reforms aimed at increasing households' purchasing power would therefore not only increase welfare in the more competitive member states, but also make life easier for the more vulnerable ones.

But let's be realistic: such reforms will take time. Even with the right policies in place, it will still take decades for many member states to get to where they need to be. In the coming years, countries with high levels of public debt will unlikely be able to weather another serious downturn without implementing far-reaching budget cuts and tax hikes. These countries then risk falling even further behind. Which would again overshadow our objective of creating a stronger and more coherent monetary union. The best way to deal with this, is something we will have to continue reflecting on.

I certainly do not have all the answers. But I do believe that the agenda I have outlined would put us on the way to a stronger currency union. With European governments investing in sustainable growth, both jointly and individually. Through more closely aligned economic policy.

More European integration is not a popular message nowadays, I realize that.

We could also choose to abstain from further European integration. That's also an option, certainly. But there is a price to pay for that option. The price involves continued economic divergence between euro area member states, more debt crises, more emergency support and lower levels of prosperity. Would the euro survive such a scenario?

All the same, we are living in a different Economic and Monetary Union than we imagined back in the 1990s. With more sharing of risk. And more harmonization of policy. In recent years we have pushed the boundaries of the Treaty. There is no guarantee we will not have to do that again. So it is equally crucial to reaffirm the political mandate. It is up to politicians to state their convictions, and present them to voters in a clear and consequential fashion.

If we want to achieve a strong, well-functioning and sustainable Europe that works for all of us, then we must be willing to do what it takes. It requires us to better harmonize our economic policies, and to jointly invest in sustainable growth. Firmly based on member states assuming responsibility for putting their own house in order. With the realization that all member states must do their bit. And with the prospect of creating a better future for us all.

Thank you. ■

François Villeroy de Galhau

Governor, Banque de France

Macro-economic and monetary challenges - towards a stronger economic union post-Covid?

Ladies and Gentlemen,

It is a pleasure to be back together with you today. I would like to extend my warmest thanks to Didier Cahen and David Wright for having literally moved mountains to make this meeting possible! And today no place could be better than Berlin: three decades ago, the fall of the Berlin Wall injected new impetus into the construction of Europe. More than ever, we need the "Berlin Spirit" back as the European project is facing another decisive moment.

In the last months, the famous words of Jean Monnet have been often and even overly quoted: "Europe will be built through crises and it will be the sum of their solutions" [1]. Once again, this paradox seems true. I will briefly argue that Europe has so far faced the stress test successfully (I). But there is less room than ever for complacency. I will then sketch the broad outlines of an effective and collective exit strategy built on four cornerstones (II).

I. Europe in the face of the Covid crisis

The Covid-19 crisis has been an unprecedented "stress test" for the European project. The health shock has affected European countries to varying degrees, but the economic shock has been more symmetrical due to the restrictive measures that have ended up being substantial in all countries. For 2020 as a whole, the recession is expected to be widespread in Europe (–8 % for the euro area as published yesterday). Nevertheless, asymmetric factors – such as the size of the different national stimulus packages – could increase the divergences between the main euro area countries. As a result, a coordinated response was and remains necessary at the European level.

And indeed, strong, rapid and convergent responses were implemented. Faced with the threat of a financial crisis, the Eurosystem was able, with other central banks, to act quickly and effectively to avoid it. This is no self-congratulation: it was a pragmatic response to two preexisting fears. First, that central banks would "run short of ammunition": on the contrary, from as early as March and in the space of a week, our Governing Council took the strongest measures in the history of the euro and provided immediate and virtually unlimited liquidity.

On our last Governing council, let me be more serious than some surprising stories we read yesterday, and sum it up following Christine Lagarde in three points:

- Our economic forecasts are slightly better for 2020 than expected in June. The recovery definitely follows a "bird's wing" profile, with a sharp rebound between May and August and then as expected a more gradual catching-up till 2022.
- Inflation, even if only temporarily negative, remains subdued. And hence we will maintain our very accommodative monetary policy for as long as needed. Steady hands and free hands: we keep all our options open, and we will be ready to do more if appropriate.
- We don't target exchange rates. But obviously the exchange rate does matter for inflation and monetary policy. And accordingly we will carefully monitor developments in the exchange rate, with regard to its implications for the medium-term inflation outlook.

The second fear, and this was ours, was that monetary policy would be "the only game in town".

The Eurosystem has long wanted Europe's economic policy to rely also on an active fiscal policy. The somewhat hard-won but impressive Brussels agreement of 21 July is a major step forward. It is an unprecedented act of solidarity towards the countries most affected by the Covid crisis, and for the first time final expenditure – up to an amount of EUR 390 billion – will be financed by a shared debt instrument... that is more than twenty times more than the previous proposal for a Budgetary Instrument for Convergence and Competitiveness (BICC). It does not mean the end of the debate: some insist that this budgetary agreement must remain exceptional and temporary in nature; others, on the contrary, are hoping for a "Hamiltonian moment", politically, and an economic quantum leap towards a genuine common fiscal stabilisation tool. I would tend to support the latter view, but with strong caveats and provisos regarding the necessary responsibility of national fiscal policies. Nevertheless, it is too early to tell: let us welcome this Brussels breakthrough, implement it efficiently, and prepare for an effective exit strategy.

II. A strong Economic Union: the four cornerstones of an effective exit strategy

This success should not lead to complacency. After the emergency phase, we are now entering the challenging crisis exit period. The timing is delicate: obviously, we should not

[1] Mémoires, 1976 p. 488.

phase out too early, and create cliff effects as in 2011–12. Nor should we, conversely, create a lasting addiction to public expenditure and public debt: this danger seems greater today in Europe. There is indeed no magic bullet, and – at the end of the day – the debt inherited from the crisis will need to be financed through growth and through our collective work. In this respect, I believe that an effective and collective exit strategy should combine four cornerstones. They have one feature in common: the building of a strong Economic Union. We all know this remains the missing counterpart to our successful Monetary Union.

The first priority should be to provide, through our significant public investment, genuine and lasting "value-added". European value-added thanks to additional investments that have positive cross-border effects. If I had to express one regret concerning the Brussels Recovery Plan, this would be the withdrawal of the EUR 46 billion dedicated to new cross-border investments and to support the solvency of European companies. And value-added for the future: Mario Draghi quietly forged the telling expression of "good debt". Expenditure at national level should be used for productive purposes and for young people: education and training, research. That is not yet a given!

The second cornerstone will be an improved capital markets union (CMU). We all know here that the euro area has the world's biggest surplus of savings relative to investment, amounting to EUR 360 billion last year. A better allocation of European private savings requires, as often advocated in Eurofi, the combination of a more effective Banking Union and a "Capital Markets Union", to make a genuine "Financing Union for Investment and Innovation". European governments all agree in principle; but so far it remains a blind spot in the recovery strategy. Let us at last turn words into action. Moreover, Brexit leaves us with no other choice: we must build a real and polycentric "financial Eurosystem", including – let me stress it – for CCPs which are systemic. It is a matter of financial stability, and furthermore of economic autonomy or sovereignty, call it what you want.

Strengthening our single market is the third cornerstone of our strategy. Europe does not sufficiently promote its single market, which is – alongside the single currency – our most precious asset. We see it with Britain's demands, which are numerous and excessive. Let us all, starting with the richest – and sometimes "frugal" – countries in our Union, remind ourselves of its benefits, which in turn underpin a legitimate demand for solidarity. But, while national governments did well in the acute phase, different national responses could create an "uneven playing field". A single market – which is in the interest of all Member States – means common rules for corporations: if not, our economies unfortunately risk further fragmentation. Thus, the European rules on state aid should be rapidly re-established to preserve the single market. Let us also unleash the single market's full potential by combining its strengths much better: free trade + financing + norms. Our normative power should boost innovation: take the example of the General Data Protection Regulation (GDPR) where Europe is leading the way.

Finally, the ecological transition should under no circumstances become a casualty of the crisis: our exit strategy cannot be aimed at preserving yesterday's world. The carbon market EUETS has led to a CO_2 price that is unfortunately too low, at nearly 25 € /tCO_2eq in 2019[2], to lead to sufficient GHG emission reductions. As set out in the Brussels Agreement, a "carbon border adjustment mechanism", associated with a revised ETS scheme, deserves our full support. This carbon border adjustment could restore fair competition between European industrial production and imported products with a higher carbon footprint. The success of such an instrument depends on its ability to adapt to the laws in force (WTO).

In this fight against climate change, our monetary policy will play its part: Christine Lagarde announced it, and this will be a significant difference between our own "Strategic Review" and that of the US Fed. We could implement our climate decisions in no more than 3 to 5 years, and hence be a pioneer among major Central banks. But, here again, and even more so, monetary policy cannot be the only game in town, and cannot perform miracles in the absence of consistent tax and sectoral policies.

The pandemic has shaken many of our previous certainties. One thing is sure, however: we can get over this shock. But the solutions to the current challenges cannot simply rely on the same "old tricks": the European reconstruction cannot be a mere restart in each Member State. We will only succeed if we reshape our common project around the four positive changes I just mentioned. Then this harsh crisis will also have been an opportunity to transform towards a more innovative and sustainable economy. This unstable and dangerous world of 2020 needs Europe.

Let our ambitions measure up to this. Thank you for your attention. ■

[2] Bureau des Marchés du carbone – DGEC – Ministère de la Transition écologique et solidaire

Isabel Schnabel

Member of the Executive Board,
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The shadow of fiscal dominance: Misconceptions, perceptions and perspectives

The euro has been built on the principle of *monetary dominance*.

This means that the European Central Bank (ECB) pursues its monetary policy objectives, as defined by its mandate in the European Treaties, without being constrained by other considerations. This principle was buttressed by granting the ECB statutory independence. The ECB is said to be one of the world's most independent central banks.

At the time of the Maastricht Treaty, high government debt was seen as a major threat to central bank independence, and it was feared that *fiscal dominance* could induce a central bank to deviate from its monetary policy objectives, endangering price stability.

This was not just idle speculation. History is full of examples of high government debt eventually being resolved through higher inflation and financial repression.[1]

The Stability and Growth Pact was designed to ensure that governments would pursue sound fiscal policies and that public debt would remain low and stable, or at least converge to such levels in a gradual and credible manner. The fiscal framework of the European Union was meant to shield the ECB from fiscal dominance and protect its independence.

In the eyes of some observers, the legacy of the 2008 global financial crisis, together with the far-reaching repercussions of the coronavirus (COVID-19) pandemic, is now threatening to undermine the consensus model of monetary dominance, not just in the euro area, but globally.

According to the International Monetary Fund (IMF), general government gross debt in advanced economies increased from 71% of GDP in 2007 to 105% last year, and is projected to rise to 132% by the end of next year. In the euro area, it increased from around 66% in 2007 to 84% last year and, provided the crisis does not deepen much further, will likely stabilise at around 100% next year, well below the average level of advanced economies.

But aggregate figures often mask large underlying heterogeneity. In some euro area countries, public debt will increase to levels well above 100%.

Rising indebtedness implies that governments will need to roll over increasing amounts of debt, on top of the need to finance newly issued debt. ECB staff estimate that the gross financing needs of euro area countries will likely reach 24% of GDP this year alone and remain elevated for a considerable period of time, likely for longer than in the aftermath of the global financial crisis.

Concerns about the state of public finances have been reinforced by structural headwinds related to the worsening demographic outlook in many advanced economies and to the material public investment needs associated with financing the transition towards an economy that is environmentally sustainable.[2]

The newly launched European recovery fund has helped alleviate some concerns about the impact of the pandemic on sovereign debt levels in the countries hit hardest by the crisis, which tend to be those with the highest public debt levels.

Yet, the euro area is still far from being a fiscal union. And even if it were, there would still be the question, as in other advanced economies, of whether rising debt has jeopardised, or will jeopardise, monetary dominance and, as a result, central bank independence.

Indeed, some observers have taken the launch of the asset purchase programme (APP) and, more recently, the pandemic emergency purchase programme (PEPP) as a sign that the ECB has started monetising sovereign debt at the expense of its primary mandate of price stability.

They accuse the ECB of undermining fiscal discipline by keeping interest rates artificially low and of assuming powers that the European Treaties reserve for national governments.

Deviations from the capital key under the PEPP are interpreted as tailoring monetary policy towards the most highly indebted euro area countries, in order to ease their debt burden and avoid destabilising the currency union as a whole.

These claims are not new. Central bank independence was already coming under close scrutiny before the pandemic, not only in the euro area.[3]

[1] See Reinhart, C.M. and Sbrancia, M. (2015), "The liquidation of government debt," *Economic Policy*, Vol. 30, No 82, pp. 291-333.

[2] See Nerlich, C. (2018), "The 2018 Ageing Report: population ageing poses tough fiscal challenges", *Economic Bulletin*, Issue 4, ECB; Dieppe, A. and Guarda, P. (eds.) (2015), "Public debt, population ageing and medium-term growth", *Occasional Paper Series*, No 165, ECB; and European Commission (2019), "United in delivering the Energy Union and Climate Action - Setting the foundations for a successful clean energy transition", 18 June.

[3] See The Economist (2019), "The independence of central banks is under threat from politics", 13 April.

I would like to structure my remarks in three parts.

The first part deals with the misconception that the ECB's policies constitute a form of "financial repression".

The second part discusses the disciplinary function of sovereign bond markets and provides evidence that it has not been lost in the wake of the ECB's unconventional policies. I will also argue that market failures imply a role for central banks in stabilising government bond market in times of stress.

The third and final part opens up perspectives on the changed interactions between fiscal and monetary policy in a low-interest-rate environment and what it implies for the longer term.

ECB policies do not constitute "financial repression"

The term "financial repression" typically refers to policy measures that aim at keeping interest rates artificially low, making it easier for governments to finance their debt.

Financial repression can take many different forms, such as restrictions on capital movements or direct interest rate controls. More recently, however, the term is increasingly being used with respect to central bank policies, including asset purchases and negative interest rates.[4]

History teaches us that financial repression typically crowds out private investment and thereby leads to lower growth and employment.[5]

But research shows that the opposite has been true for the euro area since the start of the public sector purchase programme (PSPP) in 2015. ECB staff estimate that, in the absence of our sovereign bond purchases, as of the end of last year, real GDP growth would have been around 1.4 percentage points lower.

In other words, without the positive effects of our measures on growth and inflation, the public debt ratio in the euro area would have been notably higher. By contrast, the impact through lower interest rate expenses – which is often at the centre of debate – has, on aggregate, been comparatively small. These effects are clearly visible when looking at the counterfactual paths of government debt in the euro area.

Monetary policy is not guided by the wish to lower the public debt burden but by its mandate of price stability. There is, in fact, no evidence of a feedback loop from sovereign debt developments to monetary policy decisions.

First, there is no systematic relationship between government bond issuance and the amount of bonds that we purchase in the secondary market.[6] Rather, our measures aim to deliver financial conditions that are consistent with a return of inflation to our medium-term aim.

Sovereign bond issuance is one factor that affects these conditions.[7] But there are many other factors, such as the nominal growth outlook or sudden swings in investor risk appetite, that may cause a shift in financial conditions, thereby posing a threat to price stability and inducing monetary policy action.

Second, our monetary policy stance is not directly related to the level of sovereign debt. One, albeit blunt, way to gauge the appropriateness of the policy stance is to consider simple Taylor-type policy rules.

Although such rules neglect the significant uncertainty policymakers face when setting policy, their explicit lack of discretion can be used as a yardstick for assessing whether monetary policy systematically pursues a course of action that is inconsistent with price stability.[8]

ECB research demonstrates that, since the global financial crisis, actual and shadow policy rates – a synthetic short-term rate indicator often used in the literature to also capture non-standard policy measures – have followed a path that is not far from the ECB's reaction function with respect to output and prices, as estimated from Taylor rules over the period from 2000 to 2008.[9]

In other words, the surge in debt after the global financial crisis does not seem to have led to a structural break in the ECB's reaction function, including during the current COVID-19 crisis.

When adding government debt to policy rules as an additional explicit feedback variable, its coefficient is generally not statistically significantly different from zero. This result remains true independent of the estimation sample or the precise specification of the rule.

Finally, under fiscal dominance, where the central bank is constrained in its ability to secure price stability, one would expect medium- to long-term inflation expectations to rise sharply, as the public expects the central bank to monetise debt. This was the case in the 1970s – a time when political interference in the conduct of monetary policy was still widespread and central banks were lacking independence.[10]

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4 See, for example, de Larosière, J. (2020), "Negative interest rates cannot save indebted economies", Financial Times, 20 July.

5 See Jafarov, E., Maino, R. and Pani, M. (2019), "Financial Repression is Knocking at the Door, Again. Should We Be Concerned?", *IMF Working Papers*, No 19/211, International Monetary Fund.

6 On the calibration of the PEPP, see Schnabel, I. (2020), "The ECB's policy in the COVID-19 crisis – a medium-term perspective", remarks at an online seminar hosted by the Florence School of Banking & Finance, 10 June.

7 See Ferreira, T. and Shousha, S. (2020), "Scarcity of Safe Assets and Global Neutral Interest Rates", *International Finance Discussion Papers*, No 1293, Board of Governors of the Federal Reserve System; and Ehlers, T. (2012), "The effectiveness of the Federal Reserve's Maturity Extension Program – Operation Twist 2: the portfolio rebalancing channel and public debt management", in Bank for International Settlements, "Threat of fiscal dominance?", *BIS Papers*, No 65, pp. 245-255.

8 See Woodford, M. (2003), *Interest and Prices: Foundations of a Theory of Monetary Policy*, Princeton University Press.

9 During this period, ECB policy is estimated to have exhibited desirable stabilising properties. In other words, estimated rules have generally been found to be consistent with the Taylor principle. See Blattner, T. and Margaritov, E. (2010), "Towards a robust monetary policy rule for the euro area", *Working Paper Series*, No 1210, ECB. Shadow rates are an imperfect and highly model-dependent gauge of the overall monetary policy stance. The measure used here is one example of that rate, based on Lemke and Vladu (2017), while the range of estimates in the literature is fairly wide (see, for example, Wu and Xia, 2017).

10 A systematic collection of inflation expectations for the euro area is not available for the period before 1990. The chart shows private sector estimates for the United States that build on research by the Federal Reserve Bank of New York. See Groen, J. and Middeldorp, M. (2013), "Creating a History of U.S. Inflation Expectations", *Liberty Street Economics*, Federal Reserve Bank of New York.

Today, however, financial markets and survey data do not suggest that people expect inflation to accelerate. Although inflation expectations have recovered from their record lows, they remain well below the levels that we would consider consistent with our medium-term aim of below, but close to, 2%.

Too low rather than too high inflation remains the main predicament of our times.

The disciplinary function of markets has not been lost

Let me now turn to the question of whether sovereign bond markets are still performing their disciplinary role, in spite of the ECB's asset purchases.

Although interest rates have fallen broadly across advanced economies in recent years, risk premia in euro area sovereign bond markets have not disappeared.

Today, for example, 10-year yield spreads on Italian government bonds over their German equivalents are higher than when the ECB started to purchase government bonds in early 2015.

They also remain responsive to idiosyncratic news. The marked response of Italian sovereign bond yields to the 2018 episode of political instability, which by the way was not countered by monetary policy, underlines the disciplinary role played by financial markets.

And when spreads have fallen, this often reflected improvements in fiscal fundamentals and relative growth performance.

Take Portugal as an example. Its sovereign bond spreads have dropped substantially since 2017.

This went along with substantial improvements in fundamentals. Portugal's budget balance turned from a deficit of -4.4% of GDP in 2015 to a surplus of 0.2% in 2019.

Portugal also outperformed most of its euro area peers in terms of growth: between 2014 and 2019, its economy expanded by almost 13%, compared with 7.5% in Germany. Only in Spain, where spreads have also fallen, growth was even higher over the same period.

Euro area government bonds also consistently trade in line with their international peers when taking into account credit risk. On average, the risk premia of euro area government bonds are relatively close to those of other advanced and major emerging market economies.[11]

Similarly, bond purchases by the ECB have not dampened the price discovery mechanism.

The sensitivities of euro area sovereign bond yields to macroeconomic surprises and changes in financial market risk remain far removed from the complacency that characterised financial markets in the run-up to the global financial crisis.

At the same time, the overhaul of the euro area crisis management framework, including the establishment of the European Stability Mechanism (ESM) and the creation of the Single Supervisory Mechanism (SSM), has succeeded in reducing the excessively high sensitivity that prevailed during the crisis years.

Hence, markets remain vigilant even though central banks have taken a more prominent role in government bond markets.

One important reason why financial markets are able to play a prominent role in the price discovery mechanism is that the net bond supply in the euro area is still ample.

The bond free float – that is, the share of bonds held by investors other than the Eurosystem – currently amounts to close to 80%, comparable to the level observed in the United States before the outbreak of the pandemic. It has not declined significantly in the wake of the launch of the PEPP, as new issuances have injected fresh liquidity into the market.

But financial markets are neither always rational, nor efficient. They can be prone to panic and instability.[12] Acute periods of market stress can drive a considerable wedge between a country's cost of borrowing, as justified by economic fundamentals, and actual financial conditions, giving rise to self-fulling price spirals.

Such periods of turmoil – if left unaddressed – can quickly turn a liquidity crisis into a solvency crisis, giving rise to huge costs for society as a whole. Central banks are best placed to protect the public from such destabilising forces.

In the euro area, the ECB can only be a lender of last resort to financial institutions. The Treaty explicitly prohibits monetary financing of public debt.

But the ECB can, and should, provide liquidity when the market fails to coordinate and when the risk absorption capacity of financial market participants is severely constrained. Central bank interventions quickly instil confidence and allow the market to coordinate on the "good" equilibrium once the initial fog of panic and fear has lifted.

A prime example is the announcement of outright monetary transactions (OMT) in the summer of 2012. The "whatever it takes" speech by Mario Draghi constituted a coordination device and thereby calmed markets, whereby the euro area gained precious time for reforms.

The announcement of the PEPP in March of this year operated similarly: it built a bridge for the historical response of euro area governments to this crisis and supported market functioning at a time of exceptional uncertainty.

In such situations, when yields are largely reflections of panic rather than fundamental factors, risks of moral hazard are negligible and should not prevent the central bank from acting forcefully.

The changed interaction between fiscal and monetary policy

My final point relates to how the broader macroeconomic environment has led to a change in the way fiscal and monetary policy interact.

When the ECB was established in 1999, central banks had ample policy space and the experience from previous decades had demonstrated that the short-term interest rate was an effective instrument to steer inflation over the medium term.

Today, many central banks, including the ECB, find themselves in a very different environment. Slowly-moving structural factors, such as lower trend productivity growth, an ageing society and global excess savings, have led to a long-term decline of the real equilibrium interest rate. Therefore, conventional monetary policy has much less space to stabilise the economy when required.

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[11] In the case of Greece, although overall debt is considerable, the share of debt held by private sector participants is comparatively low, which is likely to affect market pricing.

[12] See ECB (2014), "The determinants of euro area sovereign bond yield spreads during the crisis", Monthly Bulletin, May.

As a result, years of weak aggregate demand have forced central banks to introduce a wide range of non-standard monetary policy tools. Although these tools have proven quite effective in stimulating the economy, it is feared that their adverse side effects may increase the more intensively they are used and the longer they are maintained.

In short, the effective lower bound on interest rates has become a feature of our monetary policy.[13]

This has three important consequences.

The first consequence is that fiscal policy has become more important as a macroeconomic stabilisation tool. When natural rates are low and policy rates are constrained by the lower bound, a more accommodative fiscal policy is needed to lift the economy out of a low-growth, low-inflation trap.

The current pandemic crisis is a case in point. Fiscal expansion is indispensable at the current juncture to sustain demand and mitigate the long-term costs of the crisis. Monetary policy can complement these efforts. But by itself, it may not be sufficient to stabilise the economy. This is all the more true if different sectors, or regions, of the economy are affected in different ways.

In such times, it would be wrong to constrain fiscal policies today to protect monetary dominance tomorrow. Quite on the contrary, using fiscal and structural policies more actively in the current environment may foster central bank independence.

The reason is that such policies may boost potential growth and thereby increase monetary policy space in the future. Moreover, a countercyclical fiscal expansion may result in lower rather than higher government debt in the longer run.[14]

Calling on fiscal policy to play a more active role in macroeconomic stabilisation is not to be confused with modern monetary theory, which denies the government's intertemporal budget constraint. Once the economy has recovered and is back on a sustainable growth path, fiscal policy should take a backseat again and regain policy space.

The second consequence is that fiscal policy has not only become more important, but also more effective.

There is a wealth of research showing that fiscal multipliers are larger at the effective lower bound.[15] One reason for this is that fiscal stimulus normally triggers expectations of a tightening of monetary policy, while at the lower bound investors anticipate a prolonged period of low interest rates, thereby accommodating the fiscal response.

The third consequence is that, all other things being equal, the cost of debt has fallen.[16]

The extent of this drop has been such that countries may no longer need to run primary budget surpluses to stabilise or reduce their debt burden over time as long as interest rates are lower than nominal growth rates.

As a result, welfare costs of higher debt may be lower today than they were in the past, even more so when public funds are used for investment addressing growing economic externalities, such as climate change or the slow diffusion of new technologies.

But we cannot, and should not, take for granted that current financial conditions will continue indefinitely.

Interest rate–growth differentials have fluctuated widely in the past. Periods with negative "r-g" have often been followed by periods with positive "r-g", with measurable consequences for the cost of debt.[17]

The ECB will be careful to not choke the incipient recovery by initiating a tighter policy too early. But when the crisis has been overcome and inflation has returned to a sustained path towards our aim, the ECB needs to step back, in line with its mandate, and in line with its symmetric target, as it did towards the end of 2018 when the Governing Council decided to end net asset purchases.

This implies that governments will have to make a credible commitment to regain fiscal space once the economy has recovered from the crisis. Debt levels remaining too high for too long will hurt growth and make the euro area more vulnerable. In the past, many countries failed to take advantage of the good times to create a sufficient amount of policy space.

There are two broad and complementary ways to address high debt: by boosting potential growth and by cutting budget deficits. Both will have a role to play.

But there is a clear hierarchy in the sequence: governments must give clear priority to boosting potential growth by directing spending towards productive investment. Public investment in the euro area has been too low for too long, holding back economic growth.

ECB research demonstrates the beneficial effects of higher potential growth on debt dynamics: an increase in the potential growth rate of 1 percentage point would reduce public debt as a share of output by more than 10 percentage points in some economies.

Fiscal consolidation needs to follow once the recovery has matured. It must reflect the lessons learned from previous crises and should maximise the use of growth-friendly measures.[18]

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[13] See also Schnabel, I. (2020), "Going negative: the ECB's experience", speech at the Roundtable on Monetary Policy, Low Interest Rates and Risk Taking at the 35th Congress of the European Economic Association.

[14] See DeLong, J. and Summers, L.H. (2012), "Fiscal Policy in a Depressed Economy", *Brookings Papers on Economic Activity*, Economic Studies Program, The Brookings Institution, Vol. 43, No 1, pp. 233-297.

[15] See Christiano, L., Eichenbaum, M. and Rebelo, S. (2011), "When is the Government Spending Multiplier Large?", *Journal of Political Economy*, Vol. 119, No 1, The University of Chicago Press, pp. 78-121; and Coenen, G. et al. (2010), "Effects of Fiscal Stimulus in Structural Models", *IMF Working Papers*, Vol. 10, No 73, International Monetary Fund. The chart shows the response to a 1 percentage point increase in the government consumption-to-GDP ratio, which is maintained over two years before reverting back to its steady state value. The public spending increase constitutes a positive demand stimulus, increasing production and raising prices. When the effective lower bound is binding, agents fully and credibly anticipate that the policy rate does not deviate from its current level for 1 year (or 2 years). The policy rate thereafter follows a standard Taylor-rule. At the effective lower bound, the monetary authority does not increase the nominal interest rate so that the decline in the real interest rate supports private consumption and investment decisions, leading to a more positive overall effect on GDP.

[16] See Blanchard, O. (2019), "Public Debt and Low Interest Rates", *American Economic Review*, Vol. 109, No 4, pp. 1197-1229.

[17] The interest rate–growth differential is, of course, not a sufficient statistic to describe debt dynamics. Persistent large primary budget deficits could marginalise the effects of low interest rates.

[18] See ECB (2017), "The composition of public finances in the euro area", *Economic Bulletin*, Issue 5.

Similarly, it should be accompanied by an overhaul of the euro area's fiscal framework – now more than ever. Fiscal rules are still too complicated, too politicised and too procyclical.

The issuance of joint debt in the context of the European recovery plan in response to the COVID-19 crisis has made a transparent and credible fiscal framework indispensable to enable further steps towards European integration. Failure to produce such a framework could once again threaten to undermine confidence in the cohesion of the single currency area.

Conclusion

Taken together, the pandemic has not undermined monetary dominance in the euro area. My remarks today have offered evidence that refutes the claim of financial repression. The ECB's actions remain firmly geared towards its price stability mandate.

I also provided empirical evidence that our unconventional policy measures have not muted market discipline. Risk premia in euro area sovereign bond markets continue to reflect fundamental forces. They are also not materially different from those of their international peers. And when acute periods of stress threaten market stability, central banks are best placed to protect the public from such destabilising forces.

Finally, I have argued that secular trends have changed the interaction between fiscal and monetary policy. Years of weak aggregate demand and a reduction in conventional monetary policy space on the back of the long-term decline in the real natural interest rate have made fiscal policy more important, and more effective, as a tool of macroeconomic stabilisation.

History suggests that society is better off under a regime of monetary dominance. Inflation may not be a serious threat to society at the current juncture. But the factors that motivated central bank independence four decades ago, and the safeguards that were put in place to protect it, remain important pillars of stability and prosperity.

Thank you. ■

Richard J. Gnodde

Chief Executive Officer, Goldman Sachs International

The role of capital markets in supporting Europe's recovery

David Wright

David Wright introduced Richard Gnodde and thanked him for being at Eurofi.

Richard J. Gnodde

Richard Gnodde stated that he would focus his remarks on the role that capital markets can and should play to support Europe's recovery. When he last spoke at a Eurofi event, three years ago in Tallinn, he shared his perspectives on the importance of developing capital markets in Europe. Much still needs to be done, and it is more pressing now than ever. Europe has set out an ambitious roadmap for its future: a world-leading green deal, a comprehensive digital strategy, and the landmark COVID-19 recovery package. Harnessing capital markets and the financing that they can bring alongside a healthy banking system is the only way that these ambitions can be turned into reality.

The last six months have seen an unprecedented economic shock. This was smoothed by central bank support, the action of many healthy banks across the world, including Europe, and remarkably resilient capital markets. Despite volatility being at all-time highs and unprecedented volume levels, the markets coped extremely well; there are fresh highs in the S&P 500, and European equity markets are significantly up from the March lows.

Looking at the European investment-grade index as a barometer, it is now at pre-COVID levels. The index started the year at 44 basis points, peaked at 138 basis points in mid-March and is now trading back at around 50 basis points. Sovereigns and corporates have strengthened their liquidity and capital positions by accessing the global debt and equity markets in very significant scale.

Looking at the primary volumes, investment-grade corporate supply in the euro is up 35% relative to the same period last year, standing at €330 billion to date. This is an important figure because if all of this capital had to come from the banking sector it would have required an incremental €18 billion of bank capital to support these loans; capital markets, working alongside banks, can be highly effective. US dollar issuance has been even stronger, with corporate volumes up 78% relative to the same period last year, and well through $1 trillion in aggregate. Sovereign supply in euros is also 75% higher, and equity volumes also stand at record levels.

Acknowledgment is needed of central bank support, which has been absolutely critical, particularly at the beginning of the crisis, in maintaining functioning markets. The post-crisis regulatory framework held up well and, as a result, the financial sector has been able to be part of the solution to support the recovery. This is a great example of the different components working together, allowing much to be done to help drive the broader economy.

Looking forward, there are two key trends, digitalisation and decarbonisation. Organisations that have been able to leverage technology effectively through the crisis have clearly fared better. For some, this has been achieved by continuing to engage in commerce through digital channels, and others have used technology to drive efficiencies through their businesses. It is very clear that the pandemic will have a lasting impact on consumer behaviour and business models broadly across the economy, including the financial sector.

The need for scale in the financial sector has never been more important, with smaller firms struggling to find the right balance between driving returns and managing costs. Investment in technology is key to having long-term, sustainable business models, but according to PwC, 30% of global financial CFOs are considering cutting IT investment as a result of COVID-19. There is encouragement for the Commission's digital strategy. This is clearly an important initiative that can deliver real innovation, security and resilience, and put Europe on a stronger competitive footing.

Deep modernisation is another megatrend; acknowledgement of President von der Leyen's leadership is needed, with her ambitious green deal, putting Europe at the forefront of the global fight against climate change. Davos showed the focus and energy on the green agenda, and COVID-19 has strengthened the resolve of all stakeholders to tackle this challenge. This is going to be important because the scale of the challenge is very significant. At the height of COVID-19 in the second quarter, when many countries were in full lockdown, daily global CO_2 emissions were down 17% compared to 2019. However, that puts the challenge in context. To meet the two-degree scenario Europe will require a reduction in CO_2 emissions of about 6% every single year over the next 30 years.

Goldman Sachs recognises that, but also sees a very significant opportunity. The market is also seeing this opportunity. Looking at recent equity performance, high-scoring environmental, social and governance (ESG) stocks have outperformed the broader market by an average 5.5% this year, so cost of capital is coming down for companies in this space. Goldman Sachs research, branded Carbonomics, estimates that the decarbonisation of the energy industry alone will require €13.5 trillion of global infrastructure investments by 2030. In doing so, this can create 20 million jobs. This is going to be one of the big political challenges, with scope to achieve two things at the same time: decarbonisation and creating jobs. This can clearly be a key driver of the economic recovery going forward.

There is an abundance of large, low-carbon investment opportunities in the power-generation industry and mobility, and the list goes on. As Europe embarks on the path to become the world's first climate-neutral continent by 2050 it will be vital to have the right regulatory framework in place. An expansion of carbon emissions pricing could provide a dynamic, technology-agnostic incentive to find the most financially efficient solution to climate change. A global approach to this is clearly the best solution.

Putting this together, economic recovery, digitalisation and decarbonisation all need financing. The financing needs of Europe have never been more significant. The green deal would necessitate €7 trillion of cumulative investment between now and 2050. With government balance sheets already stretched, bank balances are clearly not large enough. Based on rough estimates, an additional €1 trillion of bank capital will be needed to finance the green deal between here and the end of the period. It is very clear that a significant part of the financing needs to come from the capital markets. They need to be fit for purpose. Without them, economic recovery will be shallower, longer and harder than it needs to be, and many terrific opportunities will be left on the table.

The good news is that there are a number of developments which will reinforce each other as the industry goes forward, and will provide impetus for the necessary transformation which lies ahead. First, under the recovery plan, the Commission will tap the market over the next few years to the tune of €850 billion, creating a significant long-term, risk-free, AAA-rated debt security for institutional investors and European bank-balance sheets, as well as meaningful boost for European capital markets.

There is a need for scale in the banking sector. The US clearly has it; this is less prevalent in Europe. However, recent developments give some cause for optimism. Intesa Sanpaolo's takeover of UBI created Italy's largest bank. Earlier this month, CaixaBank and Bankia confirmed merger discussions, with the potential to create the largest domestic bank in Spain. Goldman Sachs' research team in Europe covers 55 banks, which are the largest listed institutions and national champions. At the end of Q2 2020, however, 12 of these 55 banks were loss-making. Another 20% make a return below 3% in terms of return on equity, so 40% are clearly yielding very little. Banks are clearly not yet strong enough to sustain a recovery. The banking union needs to be completed and has the scope to create the conditions for a stronger, more efficient sector that is able to support European corporates across the EU and globally.

This brings the discussion back to the CMU. It is necessary for the recovery to be fast paced; the CMU can play a significant role in that, providing an alternative avenue for corporates raising capital and funding at affordable rates. Deeper capital markets would allow for efficient placement of large amounts of debt being issued at an EU level. Of course, more vibrant securitisation markets would enable banks to become stronger and allow them, on a forward basis, to fund the economy. With Brexit, there will inevitably be a rebalancing of market-based financing between the UK and Europe, and a lot of capability and expertise will be located inside the EU. This rebalancing process still has some way to go, which means that European corporates and sovereigns should have access to the true breadth and depth of the UK capital markets for some period of time, without the necessary regulatory hurdles being put in their way. Currently everybody in Europe can access markets in the US, and the same is hoped for in giving them access to the UK.

Developing Europe's capital markets is not just about size, and the ambition should not be solely about replicating what exists elsewhere. It is incumbent on everyone to work together and develop capital markets that cater for what European investors want. Investor flows in the ESG product have grown exponentially over the past five years, up nearly 2,500% between 2014 and 2019. More recently, ESG funds have, year to date, received €63 billion of net inflows only, with broad equity funds having experienced net outflows over the same period of €100 billion, so it is clear where the money is going.

It is time to show innovation and creativity, and time to share ideas on products that are or could be of interest to investors. There is clearly a demand for green key performance indicator bonds to raise capital for projects that benefit the environment and respond to investors' desire to invest sustainably: or COVID 19 bonds to raise funds whose proceeds can be used directly to finance COVID-19-related activities, where there is a lot to be done; for longer-maturity bonds for institutional investors with longer-dated liabilities such as insurance and pension companies; and for developing a framework for retail investors who are keen to invest in ESG funds.

It is not just a question of capital markets helping support the COVID-19 recovery; it is absolutely essential to make step changes to provide the scale of funding needed by sovereigns and corporates, not only to help them navigate the immediate challenges but to achieve Europe's longer-term ambition of a green and digital economy. Embracing capital markets can achieve this.

David Wright

David Wright asked Richard Gnodde how he sees Brexit affecting capital market developments in Europe, and whether he sees severe damage on both sides if there is a breakdown.

Richard J. Gnodde

The critical point is to avoid fragmentation in markets, as fragmented markets lose liquidity and their ability to provide support and access to the investors in the real economy. The good news is that there will be more capability, capital and skills located inside the EU starting on 1 January 2020. That journey has already started and will continue for some period of time. Embracing that skillset and that capital and working with it to really drive the development of these markets, provides a terrific opportunity. One of the long-term benefits of Brexit might be that across the EU 27 capital markets are embraced in a way that has not been before. The hope is that EU 27 corporates, sovereigns, agencies, retail and regulatory bodies embrace, support and try to put in place strategies that can drive growth in this space.

David Wright

David Wright asked Richard Gnodde if he considers Europe to be focusing on the right things, and whether there is enough political force changing things.

Richard J. Gnodde

Richard Gnodde responded that, on paper and in some discussions, the right things are being focused on and talked about, such as building the securitisation capability, building equity markets and developing pension schemes and insolvency regimes. There is a long list of topics that need to be tackled. The right things are on the table, but there needs to be a sense of urgency; great benefits can happen if that takes place.

If Europe has strong and efficient capital markets, then it can get to a place where it has strong banks that can play their role in the economy. The need for financing is very significant but the benefits are even more significant, such as job creation, transformation of the economy, benefits to savers and ways that people can manage their pensions. The opportunities have never been greater but there is a sense of urgency; a positive and enthusiastic approach will pay dividends.

David Wright

David Wright is of the view that, of the key points of the High-Level Forum work on CMU, which the Commission is preparing an action plan on for the end of October, the exact same point was made. The EU will simply not be able to fulfil its objectives, whether they be sustainable development, social issues or dynamic SMEs, without the capital markets being developed and integrated in Europe. ■

Helmut Schleweis

President, Deutscher Sparkassen- und Giroverband

The stabilising effects of smaller banks

Helmut Schleweis stated that the stabilising effect of smaller banks is crucial already in normal time, but even more so in times of post-COVID challenges.

In the past few years, the actual strategic options of the European financial sector have increasingly been affected by social and economic upheavals. The financial system is changing radically due to digital markets and competition from platforms, as well as a total erosion of interest rates, which means that money is almost a free commodity. There is also a challenge that will take generations to overcome, which is to ensure better protection for the natural resources that humanity depends on. All these trends will radically alter the way business is done.

However, the environment for shaping the future has changed drastically this year. The coronavirus pandemic has caused severe economic damage, affecting the financial health of many households, businesses and self-employed individuals. All players in the economy and financial system have therefore considered how their business model helps to manage the acute crisis, buffer systemic shocks, and facilitate a broad recovery so that current megatrends can be effectively managed.

Throughout the current situation, the EU banking sector has proved that it is part of the solution, and this is especially true for smaller, locally active banks such as the German savings banks. They have made a major contribution by providing new financing, extensive advisory services and forbearances. In the first 20 business days of the pandemic, savings banks conducted 1.4 million consultations with business clients to identify their immediate needs. This enabled savings banks to stabilise the situation where necessary. 390,000 businesses and private households now benefit from deferred loan payments – a total volume of €5 billion – that banks bear for customers. This directly eases the burden and is something that can only be done by principal banks –Hausbanken as they are called in Germany – that know customers personally and have supported them for a long time. Quickly and effectively, savings banks helped to prevent the otherwise inevitable collapse of many companies and small businesses by providing liquidity.

In the first seven months of this year alone, savings banks pledged €63.5 billion in new loan commitments to enterprises and the self-employed. These figures show that loan financing remains the most important source of funding for businesses. This applies particularly in times of crisis, when fast, predictable solutions are of the essence, while the response from capital markets is often particularly volatile. Germany's government also provided extensive loan assistance to enterprises. Most of these loans have been arranged by savings banks and reached businesses directly everywhere in Germany due to the decentralised structure of the Savings Banks Finance Group. Based on customer proximity and their own financial strengths, savings banks have prepared the ground for economic recovery.

Therefore, the stabilising effect of local banks should be acknowledged and kept in mind as a key benefit from this crisis.

Europe's immediate task is to create a favourable environment for long-term economic growth. The capital markets union (CMU) must encourage both capital market and loan financing. This offers a chance to rethink European financial regulation and create a proportionate framework. Strengthening decentralised structures and reducing the regulatory burden is the right approach. When addressing proportionality within prudential frameworks, the EU already took some important steps during the previous legislative term. Regulators now have the chance to continue on that road with the finalisation of the Basel III package, which is a chance to calibrate regulation more stringently to match the size of the institutions. Europe must closely follow how Basel III is implemented in other parts of the world and scrutinise the effects of Basel III to ensure they do not contradict efforts made to stabilise Europe's national economies. New regulatory measures must be applied carefully to allow credit institutions to make optimum use of their equity to finance the real economy. Regulatory projects involving significant implementation efforts for these institutions should be postponed.

Economic recovery in Europe calls for solidarity in many policy fields, including the use of jointly financed economic stimulus programmes. The Savings Banks Finance Group welcomes the framework and conditions foreseen in the Next Generation EU aid package as leaving room for subsidiarity and focussing on accountability as well as being limited in time and in size. The package also shows that solidarity among EU member states is possible.

Nevertheless, a word of warning is also necessary. The current situation must not be exploited to pursue open issues from the past arguing that 'the coronavirus makes it necessary'.

Solidarity among states can apply in extraordinary situations. Solidarity among depositors should not be forced. European solidarity does not need schemes like EDIS. On the contrary, pushing for a mutualisation of deposit guarantee schemes would destabilise the financial system in the EU. Legacy risk positions have not been reduced sufficiently and the coronavirus crisis will lead to a significant additional burden. The volume of non-performing loans will increase throughout Europe and it is difficult to predict exactly how bad it will be. In this environment, a centralisation of deposit guarantee schemes is fraught with too many risks for the stability of the banking system as a whole. Any risk of infection must be avoided - not only in the health sector.

Merging national deposit guarantee schemes would make it impossible for institutional protection schemes to operate and would jeopardise the existence of smaller banks and savings banks. But Europe's economy needs smaller institutions to get through the crisis and manage change continuously. This is true for Germany's economic structure in particular, with its many small and medium-sized enterprises: SMEs depend on the presence of regionally, locally rooted institutions with an independent business policy. SMEs need SMBs – small and medium-sized banks. The debate should focus instead on the stabilising effects of existing schemes which are already harmonised according to EU rules.

Finally, economic recovery requires determined action to shape new business models for Europe as a whole.

Digital business models are on the upswing, but Europe is not yet participating enough in this success, mainly due to the highly fragmentated payment landscape. Payment solutions are developed around national ecosystems, with little or no acceptance across other European markets. This has left the floor to big techs and international payment service providers, and with the rise in digital payments as a consequence of the lockdown experience, the current dominant market players are well-placed to further strengthen their position across Europe. As a result, valuable data from European consumers benefit third parties without triggering a European economic recovery.

To address these challenges, the German savings banks, together with a group of European banks from Belgium, France, Germany, Spain and the Netherlands, have announced their participation in the European Payments Initiative. This aims to replace the fragmented domestic solutions of participating countries and create a seamless, competitive and unified payments solution, available to consumers and merchants across Europe. Europeans can do more than just tackle the crisis. We should set the agenda for a common European digital infrastructure and prepare the ground for more European independence. ■


eurofi
The Eurofi Financial Forum 2020
BERLIN

EXCHANGES OF VIEWS

Key economic and financial priorities for the euro area and the EU–27

Klaus Regling - Managing Director, European Stability Mechanism
João Leão - Minister of Finance, Portugal
Roberto Gualtieri - Minister of Economy and Finance, Italy

Klaus Regling

The Chair opened the session and welcomed participants to the discussion about crisis measures. Europe is coming out of the deepest economic crisis of the last 100 years. The recovery has been strong since the lockdown ended, but, given how bad the decline in economic activity was earlier this year, it will still take two years to get back to 2019 activity levels.

The policy measures put in place during the last few months are rightly unprecedented in light of the crisis. At the national level, on average for euro area countries, they amount to almost one-third of euro area GDP. A combination of automatic stabilisers, discretionary fiscal action and liquidity provision guarantees means that the euro area countries will average a fiscal deficit of 10% of GDP. European measures have complemented the national ones, with two packages agreed by the Eurogroup: the first of €540 billion and then the summit in July agreed the Next Generation EU package of €750 billion. The European measures are designed to help countries that are particularly affected by the crisis, to protect the single market and ensure that divergences among euro area member states do not become too great.

Without these measures at national and European levels, the decline in GDP, which is bad enough, would have been much worse. The ECB announced the most recent estimate for the average for the year as a whole at -8%. That is the position in September of this remarkable, unusual year. The Chair asked Roberto Gualtieri whether the two packages agreed so far at a European level and the national measures are adequate to deal with the consequences of the coronavirus crisis.

Roberto Gualtieri

Roberto Gualtieri noted that there were often complaints that Europe is not doing enough and that measures are incomplete. For once, Europe has been up to the unprecedented challenge being faced. After some initial hesitation, it has been possible to put in place another great fiscal response to the crisis and this has been done thanks to a sequence of decisions. The first and easier were regulatory decisions. The decision to suspend the Stability and Growth Pact and state aid rules put member states in the condition to do what was needed, but this alone would not have been sufficient. On the contrary, it would have produced a path of divergence, because the fiscal space is different and, without any formal support, not all would have been able to borrow the necessary amount of resources.

The second step was a bold monetary decision by the ECB - In particular, the envelope for the pandemic emergency purchase programme (PEPP) of a total amount of €1,350 billion - and that has had a powerful effect on the markets. Also essential is the third wave of fiscal decisions. There were two sequences of decisions: the first was the €540 billion with the three emergency instruments in April and then a more structural agreement that was finalised in July, but there was a process by which the idea of borrowing at the EU Commission level to commonly finance common expenses for the recovery was gradually perceived as a realistic outcome since May. This created the environment where every country has been able to deploy the necessary fiscal stimulus to contain the economic impact of the virus.

As mentioned, the latest forecast at the euro level foresees an annual real GDP growth at -8% Forecasts said Italy would be at -11 or -12%. That is a sharp and unprecedented decline of GDP, but fiscal measures in the form of grants and guarantees have been fundamental in avoiding the destruction of productive capacity and to keep the economy in the condition for a recovery. But the economy has rebounded much strongly than expected… In 2020, the European economy suffers a brutal collapse, but Europe is standing and able to start again, protecting the financial system, protecting the productive system, protecting workers, and protecting families, but now it is necessary to shift the nature of interventions from a net of protection to a boost to recovery and productivity, which is the aim of Next Generation EU.

Klaus Regling

The Chair thanked Roberto Gualtieri and turned to João Leão for his opinion on the packages agreed by the group of finance ministers under the chairmanship of his predecessor, Mário Centeno.

João Leão

João Leão agreed the response was significant and concerted, and made use of flexibility on fiscal policy, state aid and the financial freedom of frameworks. The fiscal and monetary policy response was strong. Even with the strong fall in GDP, unemployment in Europe did not increase that much, compared with the US, and that is a signal that Europe responded strongly and positively.

As noted, the economy remains constrained by social distance measures. 2019 GDP levels will probably only return in 2022. So, there will be a period when the economy is well below its potential and the 2019 level, and where social distancing measures will constrain the economy on the supply side. The recovery fund is vital for the next stage, shifting from supporting firms and employment to enabling the economy to reach full capacity.

The EU recovery fund is extremely important, as it will take some time to implement expenditure and investment measures. This fiscal instrument must be complemented by next year at least with a quick boost in demand that helps the economy recover 2019 levels quickly. Especially when the COVID-19 pandemic is over and the economy can start working at full capacity again, a quick response is essential to avoid keeping the economy subdued and below 2019 levels for a while. The time and how quickly the EU recovery fund can be implemented is a problem. It should be complemented with other measures to help the economy for a while.

Klaus Regling

The Chair noted that the panel's positive view is shared widely around the world, certainly in the financial markets. Contacts with market participants demonstrate a positive attitude towards Europe that has not been seen during the last 10 years. It is better than any time in the last 10 years, so this view that Europe did the right thing is widely shared, but the work may now begin, because implementation will be key.

There are concerns looking at the medium and longer-term. Europe is coming out of the deepest economic crisis ever, but there are concerns that the potential growth rate after the crisis might be lower than before it, because capital – physical, human capital – is being destroyed. There has been a collapse in world trade and deglobalisation already for some time that means less competition, which means less productivity growth. He asked what should be done next, given that there are also huge challenges from demographic and climate issues, and digitalisation needs.

Roberto Gualtieri

Roberto Gualtieri acknowledged that the challenges are huge. It cannot be said that the pandemic is over and phase two is here. Phase one has not finished, either from a sanitary or an economic point of view. Lockdowns are not happening anymore and hopefully will not be needed again, as measures for containing the second wave to a low level are better, but it is essential not to lose the fundamental sense that the first and most effective economic measure is to contain the virus. That is more important than any other measure.

The transition phase must balance what is needed and not withdraw support too early but realise that the task is now different. The transition is complex, but there is a broad and high level of consensus around what will be done next year in the sense of focusing on growth potential, innovation and the new supply chains. These are fundamental for the economy of the future, focusing on sustainability and the goals of the programme of the European Commission, which are at the core of Next Generation EU. At the same time, it is vital to quickly deploy investment so as not to lose the momentum of the recovery and also, which is more difficult, to have a new kind of investment in place to have an immediate macroeconomic impact.

It is necessary to be ready to start on 1 January 2021 and disbursements from the EU budget should be available to Member States at the beginning of next year. There is already a legislative procedure with the European Parliament to conclude and to go into the official journal and the EU agreement needs to be ratified by Member States. This has to be done quickly first without reopening things that have been decided. Second, the right mix of productive investments that are quicker to deploy and have a huge macroeconomic impact are needed, such as railways, highways and so on, but, not only programmes based on this because, on the contrary, programmes must have a strong transformational impact on the economy, as well as recovery and resilience – and there must be not only investment but packages of investment and reform to address the immediate economic impact of the slowdown and the crisis, as well as structural bottlenecks that were inherited from the past, things which were in countries for years or decades, and problems that are very well known.

The next step is to look to the future, not just at fixing old issues, but knowing that there are deep structural changes to be made, and such changes will follow, as with other crises. Things will never be exactly as they were before and so the right mix and the right level of ambition is needed. This is a moment for being ambitious in identifying significant changes in economies and in the ways in which society is connected to the economy and public administration. This requires a high level of ambition, and the deployment of the recovery plan as quickly as possible. It is complex, so governments are working to make this better mix of ingredients. This is a unique opportunity and it must not be missed.

Klaus Regling

The Chair asked for insight on the Portuguese experience. A deep crisis eight years ago was followed by good growth performance and a balanced budget in 2019. João Leão was part of that development and the Chair asked him about the challenges for Portugal.

João Leão

João Leão advised that the medium-term challenge is implementing the EU recovery fund to improve public administration, especially the courts, health and education. A great deal of investment in digitalisation is planned, as that is a key priority to make the state work better so that both citizens and firms have a state that is more friendly and promotes growth. The environment is a key priority, so a large part of the plan is the environment and green energy. From a macro side, the recovery fund will help create fiscal space over the next four to six years, which is important for the euro area as well.

For 10 years, the euro area has had interest rates close to zero. There is a liquidity trap, so the potential or ability of monetary policy has been constrained and limited. Fiscal space is needed for a few years and that is provided by the recovery fund. It should be a target to deal with the main issues and reforms that need to be implemented to promote growth in individual countries.

The Stability and Growth Pact rules are suspended and likely to remain so next year. In 2022, it will be crucial to think about phasing these rules in. It should be gradual and compatible with the macroeconomic needs of the economy, as the world is now different from before. Most countries have high levels of debt. Interest rates are low and there is a limited space for monetary policy. The compromise between macroeconomic needs and the need for fiscal rules that are key to providing sustainability to debts must be achieved gradually. Consideration should be given over the next year how to how to phase in these rules.

For Portugal, the budget rules are likely to be easier to reach at some point as Portugal recorded a fiscal surplus in 2019 and expects a deficit of 7 -8% of GDP lower than the European average. On the other hand, the level of public debt is one of the highest in the euro area, so how fast debt needs to decrease must be considered when implementing the Stability and Growth Pact rules, given the public debt of Portugal will reach 135% of GDP this year. It is important for Portugal and Europe overall that this is done reasonably and there is a compromise between the sustainability of debt and the need for some space for Europe to recover from the crisis.

Klaus Regling

The Chair concluded by saying that Europe is coming out of an unprecedented crisis, but the challenges ahead are also, in a way, unprecedented. There are unusual positive elements, the fiscal space is bigger than normal. There will be a great deal of money available, probably the more than governments have seen in a long time, maybe most in a lifetime, so it is crucial to use that well.

Implementation will be key to address the real underlying problems, strengthen competitiveness and productivity, but also the green agenda, digitalisation and ensure that society is kept together in a way that equality is preserved. It must be balanced with sustainability concerns and moving back to a sound fiscal situation. It will be hard work for the next few years. The Chair thanked participants for joining the meeting. ■

Q&A session

Christian Sewing - Chier Executive Officer, Deutsche Bank
David Wright - President, EUROFI

David Wright, Eurofi

David Wright introduced Christian Sewing and thanked him for attending. David Wright asked Christian Sewing how he sees the banking landscape now in Germany and in the European Union, as there has been an immense pressure on banks to distribute loans and credits to impaired institutions in difficulty. NPLs are increasing.

Christian Sewing, Deutsche Bank AG

Christian Sewing considered that over the last seven or eight months since the pandemic emerged and then developed, banks have been part of the solution, different from the 2007 and 2008 financial crisis. Banks are glad to be sitting on the side where they can support the economy. Banks worked very well in all countries but particularly in Germany where they collaborated with the central banks and the government coming up with speedy, to-the-point decisions as to how they can actually set up the support programmes. Banks have shown that they are resilient, robust, efficient and able to support the economy and the society.

This can also be seen in the tonality. Tonality about banks and financial institutions is different now from what it was before, and in this regard, banks have done quite a good job. It is now very important that banks would keep this exact discipline and commitment, and that they should have the opportunity to further their robustness to do what they have done over the last six or seven months.

David Wright

David Wright asked Christian Sewing to explain how Deutsche Bank now examines banking regulations. There are many changes in the pipeline, such as further Basel IV changes, the Banking Union and the unfinished Capital Markets Union still to be driven forward.

Christian Sewing

Christian Sewing considered that banks should recognise that the changes made after the financial crisis were, broadly speaking, the right ones. Everyone is able to see how robust and resilient the whole sector is, not only in Germany but across Europe. Now, having actually gone through a real and significant crisis instead of stress tests on paper, banks have shown that they can continue to support the economy, and that they have robust liquidity and capital ratios. This moment needs to be used to hold on and say, 'Wait a minute; what does it actually mean?' In a real stress scenario banks have shown that they are resilient, and that should provide pause for thought about what it means for future changes.

Basel IV changes need to be suspended; banks need to be allowed to take the full data of the COVID pandemic and reassess what it means before a new prudential assessment or evaluation takes place, and before banks undertake changes, which may reduce their lending capacities. Banks always have to bear in mind whether others around the world are also implementing the same or similar changes that European banks are obliged to do. The European banking industry compared to the US is obviously at a competitive disadvantage, and if Europe is now rolling out Basel III or Basel IV and gold-plating it then that competitiveness will worsen.

David Wright

David Wright noted that Germany is famous for its small and medium-sized companies, and capital will be affected by some of these possible changes in the pipeline. He asked Christian Sewing if he shares the view that Freddie Mac and Fannie Mae give the US banks a tremendous competitive advantage.

Christian Sewing

Christian Sewing stated that the US is a different structure, and he will not judge other systems, but it certainly takes a little bit of pressure off the balance sheet. The Basel changes will come at a capital cost, but the real issue is that each bank will think even more about how much capacity it has to put new facilities into the economy. At the end of the day the clients will notice it because it is harder for banks to support them. After showing this resilience and robustness over the last seven or eight months it is important to allow banks to reassess what part of Basel III or Basel IV is actually needed and to let them implement it, if at all, on a level playing field.

David Wright

David Wright asked Christian Sewing if he is worried about the small and medium-sized dimension of this.

Christian Sewing

Christian Sewing confirmed that he is slightly worried, because at the end of the day that is another difference between the European and US banking industries. In the US 60% or 70% of the refinancing or liabilities is via capital markets. In Europe 70% to 80% of the refinancing or liabilities is via the banking sector. If there is less capacity, then the long-term capacity to support the industry and the economy is decreasing. Ultimately, the small and medium-sized enterprises, particularly in Germany, are the backbone of Europe's economy and Europe has to protect them.

David Wright

David Wright asked Christian Sewing if it would be beneficial for Deutsche Bank and the European financial market if, in two or three years, the European Union had moved decisively forward on the Banking Union and the Capital Markets Union.

Christian Sewing

Christian Sewing stated that the issue is not about Deutsche Bank, but it is about protecting the competitiveness of Europe versus the US and Asia. For the time being Europe has gigantic competition from the US banks in terms of profitability and size. In the second quarter, US banks obviously had pretty large numbers in terms of loan loss provision, but the profitability was nevertheless still far higher than the average of the European banking industry. Additionally, people are starting to forget that while putting more into credit reserves, because US banks have a different portfolio from European ones, US banks were still able to spend a great deal on technology, which actually widens the gap. The answer to that must be the Banking Union and Capital Markets Union in Europe. At some point in time Europe also needs to think about European consolidation in order to obtain the related benefit. That means cost efficiencies and scale in the system.

David Wright

David Wright asked Christian Sewing how he sees risks in the system, and what structural shifts or pressures are building up in the system that he worries about.

Christian Sewing

Christian Sewing considered that the immediate fallout of the pandemic is potentially not as bad for Europe and Germany as initially forecasted, but two years are needed to return to normality. The production level on average across industries will come back to normality or pre-COVID levels in 2022, which means there are huge potential opportunities, but also huge pressure for corporates to actually amend and adapt their business model. That needs to be done as soon as possible. Over time there will be winners and losers in each industry, and in this regard in 2021 and 2022 it will be easier to see which industries and segments are really suffering from this pandemic. Clearly there is everything regarding travel, and potentially everything regarding commercial real estate will have a tougher time, because at the end of the day the consumer is changing his or her habits, and this is not a six-month phenomenon. This will be potentially a long-term trend, and people and corporates need to adjust their models.

The biggest risk is not actually the imminent risk from COVID; everyone is forgetting that the structural setup, particularly of the European industry, is also changing a great deal. Europe had a golden decade between 2010 and 2020, and that was in particular from the rise in China and Europe's exports. That will decrease structurally, not only because of the geopolitical tensions but because the Chinese industry is changing its development, which means that European and German corporates need a new home market. There needs to be far more pressure and focus on starting to implement a bigger home market and that can only be in Europe. In this regard, the focus should not be on only the imminent results of COVID. Instead, the focus has to be on the long-term structure of Europe, and there needs to be a bigger home market.

David Wright

David Wright is of the view that the big EU recovery fund, very strongly supported by Chancellor Merkel, is the right way to go in order to protect, develop and sustain the internal market of Europe as trading patterns change, also due to the fact that the World Trade Organisation cannot resolve any disputes anymore.

Christian Sewing

Christian Sewing agreed. The Recovery Fund which has been created has various signals. First, it is a signal of solidarity, which is hugely important, because Germany cannot solve its problem on its own and cannot be a competitor to the US or China on its own. Germany needs a strong Europe, and solidarity is needed for that. In this regard, the fund was the right thing.

The second point is how the money is used. Hopefully, Europe has the right controls, because the money needs to be wisely invested in industries and trends where Europe can still be the winner. That is a huge task, because Europe has the capabilities, talents, passion, dedication, and excellence. Europe should not think there is no chance for it anymore, but now is the time to spend this money wisely and create a stronger home market. If that is achieved, then Europe has a strong possibility also to be a real competitor for the next 10 years.

David Wright

David Wright stated that that also requires a level of convergence at the political level. Europe is leading sustainable development and those trends are irreversible. Convergence is needed, and Europe needs to move quickly.

Christian Sewing

Christian Sewing agreed. Pre-COVID, he regularly stated that Europe needs leadership and timely decisions. Much has been learned in the last six months, including that Europe needs a leadership which is encouraged to take quick and decisive decisions. If that is delivered, then Europe has a good future.

David Wright

David Wright thanked Christian Sewing for his views and support of Eurofi. ■

Q&A session

Jean Lemierre - Chairman, BNP Paribas
David Wright - President, EUROFI

David Wright

David Wright introduced Jean Lemierre and noted that he represents one of the largest banks in Europe. He asked Jean Lemierre how he thinks the banking system is reacting to the current crisis, where the problems are, and how Europe can improve the deliverability of the necessary systems to the tissue of its companies.

Jean Lemierre

Jean Lemierre thanked David Wright for organising this physical and virtual meeting and considers it very appropriate to discuss in person with many EU decision makers a few months after the beginning of the crisis. The banking sector has been working hard, and regulators and governments have also been working hard, but his first thoughts are for the clients: corporate sectors and individuals. Banks are very close to them, everyone in the room works for them, and there is no Eurofi without them. The key person in the room is the client and the corporate sector. It is not an abstract view. It is a reality that bankers know well, day after day. These clients, in particular the corporate sector, have been thrown into the unknown, and they have delivered well. They have adjusted. They have changed their logistics, they have changed their products, and they have tried to understand what may happen. They have been working hard, and the key message from Europe is that the corporate sector is committed and has done a very good job.

Banks are not the economy. Banks finance the people who are the economy. Many speeches at this Eurofi meeting have had pure abstraction. Banks work with people who do not know what tomorrow is going to be, and they have the responsibility of millions of employees. That is very serious, and the banking sector has done an effective job by working with them, trusting them, and knowing them. Europe needs strong banks, because for a few weeks there was no market. Markets were shut. Banks were open to their clients and mobilized to address their needs, and hopefully nobody will forget that, especially in the official sector. Banks were there and have done the job. It is also important to keep in mind the fact that in the time of crisis banks are present, and there are people in the banks who have been working day and night to support their clients and to fuel liquidity. That has been delivered far before any decision by governments to give their guarantee of liquidity.

Europe is in a situation where it needs to be careful. Recovery has not been bad but may be less strong than expected. There may be a second wave of contagion. Global trade is still under stress. There are American elections, and nobody knows what is going to happen. In such a challenging environment companies, small or big, continue to need support by the banking sector. Once more, banks will be part of the solution, but they will do their job if there is not too high a pressure on some parameters, notably capital requirements. Banks need to have the capacity to do what needs to be done.

There are some prudential discussions which are very important but are perhaps not at the right time. Europe needs to understand that the key focus is to mobilise and unlock the full capacity of the banking sector to help the corporate sector, the people, and avoid a social crisis. That needs to be achieved in 2020 and 2021, but hopefully not in 2022. The signal Eurofi should send is full mobilisation of the banking sector to support the economy.

David Wright

David Wright asked Jean Lemierre where BNP Paribas sees the major and micro risks. The recovery is uncertain, and potentially more U-shaped than V-shaped.

Jean Lemierre

Jean Lemierre considers that the recovery so far has been a V shape. The question is not the beginning of the V. In terms of what is going to happen now, the French word is piétiner, which means 'muddling through'. There has been a recovery but now it is going to be step by step. It will give some growth, but not sharp growth.

Awareness is needed of the fact that the economy will be like this. Risk will eventually resurface, but it is currently 'underground' because of the efficient support given by the Member States and EU Institutions. There is income, so the money is there, but there is always an end to such facilities. The risk will come and then it will pop up; nobody knows when, but everyone needs to be ready. The main concern is a harsh health crisis once again and a second wave of contagion. In the French economy today, there is between €80 billion and €100 billion of unused money compared to 2019 in bank accounts. People do not use it because they do not know the future, they are worried about the future, and they do not spend because they fear the future. If there is another serious wave of contagion, then that will be even more serious.

David Wright

David Wright noted that the annual Jackson Hole symposium saw a statement by the Chairman of the Federal Reserve announcing a more flexible monetary policy in the United States on the inflation side. He asked Jean Lemierre if it is important that Europe should become more creative and that the rules should become less constricting.

Jean Lemierre

Jean Lemierre considers that Central Banks decide what they think appropriate for their zone or their country, which is the case in the US. Indeed, in the US there has been a significant change in the paradigm and mindset, which should not be underestimated. He is confident that everyone is comfortable with the decision. Boards and heads of Central Banks make the decisions they think are right, and everyone has to accept that and deal with it. Nonetheless this is an important change.

The nature of the change shows that the world is in a crisis where out-of-the-box thinking is sometimes needed to address the difficulties. Nobody can say, 'We are back to normal' or, 'Let us wait for a few months and we shall be back to normal'. The game cannot be, 'We have given more flexibility in March and now we are waiting to go back to business as usual'. It would be simpler, but that cannot be the message. The message coming from the US, beyond the specificity of the monetary policy, is, 'Yes, let us think in a bold way. Sometimes we have to make appropriate measures nobody would have thought of'.

People are worried and want to do something, but people tend to go back to previous debates. Care is needed. Some arguments are valid, but for others it is important to pause and think about what to do in an open-minded way. This is the lesson coming from the US.

David Wright

David Wright recalled a meeting with Jean Lemierre 20 years ago when he had said, 'la France ne veux pas de la procédure,' meaning that he wanted a Capital Markets Union. He asked Jean Lemierre how important a Capital Markets Union currently is.

Jean Lemierre

Jean Lemierre noted that he had not raised the point up front because he had done it at every previous Eurofi meeting. The Capital Markets Union needs to be done; it is a piece which is missing, and everybody agrees. Securitisation, for instance, does not work in Europe and the measures to improve this framework should be proposed by the end of this year. The CMU project will grow slowly but it needs to be done. For the sake of Europe, we need it. There are millions of people who are going to be unemployed. At the last Eurofi meeting everyone agreed that CMU was urgently needed. Brexit is coming, and the question needs to be quickly addressed. Brexit is not unexpected, and this CMU matter has been on the agenda for three or four years. He hoped not to have to repeat this at the next Eurofi meeting...

David Wright

David Wright thanked Jean Lemierre for his views and support of Eurofi. ■

Q&A session

Xavier Musca - Deputy Chief Executive Officer, Crédit Agricole S.A.

David Wright - President, EUROFI

David Wright

The Chair welcomed Xavier Musca and introduced him. He noted that all elements of the economic recovery package, including the Capital Markets Union (CMU) and sustainable financing have been discussed. Much of the large package and future EU budget – around 30% or more – is being devoted to so-called sustainable development. The Chair asked if this is right.

Xavier Musca

Xavier Musca agreed that it is the right thing to do, for environmental and also for political and financial reasons which support the choices being made at the European Council. The first is that energy has historically played a major role in the construction of the EU. It started with coal. Steel and coal were at the heart of the community, which meant energy at that time. The Euratom treaty followed. It is appropriate that Europe should remind itself that it is not only a common market, it is also common projects, and common projects in energy are essential. The recent shift in this direction is proof of the importance of common projects in the energy sector which are vital for economies.

It is also financially important. During the past five years, sustainable bonds emission has multiplied by seven, part of which – 60% – comes from European issuers. Europe has taken the lead in this type of finance and it is not often that it shows such a strong presence in the financial field. The choice made by the European Council is also an opportunity for finance in Europe to take advantage of the new situation to reinforce its presence in this segment of the market, which is exploding.

David Wright

The Chair asked whether EU strategies on sustainability are well-defined and if emerging rules on green finance and standards are clear enough. The question is whether putting 30% of financing towards sustainability will generate sustainable economic projects and business opportunities.

Xavier Musca

Xavier Musca responded that it gives a direction or a signal, but there are issues to be clarified. One of the current debates which will take place at the European Parliament, as well as in society, is to know precisely what sustainability means. This must be clear because, to be consistent, the choices being made should align with the Paris Agreement strategy. Crédit Agricole took this approach and will ensure all policies are consistent with the objectives of the Paris Accord, which means taking a transitional approach.

Energy today comes mainly from fossil fuel energies and there needs to be a progressive shift. That implies that all sources of energy must be considered, and clear priorities set. Exiting from coal is the right priority and Crédit Agricole will follow the Paris Accord in this, with a full exit in 2030. This supposes continued support for nuclear energy and gas, as that is not a political choice. That is the scientific choice which has been made by the experts who have backed the programme. It also supposes an incentive and not a punitive approach is taken in defining objectives. A brown-penalising factor is not ideal, as every company's strategy and progress must be considered, even if it is not directly conducive to clean energy immediately. Switching from coal to gas is progress and companies and countries should not be penalised for choosing to do so.

David Wright

The Chair wondered whether the own resources aspect of the economic recovery programme would include increased revenues to the EU from the border adjustment tax or from a plastics tax. Incentives must be aligned throughout the whole economy towards these sustainable goals.

Xavier Musca

Xavier Musca agreed, while being realistic. Many companies and countries are moving from coal to gas and hurdles should not be placed in the road because, although the solution is not perfect, it is a transitional solution which improves the situation. In finance, not only is the value of green bonds important, but also that of transition bonds, which means that progress is made even though the energy used is not 100% green. It is a step-by-step approach, a progressive approach and a realistic one. The solution cannot be one which would be perfect from an intellectual point of view but would not function from an economic point of view. Supports are necessary, as is the idea that the tax regime and the price of energy would reflect choices being made, otherwise it would be quite painful to go in the direction assigned.

David Wright

The Chair asked if any points could be improved on in the sustainable finance framework and whether it is precise enough or too vague in allowing anything to be classified as green, when in fact, it is not.

Xavier Musca

Xavier Musca noted that a key issue is data. Banks and financial institutions are supposed to make judgements to provide loans to companies and to report what they do in this regard, but they lack data. To function properly and smoothly, incentives must be aligned, and companies encouraged to publish the right set of data. Otherwise, banks are in a world of ambiguity and uncertainty which will make their lives difficult.

Another issue is ratings. When talking about environmental, social and corporate governance (ESG), allowances are clearer and more precise in the energy sector than in others but remain uncertain and fluid in the world of governance, for example. Creating a real asset class requires efforts at the European level to better define ESG criteria, to make them clear enough and sufficiently in accordance with European model priorities. There is a governance issue, rightly reflected in ESG.

David Wright

The Chair raised the issue of millennials and younger people, and their future investments. Research suggests that younger people's investment thinking is different from that of earlier generations. He asked whether the ESG concept could be a way to attract retail investment into equity markets if properly designed.

Xavier Musca

Xavier Musca pointed out that the Crédit Agricole has seen a positive effect on the commitment of employees and people working with the company from having a clear commitment towards ESG criteria and principles. They are more positive about the company and more prepared to engage themselves in their role. It is important because millennials are often portrayed as not putting all their lives or main interest in their work. They are looking for something outside their work to give a meaning to their lives. ESG issues are a way to reconcile young people with companies and the work of enterprises.

For investment, there is an increasing customer demand to be reassured in this regard, but here projects and investment opportunities are lacking. The issue is not about the financial products themselves, but that the underlying economy does not yet provide all the necessary and desirable investment opportunities.

David Wright

The Chair noted out that for ESG it is easy to be clear about what the E stands for and also the G. S is much less clear. He asked what Xavier Musca considers the S part of ESG stands for.

Xavier Musca

Xavier Musca queried whether everyone is clear about what G means. Rating agencies consider that if employees sit on the board, that is not in accordance with G, because the board should express the interest of shareholders and the fact that others than shareholders could be represented is a problem. Even on this ground, there are things to clarify about what G is for countries like Germany in which the presence of employees in the board is mandatory and France where companies often have them on the board.

Social is even more difficult to give a sense to. It supposes respect for the social laws of the country, for the rules of the game, for the role of trade unions and not accepting that the difference of salaries between certain categories is too high, in particular between top management and other employees. It also supposes that gender equality is fully respected at all levels. That is one approach to S. Amundi has mechanisms which state that the difference between the best-paid people in the company and the lowest should not exceed a certain level. That is a way to reflect some kind of social cohesion.

David Wright

The Chair asked Xavier Musca what he would say about macroeconomic risks if he were back in his previous role as the Chair of the Economic and Finance Committee and speaking to ministers later.

Xavier Musca

Xavier Musca remarked that the over-evaluation of certain assets and the risk of a likely bubble is a concern. It reflects the choices made on monetary policy. Without criticising, it is important to be aware of the potential risk of this situation. Ministers should be alerted to the fact that the situation is not sustainable and there are risks on the financial markets. They should look at banks, obviously, but also to other financial actors of significant size, which are not as well regulated and supplied as banks and in which precisely this over-evaluation of assets could lead to an unsustainable situation. ■

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- **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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