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IS THE EU RESPONSE TO THE COVID-19 ECONOMIC CRISIS FIT FOR PURPOSE?

Note written by Didier Cahen, EUROFI

The COVID-19 pandemic has led to severe socio-economic dislocations and hardship. In March 2020, the EU moved quickly to support countries by providing greater flexibility in their use of EU funds to combat the pandemic (Coronavirus Response Investment Initiative Plus), and by activating the escape clause in the fiscal rules and temporarily allowing state aid to firms. This was followed in May by a package of financing support worth over 4 percent of EU27 GDP.

Finally, in July, the European Council reached an historic agreement on the €750 billion Next Generation EU (NGEU) package. Once legislated, this temporary instrument will provide grants and loans to EU members over the next few years to help accelerate the recovery modernize EU economies, make them cleaner and greener, more digital and more inclusive.

Indeed, the NGEU recovery package could provide a meaningful boost to euro area growth, especially in some of the countries hardest hit by the pandemic if the funds are deployed for productive public spending and go hand in hand with effective national structural reforms. Funds fostering investments in innovation and research, to favor digital agenda, and supporting small and medium-sized enterprises are effective countercyclical tools, while funds that foster education and health have more important medium-term repercussions.

The Next Generation EU (NGEU) is a significant step forward, which complements the fiscal measures at the national level. The total is equivalent to 5 % of the EU's annual GDP[1]. For the first time, the EU will collectively borrow the plan's full amount from the financial markets and repay it from the EU budget over almost 40 years. The shock absorbing role for the EU is a real novelty and this EU fiscal deal may set a precedent for future crises to be met with collective debt.

The magnitude of the economic impacts of the NGEU investments will depend on the quality of the programmes implemented in the member states. But absorbing all these EU funds might prove a huge challenge for some countries. And in all cases the name of the game remains national.

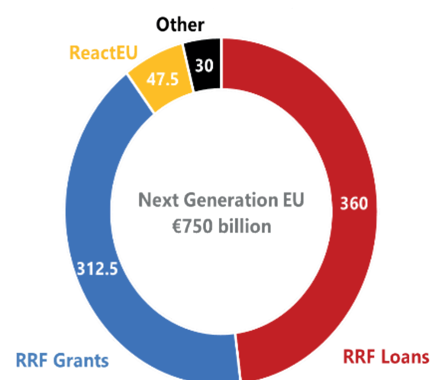
1. The historic NGEU recovery package could provide a meaningful boost to euro area growth, especially in some of the countries hardest hit by the pandemic

The NGEU recovery package entails the European Commission borrowing €750 billion to be used to finance €390 billion in grants and €360 billion in loans to members. These will be disbursed up to the end of 2026 and repaid by 31 December 2028 at the latest.

The main component is the Recovery and Resilience Facility (RRF), which will disburse all the loans and the bulk of the grants (€312.5 billion). The remainder of the grants will be used to top up other programs in the 2021–27 EU budget.

While many of the details of the NGEU package remain to be clarified - including how the debt incurred by the European Commission will be repaid- estimates suggest Southern and Eastern EU countries will benefit most from the grants.

Figure 1. Next Generation EU Recovery Package 1/



Sources: European Council (2020); and IMF staff estimates.

1/ RRF is Recovery and Resilience Facility. «Other» includes the Just Transition Fund, Rural Development, Invest EU, Horizon Europe, and RescEU.

NGEU comes in addition to the regular Multiannual Financial Framework (MFF) worth around €1 trillion over the next seven years and the EU agreement of April 2020. Indeed, the "Next Generation EU" recovery plan is the second part of the EU's response to the pandemic. In mid-April 2020, the European Heads of State agreed on a three-layer safety net for workers, businesses and sovereigns totaling €540 billion:

- A temporary solidarity Instrument (SURE) has been established to support protecting workers and jobs in the current crisis. Loans, backed by the EU budget, can be provided up to €100bn.
- The EIB has created a pan-European guarantee fund of €25bn to support €200 bn of EU businesses, in particular SMEs throughout the crisis[2].
- The ESM has also provided pandemic crisis support, in the form of precautionary credit lines not subject to macro-economic policy conditionality. A Member State that draws under these Enhanced Conditions Credit Line (ECCL) will commit to using the money only to cover corona related costs. Each Eurozone

1. Calculated on the basis of the 2019 EU GDP without including the UK GDP.
2. At least 65% of the financing will go to small and medium sized businesses. Up to 23% to companies with 250 or more employees, with restrictions applying to companies with more than 3,000 staff. Up to 5% will go to public sector companies and entities active in the area of health or health-research or providing essential services related to the health crisis. Up to 7% will go to venture and growth capital and venture debt.

country can benefit from this support up to the benchmark amount of 2% of GDP[3].

2. The Recovery and Resilience Facility (RRF) is the main element of the EU recovery plan and provides clear rules for spending the money and avoiding a misuse of the funds

This facility will make €672,5 billion (in 2018 prices) in loans and grants available to support reforms and investments undertaken by Member States. Member States have to prepare recovery and resilience plans that set out a coherent package of structural reforms and public investment projects for the years 2021-2023 and address the challenges identified in the context of the European Semester.

The financial support is not committed for ordinary budgetary expenditure to finance deficits but is intended to focus on investment and reforms. At least 37% of the allocation of each national plan has to support the green transition[4], and at least 20% the digital transformation (e.g. investing in the deployment of 5G and Gigabit connectivity, developing digital skills through reforms of education systems and increasing the availability and efficiency of public services using new digital tools).

Member States have until 30 April 2021 to submit their recovery and resilience plans to the Commission. These national plans will then be assessed by the EU Commission within two months of receiving them and approved by the Council by a qualified majority. Under the Facility, member states will be able to get pre-financing in 2021 of up to 13% of the grants provided for in their approved domestic plan.

Under the Recovery and Resilience Facility, payments will be linked to performance. The Commission will authorize disbursements based on the satisfactory fulfilment of a group of milestones and targets reflecting progress on several reforms and investments of the plan. Milestones and targets should be clear, realistic, well defined, verifiable, and directly determined or otherwise influenced by public policies. The national plans should notably present clear reform commitments that should be reflected in the milestones. They should also reflect a clear strategy for embracing the twin transitions and implementing reforms in line with the country-specific recommendations.

The RRF is expected to finance countries' public spending in line with the country-specific recommendations adopted by the Council in 2019 and 2020. These country specific recommendations, which are sent to all member states every year on how to improve deficiencies in their economies are usually ignored. But the RFF will use them as the basis for judging national recovery plans - European funds will only be disbursed if the Member States really take them into account -, which should give them more force.

In addition, the Commission needs to see effective systems in place to prevent, detect and correct conflicts of interest, corruption and fraud.[5] If the Member State has not satisfactorily implemented the milestones and targets, the Commission will not pay all or part of the financial contribution to that Member State[6].

This conditionality should encourage governments to tackle the key weaknesses that the crisis has exacerbated and increase economic growth potential by improving the business environment, the labour market and education, among other factors.

The Council agreement, which must be formally approved by European and national parliaments before entering into force[7], foresees repayment of the borrowing either with new EU revenues (a recycled plastic packaging waste tax, a carbon border adjustment tax, a digital levy, an emissions trading scheme, or a financial transaction tax), or by additional country contributions, over 2028-58.

3. Eastern and Southern countries would be the largest beneficiaries of the grants, as a share of their GDP

Over the entire period, a country's allocation will be proportional to its population size and inversely proportional to its per capita income level (i.e., richer countries get less). During 2021- 22, the allocation of 70 percent of the funds will also consider the unemployment rate in 2015 -19. In 2023, however, the allocation of 30 percent of the funds will reflect the economic impact of the crisis instead.

Under these assumptions, Eastern and Southern countries would be the largest recipients of grants, with Croatia, Bulgaria, and Greece estimated to receive between 8½ and 11 percent of their 2019 GDP (*see Figure 2*).

Italy and Spain, two large countries hard hit by the pandemic, would receive 3.7 and 4.8 percent of GDP, respectively (*see Figure 3*). Italy would receive €68.9bn in grants from RRF, ES 69.5bn.[8]

3. Should all 19 euro-area countries draw from the credit line, this would amount to a combined volume of around €240 billion.

4. 100 per cent of European money must not harm the environment and the climate. Each measure proposed in a recovery and resilience plan will also have to respect the "do no significant harm" principle. Specifically, there are six environmental objectives to which no significant harm should be done: (i) climate change mitigation, (ii) climate change adaptation, (iii) water and marine resources, (iv) the circular economy, (v) pollution prevention and control, and (vi) biodiversity and ecosystems. This obligation applies to all reforms and investments and is not limited to green measures. The Commission will provide technical guidance to Member States giving further support on the application of this principle.

5. V. Dombrovskis, Remarks at the ECOFIN press conference, 19 January 2021.

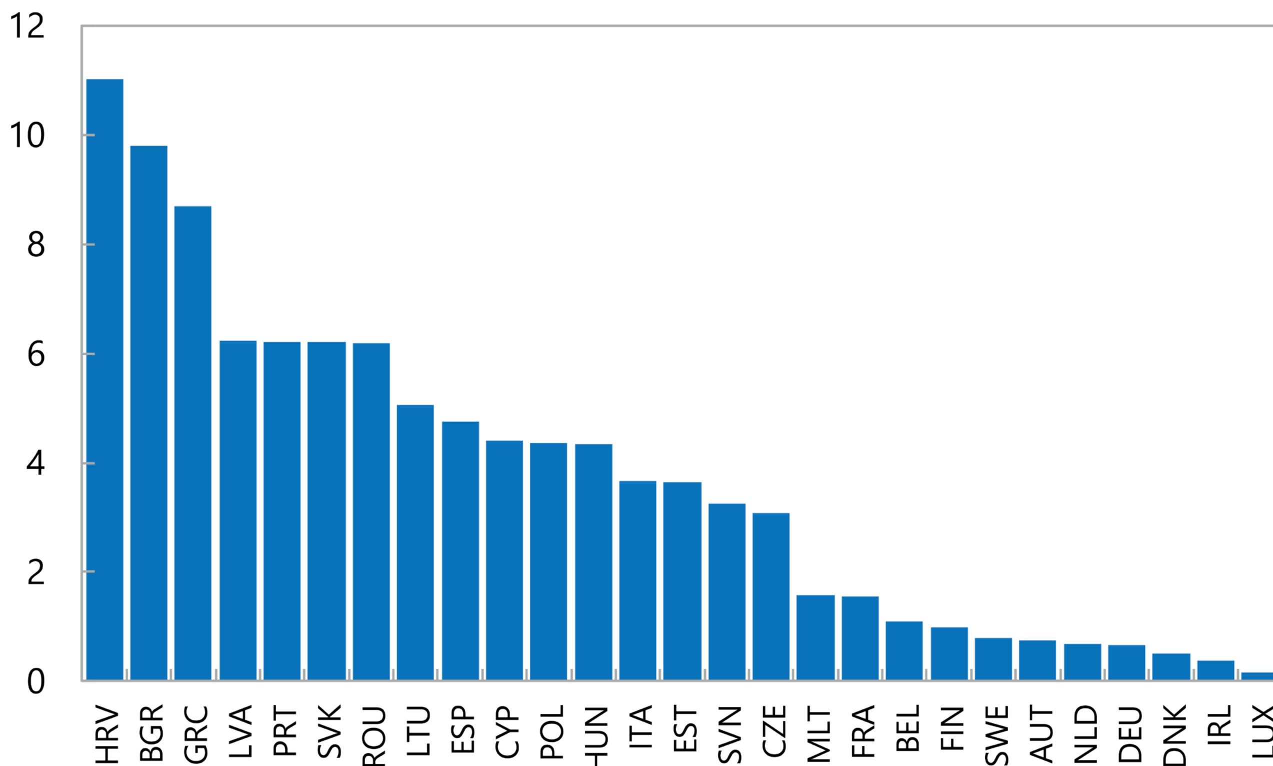
6. Upon completion of the relevant agreed milestones and targets indicated in its recovery and resilience plan, the Member State will present a request to the Commission for a disbursement of financial support. The Commission will prepare an assessment within two months and ask the opinion of the Economic and Financial Committee on the satisfactory fulfilment of the relevant milestones and targets. In exceptional circumstances where one or more Member State considers that there are serious deviations from the satisfactory fulfilment of the relevant milestones and targets of another Member State, they may request that the President of the European Council refers the matter to the next European Council.

7. The ratification process is not without risk: the 27 national parliaments (and regional parliaments in some countries) are called upon to decide and the absence of a single one would jeopardise the implementation of the EU Recovery Plan.

8. These figures are in current prices, and if dividing by current-price 2019 GDP Italy would get 3.8% and ES 5.6% of GDP. See page 50 of the following document: https://data.consilium.europa.eu/doc/document/ST-14310-2020-INIT/en/pdf.

Figure 2. Recovery and Resilience Facility Grants

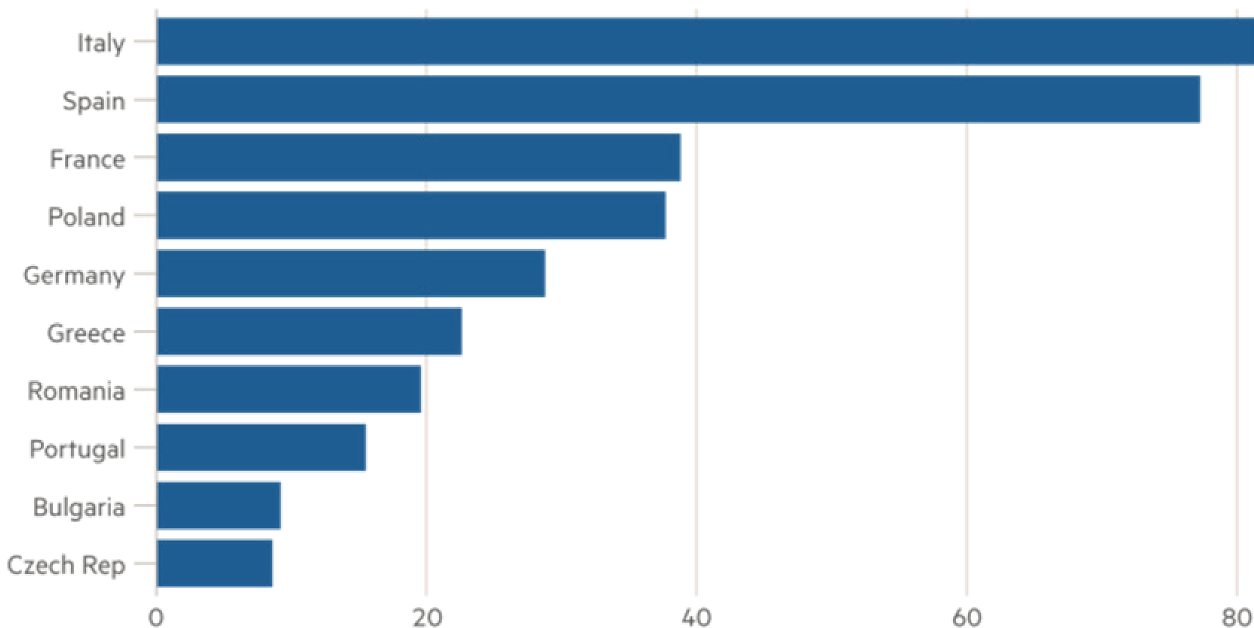
(Percent of 2019 GDP)



Sources: European Commission, IMF World Economic Outlook, and IMF staff calculations

Figure 3. Proposed grants for EU member states to counter Covid-19 recession

Top ten (€bn)



Sources: European Commission; Statista

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4. The sheer volume of financial support available presents an absorption challenge

Spain and Italy could receive respectively €210 bn and €140 bn of EU recovery funds over three years.

But fund absorption rates from the last EU multiannual financial framework have differed a great deal between individual sovereigns. For instance, Spain and Italy have one of the worst track records for spending EU structural funds. In the 2014-2020 period, Spain managed to spend only 36% of these funds by last year, with Italy only a little better at 43%. By contrast, France's absorption rate was 61%, and Finland 81% (*see Figure 4 below*).

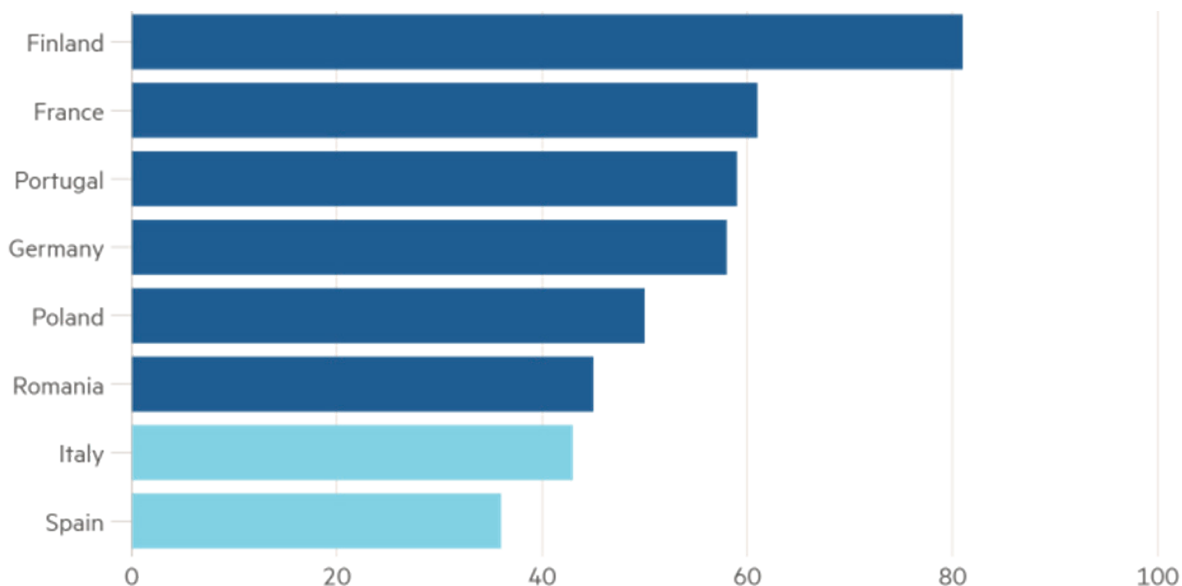
According to some experts, Italy's structural incapacity to spend money is related to the public sector's inability to make decisions, pursue transparent processes, and undertake auditing. Regarding Spain, a reform of the public administration also seems appropriate since "Spain 's large and compartmentalized bureaucracy – with 8000 entities spread over national, regional and local levels – combined with a complicated public contracting law cause an average lag of a year to adjudicate a contract[9]".

This suggests that faster deployment of EU funds in these two countries requires a strengthening of the public procurement framework and a reorganization of public administration to increase the speed, efficiency, and quality of spending.

Sufficient beneficiaries capable of developing quality projects in line with the green and digital transition will also be a key success factor of the EU Recovery package.

Figure 4. Italy and Spain struggle to spend EU structural funds fast enough

Share of structural and investment funds from 2014-20 budget spent by Sept 30 2020 (%)



Sources: European Commission © FT

Yet together Italy and Spain will receive no less than 40 per cent of the EU recovery fund harvest — dominating the spending programme. This means the reputation of the entire project rests on those countries' ability to come up with credible programmes that meet the Commission's green and digital priorities, minimize administrative bottlenecks, waste and fraud and promote efficient public-private sector collaboration.

Some officials hope the Next Generation EU project — which is officially designed to be temporary — could become a permanent feature of Europe's set-up. But that dream only has a chance if the money is well spent and certainly not wasted...

Furthermore, Europe needs much more to fill its infrastructure gap, the goals of climate change, and other sustainable goals. More will be needed for Europe to escape the current trap of low trend growth. The EU plan is not designed to cover all investment needs but to help low-income countries narrow their gap. Among other key policies that must be delivered are the European Banking Union and Capital Market Union (CMU) without which the EUs' key political priorities will not be able to be implemented.

Faced with the "technological war" between the United States and China, Europe must also lay the foundations of its sovereignty for the next 20 years.

9. M. Khan &D. Ghiglione & I. Amount, "EU recovery plan faces bottleneck, economists warn", Financial Times, 5 January 2021

In the field of security and defense, reinforcing technological autonomy is essential. Sovereignty must also be exercised in the field of green technologies, and Europe must become the leader in this area. Technological challenges require a European industrial policy and strategy for technology funding. A holistic industrial policy marrying finance, research, industry, competition, trade, existing local eco systems and education is vital and urgent.

5. The name of the game remains national

The EU safety net and the Next Generation EU plan represent a fiscal response of around 8% of the EU's GDP, made available over several years and with loans and guarantees comprising the bulk of the support. This is a significant amount but not a game changer. The main name of the game still remains national.

By means of comparison, in 2020, Member States have provided huge support for their economies: according to a Communication from the EU Commission to the Council[10], in total, fiscal support in the EU – automatic stabilisers and discretionary measures – in 2020 is estimated at about 8% of GDP - considerably more than the fiscal support provided in 2008-2009 – in addition to liquidity schemes of about 19% of GDP in the euro area..

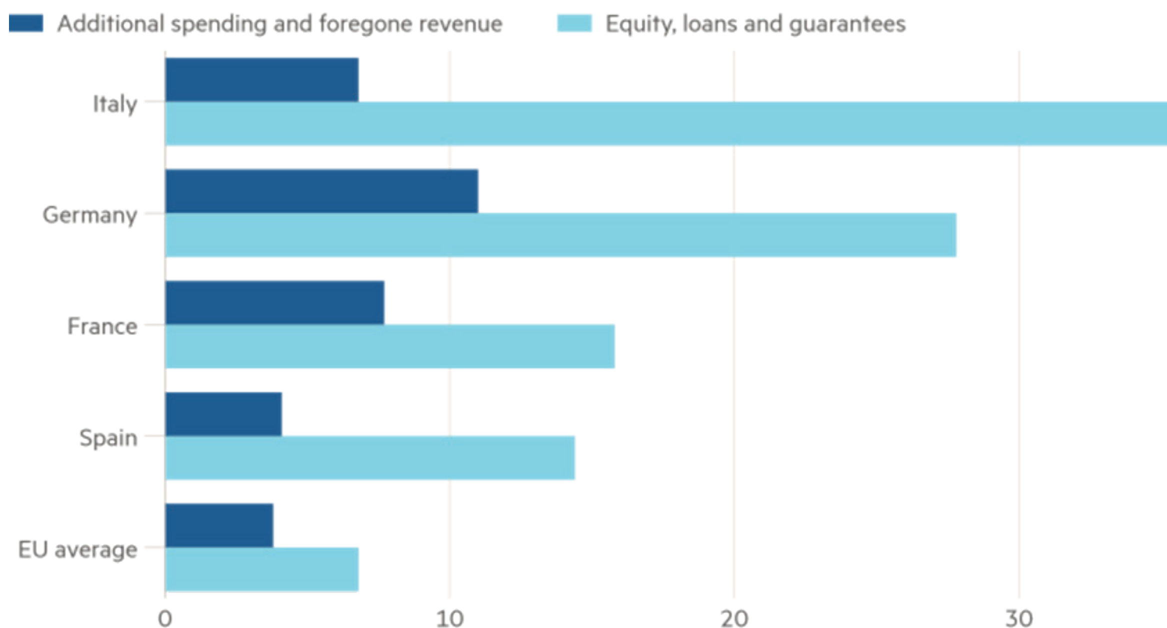
Member States took crisis related discretionary fiscal measures amounting to close to 4% of GDP in 2020 (*Appendix Table 1*) on top of already sizeable automatic stabilisers estimated at around 4% of GDP. The bulk of discretionary measures consisted of additional spending (3.3% of GDP). This included emergency spending on health care (0.6% of GDP), for example to increase the capacity of health systems, to provide protective equipment or to set up testing and tracing systems. Expenditure measures in other areas (2.7% of GDP) consisted of compensations to specific sectors for income losses, as well as short-time work schemes and other items. Tax relief measures accounted for an additional 0.4% of GDP.

Member States also provided sizable liquidity support (around 19% of GDP), mostly in the form of public guarantees for bank lending to businesses, markedly dampening the socio-economic impact of the crisis.

According to the ECB[11], these guarantees amount to around 17% of DGP for the euro area as a whole, but the size of the envelopes differs substantially across countries. The loan guarantees are contingent liabilities for governments and any amount of guarantees called on will therefore constitute additional public spending that raises government debt.

Figure 5. European countries' support for struggling companies

% of 2020 GDP



Source: Financial Times, Brussels Briefing European Union, 8 February

10. Communication from the Commission to the Council, "One year since the outbreak of COVID-19: fiscal policy response", 3 March 2021.

11. ECB, Fiscal developments, Economic bulletin, Issue 8/2020.

A study of CaixaBank highlights the differences in the scale and strategies of the fiscal responses between the various countries[12]. In Italy, for instance, the direct-impact fiscal measures announced so far (3.4% of GDP) have been much smaller than those announced by Germany (8.3% of GDP), while the amount of the guarantees proposed has been considerable. In Spain, the measures in all three categories seem timid compared to the rest of the major euro area countries.

These figures show that the fiscal space available was not the same in every country at the start of the crisis and how much the policy, particularly in Germany, of reducing the public debt-to-GDP ratio to the level prescribed by the Maastricht rules, has paid off. Starting with 60% of public debt, compared to more than 100% in other countries, Germany has been able to embark on a massive programme of aid to the economy while its neighbours do not have the same margin for manoeuvre.

Table 1. Fiscal measures announced by the main European national governments

	Direct fiscal mesures	Tax defferals	Guarantees
Spain	3.8	4.3	13.3
Germany	8.3	7.3	24.3
France	4.4	8.7	14.2
Italy	3.4	13.2	32.1

Source: CaixaBank Research, based on own estimates (Spain) and estimates by Bruegel

These disparities are also connected with the structure of the economy, the weight of the services sector, of tourism that the Covid- 19 crisis hit in particular, or the average size of companies. Some euro zone countries are more exposed to these sectors than others.

Furthermore, the national measures will push public deficits to deeper levels. Italian, Spanish and French public sector deficits are going to increase by EUR 145, 100 and 160 billion respectively in 2020. Their public debts are going to jump by more than 20 percentage points of GDP in 2020 to reach respectively 160% of GDP, 120% and 116% of GDP in 2020.

So, the name of the game still remains predominantly national. Monetary policy cannot do everything-pushing too hard and too long on the monetary pedal generates financial vulnerabilities and imbalances - fodder eventually for the preparation of future crises. Likewise, there are limits to how far the boundaries between fiscal and monetary policies can be pushed without running the risk of undermining the central bank's credibility.

High sustainable growth in Europe can only be achieved by reducing reliance on debt and reinvigorating productive economic activity through sensible investment. This means that to restore growth in the EU, governments must stand ready to take corrective action to ensure a path of primary fiscal balances consistent with fiscal sustainability. It also means implementing structural reforms to lift potential growth rates, mitigating failures of healthy firms, orienting fiscal policies towards sustainable and digital investment...

The psychodrama of so-called austerity has to be arrested which has undoubtedly weakened certain States of the Union. In fact, it is the fiscally virtuous countries that have best prepared their economies for the challenges of this pandemic crisis. In countries with too much debt, decisions must now be made to stop "walking on their heads», and to reduce forthwith unproductive and inefficient public spending. This is the only way to release the necessary resources for the productive sector. Just a few years of efforts mobilizing all the energies are all that is needed. Such fiscal policy requires a spirit of cooperation among different political parties and on a bi-partisan basis; examples abound in the Northern European Member State.

12. A. Leandro, "The fiscal response to COVID-19 in Europe: will it be enough?", Monthly report, CaixaBank, January 2021.

Appendix

Table 1. Overview of national fiscal measures in response to the COVID-19 pandemic

EU-27	2020		2020-2021		2020-2022	
	bln EUR	% of GDP	bln EUR	% of GDP	bln EUR	% of GDP
Initiatives by the Member States[1]						
A. Measures with a direct budgetary impact [2]	**497.8**	**3.8**	**364.7**	**2.6**	**83.1**	**0.6**
1. Expenditure	**438.5**	**3.3**	**322.2**	**2.3**	**65.9**	**0.4**
1. a) Health care	80.8	0.6	58.9	0.4	14.9	0.1
1. b) Other	363.0	2.7	264.5	1.9	52.3	0.4
2. Revenue	**59.3**	**0.4**	**42.5**	**0.3**	**14.1**	**0.1**
B. Automatic stabilisers [3]		± 4				
C. Liquidity measures without a direct budgetary impact	**2505.9**	**18.9**				
1. Tax deferrals	206.5	1.6				
2. Public guarantees (available framework)[4]	1877.0	14.2				
of which current take-up (actual contingent liability)	456.0	3.4				
3. Others	422.4	3.2				

[1] The amounts included cover the impact of nationally-financed measures, net of funding provided e.g. by EU initiatives

[2] The impact of the measures is given in increments compared to 2019 in accrual terms (ESA2010). GDP projections are based on the Commission 2021 winter forecast.

[3] The impact of automatic stabilisers is estimated as the residual after subtracting the estimated impact of fiscal measures from the change in the primary balance

[4] Figures refer to the maximal public funds involved if all of the available guarantees were taken-up. Guarantees to EU and international level instruments are excluded. For Germany, the size of available guarantee schemes is included, while the overall guarantee framework is actually unlimited.

Euro Area	2020		2020-2021		2020-2022	
	bln EUR	% of GDP	bln EUR	% of GDP	bln EUR	% of GDP
Initiatives by the Member States[1]						
A. Measures with a direct budgetary impact [2]	**422.3**	**3.7**	**339.4**	**2.9**	**57.9**	**0.4**
1. Expenditure	**368.8**	**3.3**	**298.6**	**2.5**	**42.3**	**0.3**
1. a) Health care	74.0	0.7	51.8	0.4	7.8	0.1
1. b) Other	295.7	2.6	248.0	2.1	35.7	0.2
2. Revenue	**53.5**	**0.5**	**40.8**	**0.3**	**14.9**	**0.1**
B. Automatic stabilisers [3]		± 4				
C. Liquidity measures without a direct budgetary impact	**2164.8**	**19.2**				
1. Tax deferrals	112.3	1.0				
2. Public guarantees (available framework)[4]	1790.9	15.9				
of which current take-up (actual contingent liability)	448.4	4.0				
3. Others	261.5	2.3				

[1] The amounts included cover the impact of nationally-financed measures, net of funding provided e.g. by EU initiatives

[2] The impact of the measures is given in increments compared to 2019 in accrual terms (ESA2010). GDP projections are based on the Commission 2021 winter forecast.

[3] The impact of automatic stabilisers is estimated as the residual after subtracting the estimated impact of fiscal measures from the change in the primary balance

[4] Figures refer to the maximal public funds involved if all of the available guarantees were taken-up. Guarantees to EU and international level instruments are excluded. For Germany, the size of available guarantee schemes is included, while the overall guarantee framework is actually unlimited.

Source: European Commission 2021 winter forecast

WHAT IS THE RIGHT MACRO-POLICY MIX FOR A SUSTAINABLE ECONOMIC RECOVERY?

Exchange of views between Larry Summers and Jacques de Larosière *

David Wright, Chairman, Eurofi

Our first session is about what the right macro policy mix for a sustainable economic recovery is, and we have two really outstanding people to discuss this. We have Larry Summers, who is the Charles W. Elliot University Professor and President Emeritus of Harvard University. He served as the 71st Secretary of the Treasury for President Clinton and the Director of the National Economic Council for President Obama, and before that he was the Chief Economist at the World Bank.

He will start and then he will be followed by Jacques de Larosière, who is the Honorary President of Eurofi, who has had most distinguished public service as the Director of the French Treasury, the Managing Director of the IMF, Governor of the Banque de France and the President of the European Bank for Reconstruction and Development. Thank you both in advance from all of us. May I turn it over to President Emeritus Larry Summers?

Larry Summers, President Emeritus, Harvard University; Former Secretary, US Department of Treasury

Thank you very much. It is a privilege to be with you. It is a privilege to be with my friend Hal Scott, whose work at the Harvard Law School does so much to make connections internationally with respect to financial services issues. I see Ken Bentsen, and I have pleasant memories of his time in Congress and our work together. I am particularly honoured to be in dialogue with Jacques De Larosière, from whom I have learned so much as we have worked together in various capacities for nearly 30 years. He has to be one of the supreme financial statespersons of our generation.

I must say that I have been driven by events to find myself with a prospective more like the perspective that Jacques frequently has than has been my usual experience. In general, I think Jacques and I have had productive dialogue and very useful exchanges of views over time. I certainly have listened to Jacques' views with great respect to my great benefit. I think there has been some difference in our orientation at most moments. I have, in general, being concerned with the maintenance of aggregate demand and with the adverse consequences of underutilised resources in a variety of respects. I have felt that debts can be managed, and I have felt that lower interest rates represented fuel for investment that was desirable, and I have therefore had a tendency to be supportive of expansionary policies that have tended to analyse the economy in relatively Keynesian terms.

Jacques has, I think it is fair to say, been more cautionary than I about fiscal excess and more concerned about the potential contribution of easy monetary policy to financial bubbles. He has had more concern about instability breaking out with a deep fear and recognition of financial authorities' first obligation to avoid inflation and a tendency to put more stress than I did on the insight that real problems cannot be addressed with a monetary solution but need to be addressed in structural ways. That difference in perspective has been with us almost since we met each other in the early 1990s. At times, it has led to substantial changes of view; at times, it has not led to important differences of opinion.

The United States has today embarked on an experiment of such sweeping boldness in both the fiscal and monetary arenas that I find myself, for the near term, very much with the kinds of concerns that my friend Jacques traditionally had. I have been warning for seven or eight years now about secular stagnation. I have believed and continue to believe that in the industrial world a whole range of structural changes has led to a situation where private saving naturally exceeds private investment at reasonable interest rates, and therefore we are going to have to accommodate ourselves to a rather different level of lower interest rates and more expansionary fiscal policies along various dimensions than we had been accustomed to.

I have to say that I could not have dreamt nor imagined that the United States would be entering into a new year when the employment rate was beginning at 6.3%, when the CBO was projecting that at year end the GDP gap would be in the order of 2%, when the gap between labour income and its normal trend level associated with the dislocations of COVID was in the order of 1.5%, when automatic stabilisers were operating, and when there was a substantial overhang of unspent private saving from last year that represented 3 4% of GDP in funds that people would have spent last year but were unable to. In the face of all of that, the United States has embarked on a fiscal programme worth 14% of GDP without a penny of long term intended public investment, intended fully as transfer payments. The Chairman of the Federal Reserve responded to this by saying that his greater concern was economic slack and social justice through the promotion of employment and that he regarded inflation as very much a secondary concern in the environment both because he suspected that inflation would remain below target and he expected that, if it were above target, that would be fine since it had previously been below target.

** This exchange of views took place on 11 February 2021 on the occasion of the webinar organised jointly by EUROFI and the Harvard Law School. This webinar was dedicated to "The implications of the US elections for financial services and the Economy: EU and US perpectives".*

I could not have imagined a Keynesian revolution on that scale. I think we will learn a great deal about how economies function from this kind of experiment. It is the essence of science that astronomers learn the most from supernovas, biologists learn the most from the most powerful microscopes and thermodynamics learn the most from environments in which extreme pressures are placed on gasses. It is always the case that, when you take variables out of their normal range, you are able to learn much more about relationships than you could previously.

I do not know what will happen. My suspicion is that there is at least a real risk that the fiscal and monetary policy will prove to have been excessive and that inflationary forces, both in product and labour markets and asset markets, will soon become evident and that fiscal and monetary policymakers will face very difficult challenges that they will have to manage. An extreme pessimist would bring to mind the early Mitterrand experience in France in the early 1980s or the Lafontaine experience in Germany in the latter part of the 1990s. An alternative view would be that the world is importantly different and that we will see more elasticity of supply, more flexibility of policy and more insurance that needs to be taken out because of COVID. All of those things are possible, but I have to say that I am more surprised by the general orientation of policy and its seeming potential disproportion with my own reading of the economic statistics than at any time that I can remember.

David Wright

Thank you very much, President Emeritus.

Jacques de Larosière, Honorary President, Eurofi

Thank you very much. I am delighted to converse today with my friend Larry Summers. I have for him and for his thinking an enormous amount of respect, because he is a man who, in spite of the changing circumstances, thinks and thinks for himself. He has been my mentor over the years in many respects. The way he has characterised the differences in the approaches we both have on these issues is very fair, and I thank him for the generosity of his exposition.

Today's world is made up of paradoxes.

Global demand is weak, while investment needs are enormous and are not being realized, at least in Europe.

Interest rates have been very low for many years and non-residential productive investment has been declining.

So, let's try to put some order into these apparent contradictions.

Firstly, if aggregate demand remains weak, it is mainly due to structural factors which L. Summers has analysed masterfully: ageing, globalisation, technological advances, changes in labour market behaviour, leading to an overall saving surplus. This is where the debate on monetary policy and interest rates starts and where we see the nuances expressed by Larry.

We are told that in the face of excessive savings, we need fiscal and monetary policies that stimulate demand.

Let us pause for a moment to consider this apparent obviousness.

Monetary policy has been particularly accommodative for more than 10 years and interest rates have converged to zero. Public deficits have been booming and the public debt-to-GDP ratio has risen from 100% to 120% in the advanced countries within 5 years.

But what do we see?

Over the past 20 years, the stock of non-residential productive investment (without intangibles) has fallen from 14,4 % to 12 % of GDP in advanced economies which has been only partially offset by the rise in intangible investments which have risen from 4,3 % to 4,9 % of GDP.

What surprises me is that this statistic – which is one of the most significant in terms of global demand – is not highlighted more. And this collapse of productive investment has occurred despite historically low interest rates.

Let's continue this line of thinking. A strange hypothesis eventually emerged: What if it was low interest rates that contributed to lower investment?

"Absurd and nonsense" I will be told: if the financing conditions are easy and inexpensive, how could the investment be penalized? This is where the liquidity trap comes in.

Once again, Keynes was right. He was in favour of low interest rates, but not too low interest rates. Indeed, when they are too low, they deter savers from investing in long bonds and encourage them to either keep their savings in liquid form or in assets remunerated because they are risky. On the other hand, entrepreneurs, discouraged by the prospect of non-growth emanating from zero interest rates, are turning away from productive investment in favour of share buybacks and speculative opportunities.

What I just said is not a confabulation. This is confirming a study carried out last year on the development of the financial part of household savings in Europe: over the past 10 years, we have seen a massive increase in the purely liquid part of household savings (notably overnight bank deposits). And this, of course, before the Covid crisis (*see figure 1*)

For sure, this research is European and may be less verifiable in the United States, where investors are less risk-averse than in Europe and more interested in the opportunities offered by Wall Street. So, I don't pretend that my interpretation is universal. But if it is correct in Europe, we should give serious thought to the problems posed by current monetary policy.

This is all the more so as the role of banks in financing the European economy is much more marked than in the United States (3/4 in Europe, ¼ in the United States). The profitability of banks is penalized by zero interest rates. This penalty is all the more pronounced in Europe as interest rates are lower than in the United States.

So there is a problem in Europe: is it possible that the mantra that we have been taught for 20 years is not adequate? Could it be that slightly higher rates could boost the morale of European companies and steer savings towards productive investment?

Of course, what I have just said might not be of great interest to American economists: their country has an extremely strong stock market and economic agents are less sensitive to interest rates because of their natural tendency to move from bonds to equities. In addition, the United States issues the world currency, which gives it some leeway to finance its deficit.

So, I ask the question: rather than being satisfied with a paradigm of low growth in Europe, isn't it time to ask the fundamental question: «what if zero interest rate monetary policy was not the right recipe to revive the global economy?

I have heard recently a Chinese economist, a professor at Peking University, say the following: « A too accommodating monetary policy raises many objections:

- Our economies need investments: to finance them we must encourage instruments with sufficiently high returns to cover the risks involved.
- Using monetary policy to stimulate the economy inevitably leads to inflation of financial assets and thus increases the danger of a crisis».

The profound truth of the real world is that a well-functioning economy is always based on work and normal returns on savings and therefore interest rates freely defined by the markets.

I will be told that, for all the secular reasons we know, the "natural» interest rate is declining. That's certainly true. But what is not said is that monetary policy plays a major role in lowering rates. It is so true that when the market anticipates the start of a rate hike, central banks immediately buy billions of securities to discourage this trend.

Of course, I am aware of the effects of this approach on sovereign securities markets. But monetary policy should not be at the service of the fiscal sustainability of States (fiscal dominance). Markets must play their role and not be entirely dictated by central banks.

Or should the wartime Accord between the Fed and the US Treasury be revived and sustained worldwide?

Even if the above does not convince the leading monetary thinkers, there remains an unescapable issue: that of financial instability which Larry was kind enough to refer to.

The Financial Times has recently reported that "the riskiest borrowers in corporate America are making up their largest share of junk bonds sales since 2007.

From the start of 2021, more than 15 cents of every dollar raised in the US high-yield bond market have been issued by groups with ratings of triple C or below".

And I would add that, according to a gauge of cross-asset complacency from JP Morgan, investors are feeling the least fearful and most complacent since the dotcom bubble.

This sounds familiar and should be taken seriously by those who feel comfortable with present monetary expansion.

David Wright

Thank you both so much. Hal, do we have a little time for a quick comment from either Larry or Jacques? Do we need to move on?

Hal S. Scott

Let us maybe give each of them a couple of minutes to respond.

Larry Summers

I have found, as I expected to, Jacques enormously thoughtful. Jacques, if you would be able to forward me a copy of your remarks, I would be grateful, particularly for your statistics on what happened with respect to global investment. I think I am saying something Jacques would agree with, but the latter 60% of my remarks were heavily devoted to the policy response to Covid in the United States and possible excesses of the policy response to COVID. Jacques' remarks, if I understood them correctly, were in a sense more deep, long run and structural. He addressed issues that we were grappling before there was Covid and that we may well be grappling with in the aftermath of Covid.

Jacques raises a very profound issue, which in the language of my classroom economics would be the question of whether the IS curve in fact slopes downwards, i.e. whether it is in fact true that declines in interest rates do contribute to increases in aggregate demand or, through the various mechanisms he describes, in a context like Europe whether they actually reduce aggregate demand. I have considerable sympathy with Jacques here, and indeed I have a manuscript that I have been working on that raises questions about the impact of interest trades on aggregate demand in the way he described. Jacques makes an important point, which I have been aware of but have focused on insufficiently and will focus on more in the future, having to do with the distinction between the bank centric European system and the less bank centric American system in the transmission mechanism of low interest rates.

There is a challenge I would put to my friend Jacques, though. If one accepts his view about interest rates, if one accepts his view about the perils of central bank financing of the long end of the bond market, if one accepts his views about excessive fiscal indebtedness, what is the source of the energy that will lift these economies that are in something of a deflationary situation? Perhaps his focus is Europe, and his answer is a significant further decline in the value of the euro, but that is something that is not going to be entirely welcome internationally. So the question I would put to my friend Jacques would be, presuming that we are somehow past Covid, where is the energy going to come from? Is he confident about the efficacy of the structural reforms that he has long favoured?

Jacques de Larosière

Thank you. In a nutshell, you have presented the different approaches between us in a very clear and

lucid way. I would add two remarks, however. First of all, yes, it is true that I am more geared on structural reforms than Larry is in his statements, but I will remark that the absence of structural reforms for some 40 years, which I have observed in my own country for instance, eventually creates conjunctural problems. If you have an economy that is less productive and less competitive, if you have an absence of supply side reforms, eventually you get into lower growth. In order to offset low growth, you get into more stimulative policies, which themselves have financial drawbacks and compound the balance of payments. That is one general remark.

The second point is this one. In the United States, monetary policy works rather well, because when you reduce interest rates to close to zero – not completely zero but close to it – you have an immediate offsetting mechanism which pushes up shares on the equities side, and therefore the economy is stimulated by the fact that shares are being bought by investors. In Europe, it is different. People are more sceptical about shares. They feel the risk is substantially higher in shares, and therefore you do not have the transmission of low interest rates going into dividend creating instruments. I think we have to understand the difference in investment behaviours in Europe and in the United States. However, I very much appreciate the openness of Larry, which is for me extremely important for the reasons I set out at the very beginning. Thank you.

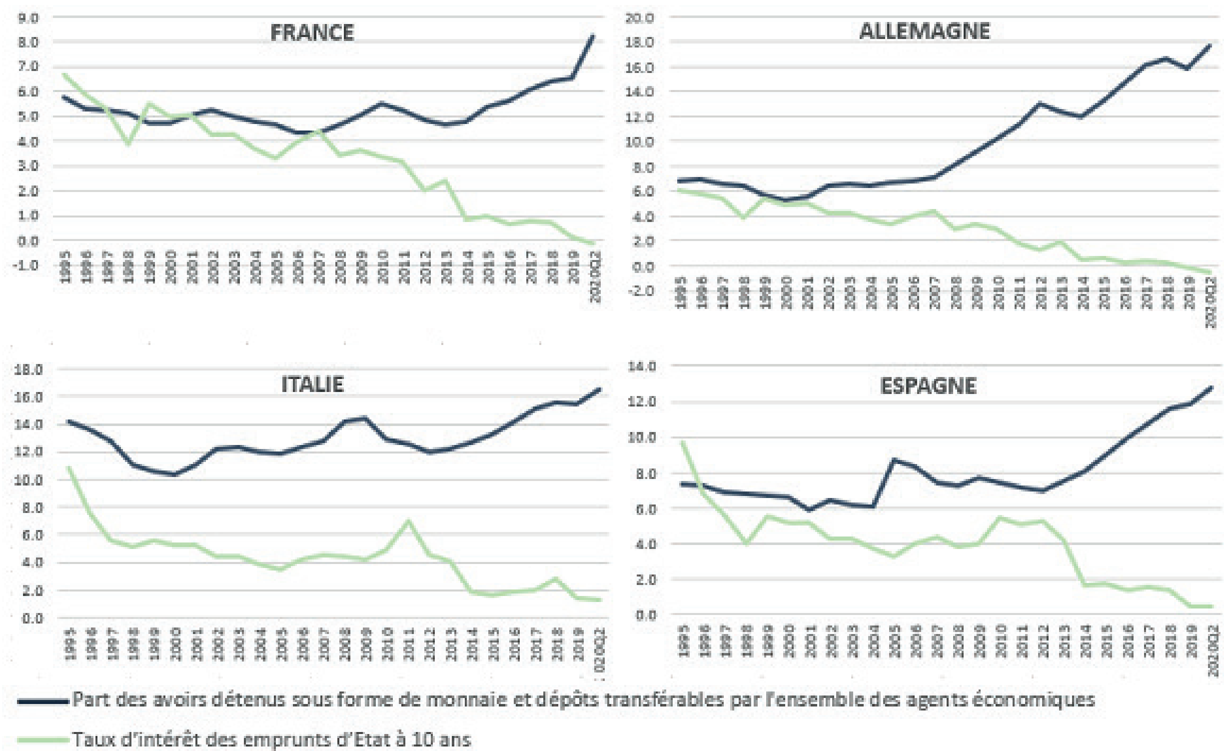
To sum up, I answer your question: the "energy" will come from two things:

- Restoring normal remuneration on long term investments and savings (growth has never been observed in an environment of zero interest rates)
- Reforming structural deficiencies that hinder production

Hal S. Scott

Thank you, Jacques and Larry. I could listen to this for hours. It is too bad that we have limited time, but I think even in this limited time we have benefited tremendously from both of your remarks, and I want to thank you very much for being with us.

Figure 1. Evolution of liquid assets held by economic agents and sovereign interest rates



Source: Eurostat, Thomson Reuters, calculs OEE (Observatoire de l'Epargne Européenne)

REFLEXION ON THE APPROPRIATE STANCE OF MONETARY POLICY

Note written by Jacques de Larosière

Today's world is made up of paradoxes.

Global demand is weak, while investment needs are enormous and are not being realized, at least in Europe.

Interest rates have been kept very low for many years, although non-residential productive investment has been declining.

Let us try to put some order in these apparent contradictions.

1. Why has monetary policy been particularly accommodative for more than 10 years and interest rates have converged to zero or less?

M0 (ie bank notes in circulation and bank reserves held at the Central Bank) has grown extremely fast since 2008: 13,5% a year in advanced countries, while their GDP grew on average 2% in real terms.

Given an annual GDP inflation around 1,5%, the average nominal growth of GDP in the advanced countries has been in the order of 3,5%. Therefore, during those 10 years, the Money base had grown almost 4 times quicker than the nominal economy.

How can we explain such a prolonged and rapid expansion of money through the massive recourse to QE?

The explanation is simple but worrisome.

In a nutshell, it is the following:

Monetary policy has been geared to an overriding objective in terms of Consumer Price Index (CPI) in order to keep inflation at a level close to 2%.

But this objective gives rise to a major problem:

Structural factors have been at play over the last 10 to 15 years (while they did not manifest themselves in the earlier years - 80's and 90's - during which the objective of 2% was conceived).

Indeed, since then, a number of structural factors have coalesced and have exerted, together, a significant and lasting dampening influence on inflation:

- The ageing of population reduces the pressure of consumption and investment on resources;
- The opening of international trade and globalization have allowed "western" countries to import massive amounts of goods and services that are made up of very low wages (approximately 1/10th of those of industrialized countries);
- In order to try and resist this over-competitiveness of emerging countries exports, the "west" has been obliged to contain its own wages, thus exerting a dampening influence on costs as well as on wage earners behavior;
- And one should add the consequences on prices stemming from technological innovations that are significantly reducing the costs related to the information technology.

The above factors explain the moderation of inflation.

This moderation was not the result of a weakness in demand, but, basically, of structural changes.

That is where, in my view, monetary policy makers have made a serious mistake.

They seemed to believe that low inflation – lower than the, arbitrary, target of 2% - was essentially the manifestation of insufficient global demand. Therefore the Keynesian recipe: ie monetary stimulus – was justified in their eyes.

So they decided to increase monetary creation as long as inflation was lower than the sacro-saint target.

I believe the nature and the causes of the desinflationary forces should have analysed more precisely. To the extent these forces are structural – and thus unavoidable – one should not try to repress them by more money expansion. It is remarkable that money expansion, in fact, did not create more demand nor more inflation but translated into less velocity. If one looks at M3 (that includes banking deposits) one observes a much slower expansion (3,8% annual average in the EU). This shows that the push in Central Bank money (M0) has not seeped into the real economy and has not created much banking credit.

Indeed, the structural environment that I describe showed that an "inflation objective of around 1%" would have been, in fact, the equilibrium rate. Such a target would have avoided inflation as well as deflation.

If monetary policy over the past 15 years had been geared to a more realistic inflation target of around 1% instead of 2%, the world would have avoided the un-necessary expansionist monetary stance as well as deflation.

This systematically loose monetary policy has contributed to the building of the enormous credit bubble that nearly broke down the financial system in 2008. All financial indicators were flashing. But as the CPI was low, Central Banks were not worrying.

However, they should have been concerned by the huge asset bubble that was building.

Such bubbles are indeed the present manifestation of inflation in an environment of technological price desinflation.

As strange as it can seem, the extreme magnitude of the excess leverage that was appearing in the financial cycle, did not attract the attention of Central Bankers, simply because CPI was stable. The financial

house was burning, but no alarm bell was ringing; complacency was the name of the game and the fire became threatening.

2. Thus monetary policy has been extremely accommodative, while growth has been subdued and investment has receded. What have been the results of such a policy on growth?

Let's try – once again – to put some order into apparent contradictions.

Firstly, if aggregate demand remains weak, it is mainly, as I have just shown, due to structural factors: ageing, globalisation, technological advances, changes in labour market behaviour, leading to an overall saving surplus. This is where the debate on monetary policy and interest rates starts.

We are told that in the face of excessive savings, we need fiscal and monetary policies to stimulate demand.

Let us pause for a moment to analyse this apparent obviousness.

As we have seen, monetary policy has been particularly accommodative for more than 10 years and interest rates have converged to zero. Public deficits have been booming and the public debt-to-GDP ratio has risen from 100% to 120% in the advanced countries within 5 years (2015-2020). Private debt incurred by non-financial enterprises has also ballooned (in France, for example, the private debt service of non-financial enterprises is reaching 22% of their disposable income, while the figures are 15% and 10% respectively in the US and in Germany).

What do we see?

In spite of the explosion of debt over the past 20 years, the stock of non-residential productive investment (without intangibles) has fallen from 14,4 % to 12 % of GDP in advanced economies which has been only partially offset by the rise in intangible investments which have risen from 4,3 % to 4,9 % of GDP (see Figure 1). This is a major downward evolution.

What surprises me is that this statistic – which is one of the most significant in terms of global demand – is not highlighted more. And this collapse of productive investment has occurred despite historically low interest rates.

Let's continue this line of thinking. A strange hypothesis eventually emerges : What if it was low interest rates that contributed to lower investment ?

"Absurd and nonsense" I will be told: if the financing conditions are easy and inexpensive, how could the investment be penalized? This is where the liquidity trap comes in.

Once again, Keynes was right. He was in favour of low interest rates, but not too low interest rates. Indeed, when they are too low, they deter savers from investing in long term bonds and encourage them to either keep their savings in liquid form or in assets remunerated basically because they are risky. On the other hand, entrepreneurs, discouraged by the prospect of no-growth emanating from zero interest rates, are turning away from productive investment in favour of share buybacks and speculative opportunities.

What I have ust said is not a confabulation. This is based on a study carried out last year on the development of the financial part of household savings in Europe: **over the past 10 years, we have seen a massive increase in the purely liquid part of household savings (notably overnight bank deposits). And this, of course, before the Covid crisis.**

For sure, this research is European and may be less verifiable in the United States, where investors are less risk-averse than in Europe and more interested in the opportunities offered by Wall Street. So, I don't pretend that my interpretation is universal. But if it is correct in Europe, we should give serious thought to the problems posed by our current monetary policy.

This is all the more so as the role of banks in financing the European economy is much more marked than in the United States (3/4 in Europe, ¼ in the United States). The profitability of banks is penalized by zero interest rates. This penalty is all the more pronounced in Europe as interest rates are lower than in the United States.

So, there is a problem in Europe: is it possible that the mantra that we have been taught for 20 years is not adequate? Could it be that slightly higher rates could boost the morale of European companies and steer savings towards productive investment?

What I have just said might not be of great interest to American economists: their country has an extremely strong stock market and economic agents are less sensitive to interest rates because of their natural tendency, when interest rates get very low, to move from bonds to equities. In addition, the United States issues the world currency, which gives it some leeway to finance its deficit.

3. So, we have to deal with the question: rather than being satisfied with a paradigm of low growth in Europe, isn't it time to ask the fundamental question: «What if zero interest rate monetary policy was not the right recipe for reviving the global economy?»

I have recently heard a Chinese economist, a professor at Peking University, say the following: «A too accommodating monetary policy raises many objections:

- Our economies need investments: to finance them we must encourage instruments with sufficiently high returns to cover the risks involved.
- Using monetary policy to stimulate the economy inevitably leads to the inflation of financial assets and thus increases the danger of a crisis».

The profound truth of the real world is that a well-functioning economy is always based on work and normal returns on savings and therefore interest rates freely defined by the markets.

I will be told that, for all the secular reasons we know, the "natural» interest rate is declining.

That's certainly true. But what is not said is that monetary policy plays a major role in lowering rates. It is so true that when the market anticipates the start of a rate hike, central banks usually buy billions of securities to discourage this trend.

Of course, I am aware of the effects of this recommended approach on sovereign securities markets. But monetary policy should not be at the service of the fiscal sustainability of States. Markets must play their role and not be entirely dictated by central banks.

Or should the wartime "Accord" between the Fed and the US Treasury be revived and sustained worldwide?

Even if the above does not convince the leading monetary thinkers, **there remains an unescapable issue: that of financial instability.**

The Financial Times has recently reported that "the riskiest borrowers in corporate America are making up their largest share of junk bonds sales since 2007.

From the start of 2021, more than 15 cents of every dollar raised in the US high-yield bond market have been issued by groups with ratings of triple C or below".

And I would add that, according to a gauge of "cross-asset complacency" from JP Morgan, investors are feeling the least fearful and most complacent since the dotcom bubble.

This sounds familiar and should be taken seriously by those who are responsible for monetary stability and still feel comfortable with the present monetary expansion.

Conclusion

Time has come to start getting out – gradually and with the benefit of international concertation – of the present monetary trap : I would propose three orientations :

1. Allow long term financial markets express their inflationary expectations through higher yields. This would provide investors with a more normal remuneration: to foster long term investment, adequate remuneration for risk is essential;
2. Have a more realistic view on price developments. A positive CPI but slightly less than 2% is not a sign of instability, on the contrary;
3. If yields tend to get somewhat higher, Central Bankers should not consider that they should, by all means, repress that tendency and provide Member States with the unconditional benefit of a zero-rate guarantee.

Fiscal domination – which is presently a fact of life – should not become the rule.

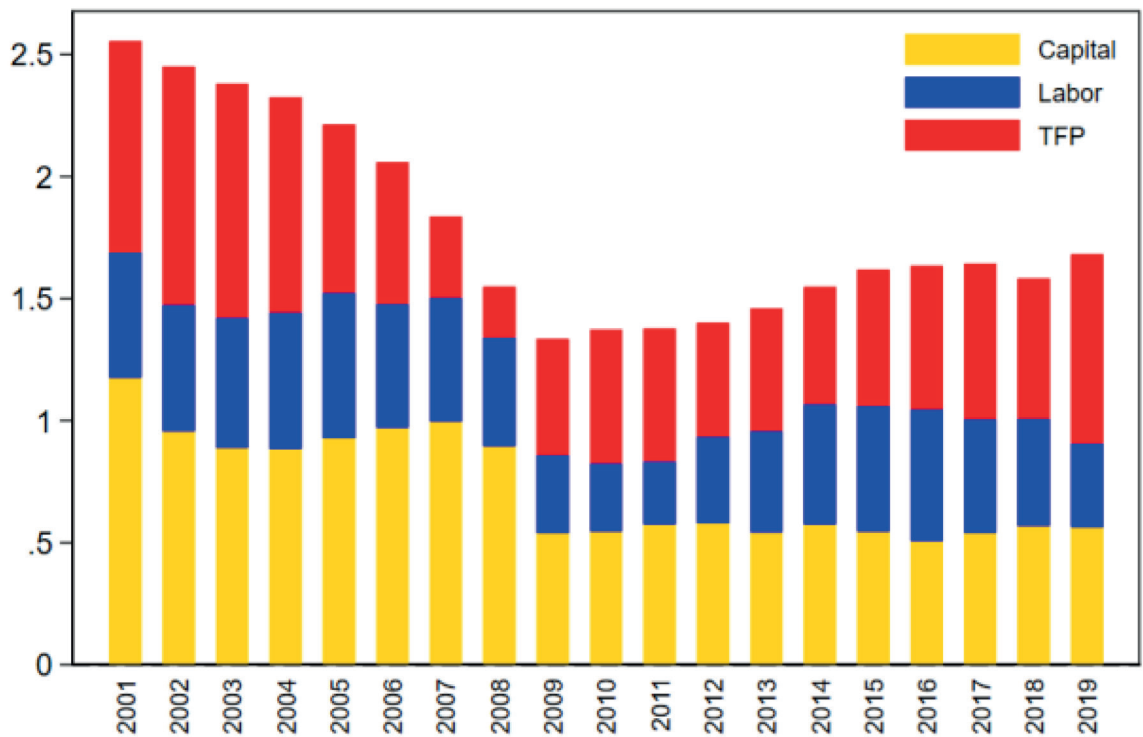
Appendix

Figure 1. Advanced Economies: Non-residential Fixed Investment in GDP (Percent of GDP)

Source: OECD; IMF Staff Calculations.

Advanced Economies = Australia, Canada, France, Germany, Italy, Japan, Korea, Spain, United Kingdom, United States.

Figure 2. Advanced Economies Production Decomposition Function (Percent, year over year)



* Potential GDP = Estimate from a multivariate filter.
* Capital = OECD non residential capital stock.
* Potential labor = Trend labor participation rate x working age population x (1- NAIRU); NAIRU from multivariate filte.
* Labor share = average over the period, from Penn World Table.

Sources: OECD; Penn World Table; IMF Staff Calculations.

Advanced Economies = Australia, Canada, France, Germany, Italy, Japan, Korea, Spain, United Kingdom, United States.

LESSONS FROM COVID REGARDING THE EU FUND SECTOR'S RESILIENCE

Note written by Marc Truchet, EUROFI

1. The debate about fund liquidity risks has been revived by the Covid crisis

Liquidity issues experienced by some investment funds in March and April 2020, as well as previous events in 2019 related to the collapse of Woodford Investment Management or H2O AM have revived the debate about fund liquidity and resilience, which was a key concern after the 2008 financial crisis.

Although the European fund sector generally demonstrated resilience during the market stresses of March-April 2020, liquidity mismatches in the set-up of certain funds were amplified by a deterioration of the liquidity of their underlying assets combined with significant investor redemptions. Some industry players have however emphasized that although these redemptions were high in nominal terms, they remained at manageable levels when viewed as a percentage of fund assets under management (AuM). The funds concerned are certain open-ended funds that invest in potentially less liquid and / or more risky assets, such as corporate high yield and emerging market bonds[1] or real estate[2], and offer high redemption frequency with no or short notice periods. The fact that some of these funds had low liquid asset buffers before the crisis has also been stressed by some regulators. Some market players have pointed out however that the buffers measured only include cash and government bond holdings whereas these funds may sell a wider range of securities to weather a market shock or manage large outflows and thus do not rely on liquidity buffers per se for meeting redemptions[3]. Other influences on market dynamics that have also been highlighted include the drop in equity prices that led to portfolio rebalancings from fixed income into equities, leverage used by volatility-targeting funds[4] and loan covenants for real estate funds that may have triggered fire sales.

The data collected by ESMA[5] in response to a recommendation of the ESRB[6] show that the vast majority of EU corporate debt and real estate funds were able to meet redemption requests and maintain their portfolio structure during the Covid events of 2020 and quickly recovered. Only a limited number of funds were obliged to suspend redemptions (0.4% of the ESMA EU corporate debt funds sample in March). ESMA's data also show that redemption suspensions were mainly motivated by material valuation uncertainty and insufficient market liquidity of some underlying market segments, rather than outflows. While redemptions from funds picked up towards the end of March, they shortly afterwards reversed into inflows, as significant central bank interventions[7] improved investor confidence in bond markets, in the absence of sufficient market-making activity, and as fiscal policy helped to support debt issuers through the first stages of the pandemic. Some Liquidity Management Tools (LMT) also played a role in the management of redemptions. Approximately 25% of corporate debt funds of the sample analysed by ESMA used swing pricing[8] in order to treat remaining investors fairly. Temporary borrowing was also used by approximately 10% of these funds.

Many EU money market funds (MMFs) were also affected in March 2020 by high levels of redemptions from their investors close to the levels seen in the 2008 financial crisis (10 to 20% of holdings during the most stressed period in March)[9],

1. For example high-yield corporate bond funds experienced significant outflows of more than 10% of their assets under management during the first quarter of 2020. Source ECB, speech by I. Schnabel 19 November 2020. The liquidity of certain corporate bond markets practically disappeared during that period or costs of transacting rose significantly.
2. Only certain jurisdictions such as the UK allow real estate funds to use an open-ended structure with daily redemptions.
3. This is backed by ESMA analysis showing that corporate bonds were able to meet redemptions by vertical slicing, thereby maintaining a consistent liquidity profile
4. i.e. contractual obligations relating to the loans received.
5. ESMA report on the Recommendations of the ESRB on liquidity risks in investment funds – 12 November 2020.
6. Recommendation of the ESRB on liquidity risks in investment funds (ESRB/2020/4).
7. The ECB expanded its asset purchase programme (APP), extending eligibility for the corporate sector to commercial-paper of select non-financial corporates. A € 750 Bio Pandemic Emergency Pandemic Programme (PEPP) was put in place targeting all assets under the APP i.e. commercial paper, corporate bonds, covered bonds and public sector securities and without conventional country-level and maturity restrictions. Additional liquidity support was given by the ECB through a 25 bp curb on an expanded TLTRO III programme, extending financing to banks linked to household and non-financial corporate lending followed by a relaxation of collateral acceptability criteria (including Greek government debt and "fallen angel" corporate bonds) and additional emergency longer-term refinancing operations.
8. The objective of swing pricing is to protect existing investors from the dilution of value caused by trading costs resulting from subscription and redemption activity on the fund. Swing pricing allows the fund sponsor to adjust the price of a fund unit using a parameter, known as the "swing factor", which incorporates an estimate of the bid-ask spread, so that all investors who deal on a given dealing day bear the cost of transactions to meet their redemptions (or subscriptions) if there are large outflows or inflows.
9. On the liability side, investor redemptions peaked in the second part of March, with outflows totalling 20% of LVNAV MMF holdings and more than 10% of VNAV MMFs in some EU countries (Source Speech by S. Maijoor at the EFAMA investment forum). EUR LVNAV saw 16% AUM outflows over most stressed 7 days in March, Sterling -11% over similar period and Dollar -29% over worst 19 days (of which 60% went to Gov Liquidity CNAV). Looking at the whole month of March EUR VNAV and LVNAV both saw 14/15% outflows (source: Central Bank of Ireland and Central Bank of France).

combined with a deterioration of the liquidity of commercial paper (CP) markets on the asset side[10].

This asset outflow concerned particularly USD denominated Low Volatility NAV MMFs (LVNAVs)[11] and EUR denominated Variable NAV MMFs (VNAVs), whereas Constant NAV MMFs (i.e. CNAV funds that are quasi-exclusively exposed to sovereign debt) benefitted from inflows, due in part to a 'flight-to-safety' in particular for those in US dollars. Two other underlying drivers of MMF redemptions were an increase in CCP margin calls that led market participants who faced liquidity pressures to withdraw liquidity from MMFs in order to meet these margin calls and redemptions by non-financial companies seeking to meet their operational cashflow needs in the Covid context.

Many LVNAVs in the EU were able to meet redemptions through the market turmoil in part by selling securities in the secondary market. Where lack of dealers did not allow that, cash was retained from maturing securities[12] (rather than reinvesting in new CP/CD paper). Only a small number of LVNAVs dipped below their mandated 30% weekly liquidity buffers and none were forced to impose redemption gates or liquidity fees.

For VNAVs that did not have such requirements linking liquidity buffers with the possibility of imposing gates and fees, these buffers were a more effective tool for meeting redemptions, although some of them also had to sell securities and stop reinvesting the proceedings of maturing ones to cover redemptions. Central bank interventions were put in place by the ECB, aiming at compensating the lack of market liquidity (widening of asset purchases, liquidity operations, bank refinancing operations and backstop facilities) but these concerned part of non-financial CPs[13] and longer maturity instruments and thus did not benefit most MMFs directly. Regulators and market participants have however considered that these measures helped to restore confidence throughout the system.

With volatility decreasing and the market stabilising, outflows fell from the beginning of April 2020 and have been replaced by inflows since then. In general however, the short term markets in Europe remained stressed for several weeks in contrast to the US where temporary capital requirement relief for dealer banks unblocked the short-term markets.

2. The on-going Covid crisis may lead to further market stress

Although no significant financial stability issues emerged related to investment funds during the first phase of the Covid crisis, many regulators consider that potential vulnerabilities in the fund sector were exposed by the March-April events and need addressing, together with the factors that led to insufficient liquidity of some underlying markets, in order to avoid further distress and central bank interventions. They indeed argue that liquidity issues may have significant consequences for investors if they result in a suspension or a higher cost of fund redemptions and that they may cause systemic spill-overs due to potential fire sales and interconnections within the financial market[14].

The next stages of the Covid crisis could indeed lead to more risks to financial markets. The Covid pandemic may provoke some new periods of market stress in the coming months (e.g. related to virus variants or the effectiveness of vaccination). In addition the current decoupling between market valuations and the real economy may create further volatility episodes. Monetary policy is a second factor. Ultra-low interest rates may spur continued risk-taking from investors in search for yield and foster asset bubbles creating possible market stress. Other elements also need considering, such as the risk of higher inflation in the future or cross-asset correlations that have increased during the first months of the Covid crisis, reducing diversification benefits[15].

Regulators have also pointed out some remaining issues in the fund sector, as mentioned further up. These include potential liquidity mismatches, with up to 90% of corporate bond funds offering daily redemption while investing in less liquid assets and 42% of real estate funds, according to ESMA assessments and the fact that only a limited number of funds with liquidity mismatches have adjusted their liquidity management processes following the Covid crisis. Other issues that have been mentioned concern the cash holdings of EU corporate bond funds that remain low, despite a temporary increase in Q2 2020, and an increase of the leverage of hedge funds.

The functioning and structure of underlying markets that were distressed during the first episode of the Covid crisis (certain corporate bonds, real estate, short-term markets…) and in particular the challenges associated with market-making activities that had to be compensated by the intervention of central banks are also an essential issue that needs tackling, according to many commentators, as well as the modalities of CCP margin posting.

In addition, the limitations of the tools used for tackling liquidity issues in March / April 2020 need to be considered. The central bank actions that helped to swiftly alleviate market stress through different

10. The fact that the liquidity of money markets is relatively low in normal times also has been mentioned by some regulators. However many market participants stress that while there is low turnover of CP in normal market conditions, this does not necessarily equate to low liquidity (i.e. CP may trade infrequently but normally).

11. Low Volatility NAV MMF can maintain a constant dealing NAV provided the mark-to-market NAV does not deviate from the dealing NAV by more than 20 bps

12. Source: Thematic note 'MMFs during the March-April episode' – IOSCO November 2020.

13. Only non-financial companies that were rated by ECB approved CRAs were eligible (e.g. not those rated by all ESMA-approved CRAs).

14. These regulators consider that mismatches between the liquidity of open ended funds and their redemption profile may lead to fire sales to meet redemptions, potentially amplifying market stress and affecting other financial market participants holding the same or correlated assets, given that investment funds hold a significant proportion of the stock of some less liquid securities in the EU such as non-financial corporate bonds or commercial real estate. The interconnections that exist between MMFs and the financial system are also pointed out by regulators since MMFs play a significant role in the short term funding of banks and CCP participants hold liquidity positions in MMFs that they may sell to post margin in cash.

15. Source IMF: Global financial stability report October 2020.

channels may create moral hazard and foster the wrong incentives in terms of risk management, if they are systematically reproduced. Secondly, the present variability in the availability of liquidity management tools (LMTs) across member states means that these tools are not as effective as they could be to mitigate these risks. Some observers however stress that they are already quite widely available notably in the 4 main EU fund domiciles (Luxembourg, Ireland, France and Germany) and widely operationalised in the EU's primary cross-border fund domiciles.

3. Fund liquidity rules have been updated since the 2008 financial crisis

EU fund frameworks contain a wide range of liquidity rules that are complemented by international recommendations developed by IOSCO, as well as liquidity management tools (LMTs) available at domestic levels in the EU. Concerns were however repeatedly expressed by supervisors and regulators about the build-up of potential liquidity mismatches in investment funds before the Covid crisis, raising the question about whether liquidity rules are complied with in practice by all funds in the EU.

3.1. Existing UCITS and AIFMD liquidity requirements and domestic LMTs

The UCITS and AIFMD directives both contain liquidity management requirements that aim at ensuring the fund's ability to meet investor redemption requests according to the fund rules, in a manner consistent with the fair treatment of all investors[16].

AIFMs are required to maintain consistency between the investment strategy, redemption policy and the liquidity profile of their AIFs. Mandatory disclosures to regulators and investors also cover liquidity risk. For example, the details concerning the liquidity profile of each AIF must be shared with the National Competent Authorities (NCAs) and fund inventories must also be reported to the central bank in Eurozone Member States. Investor disclosures must also include information on illiquid assets, liquidity arrangements that can be potentially used by AIFs such as gates or side pockets and on redemption rights. Both AIFMs and UCITS managers under ESMA's stress testing Guidelines, most recently updated with effect from September 2020, must conduct regular stress tests of the funds they manage under both normal and exceptional liquidity conditions assessing both asset and liability risks and the results of these stress tests must be shared with NCAs.

Management companies are also required to employ an appropriate liquidity management process in order to ensure that the UCITS they manage are able to comply at any time with allowing investors to redeem their units on demand. This includes ensuring that the liquidity profile of the investments of the UCITS is appropriate to the redemption policy laid down in the fund rules and also conducting regular stress tests. UCITS may also temporarily suspend redemptions in the interest of unit holders under certain conditions. In addition, UCITS are subject to detailed eligibility rules that govern the types of assets in which they are allowed to invest and that limit exposures to derivative instruments and concentration with counterparties.

Following recommendations made by the ESRB in December 2017[17] on liquidity and leverage risks in investments funds, ESMA has complemented UCITS and AIF liquidity rules with guidelines on stress testing in order to support the regular testing of the resilience of funds to liquidity risk under normal and exceptional liquidity conditions. ESMA has moreover undertaken different supervisory actions in connection with the NCAs with regard to liquidity risk including: a stress simulation exercise (STRESI) combining asset liquidity and redemption shock simulations (which showed vulnerabilities among about 10% of EU fund) and a common supervisory action as well as a data collection exercise on liquidity risk management.

LMTs such as gates, swing pricing or side-pockets are also accessible at the domestic level for managing fund liquidity risks, both for UCITS and AIFs. These tools are already used by investment funds in the EU when needed, since they are available in the main EU fund domiciles, but their availability varies across jurisdictions and they are not standardized at the EU level. At present, the suspension of redemptions is the only LMT that is available to all funds in all jurisdictions.

A final element that needs considering is that the design and features of all regulated funds (UCITS and AIFs managed by regulated AIFMs) including their liquidity features, have to be submitted for authorisation to the regulator of the fund domicile, who also ensures the monitoring of risks and investor protection on an on-going basis.

3.2. MMF liquidity rules

As for MMFs, they are mostly structured as UCITS in the EU and therefore come under the liquidity rules mentioned above. A specific MMF regulation (MMFR) was moreover adopted in 2017 aiming to improve the resilience of MMFs. MMFR limits the use of a constant NAV to MMFs investing at least 99.5% of their assets in public debt and has created a new type of MMF (Low Volatility NAV MMF) which can maintain a constant dealing NAV provided the mark-to-market NAV does not deviate from the dealing NAV by more than 20 bps.

Beyond the definition of fund structures, MMFR also introduced liquidity requirements including daily and weekly liquidity buffers which vary across the different fund structures and specific provisions around liquidity fees and redemption gates completing UCITS provisions (fund boards are required to take a decision as to whether to use these tools when breaches of the minimum weekly liquidity levels, coupled with 10% daily outflows from the fund are observed). The MMFR also contains risk management requirements imposing internal processes to monitor credit quality, portfolio diversification, maturity thresholds and KYC procedures. Stress testing, the guidelines for which have recently been updated by ESMA, is also mandatory and has been implemented by EU fund management companies.

16. The UCITS and AIFM directives also provide a legal basis for limiting the build-up of leverage in investment funds.

17. Recommendation of the ESRB of 7 December 2017 on liquidity and leverage risks in investment funds (ESRB/2017/6).

In addition, transparency requirements are imposed notably regarding portfolio holdings and their liquidity for informing investors and NCAs.

3.3. International fund liquidity guidelines

At the international level, recommendations were introduced by IOSCO in 2018 for addressing liquidity risks from asset management activities, following work conducted by the FSB on vulnerabilities from market-based finance activities. These recommendations are broadly consistent with EU fund liquidity rules. A thematic review of these rules was launched in March 2021 by IOSCO aiming at gathering information about how they were implemented by the responsible entities.

The objective of these IOSCO recommendations, which concern the design of funds, their day-to-day liquidity management and contingency planning is to make sure that asset managers are prepared for and are able to adapt to a constantly changing market environment and potential liquidity risks.

IOSCO therefore recommends that "responsible entities" for fund management should include liquidity risk management processes and tools in the design of their funds (e.g. appropriate liquidity thresholds, suitable dealing frequency, appropriate subscription and redemption arrangements, liquidity aspects related to its proposed distribution channels…) and integrate liquidity management in investment decisions. The responsible entity should moreover monitor the performance of its liquidity risk management process, regularly assess the liquidity of the assets held in its fund portfolios, perform regular fund level stress testing and identify any emerging liquidity shortage risks. In addition, IOSCO recommends that entities should determine whether or not and also how to possibly activate additional liquidity tools and also put in place contingency plans to ensure that liquidity management tools can be used if needed.

4. Proposals for improving fund liquidity risk management in the EU

Many regulators are calling for a stricter enforcement of existing fund liquidity rules as well as a review of these rules in the light of the latest Covid-related events. Suggestions have also been made that a broader macro-prudential framework should be put in place for investment funds.

Reinforcing the resilience of the NBFI sector and addressing potential vulnerabilities related to liquidity mismatches, leverage and interconnectedness is also an objective put forward at the international level by the FSB, following the Covid events.

4.1. UCITS and AIFMD liquidity rules and tools

ESMA has identified five priority areas for further enhancing the preparedness of corporate debt and real estate funds in particular to potential future redemption and valuation shocks[18].

Three of them relate to an improved implementation and supervision of key liquidity provisions of the UCITS and AIFMD frameworks i.e. (i) the requirement to align the fund's investment strategy with the redemption policy; (ii) the quality of the liquidity risk assessment; and (iii) valuation processes in a context of valuation uncertainty. Asset managers are encouraged to step up their efforts to ensure that the relevant requirements are adequately complied with. NCAs are also asked to pursue the ongoing monitoring of compliance with these rules, particularly concerning any corporate bond and real estate fund that has been identified as being in breach with EU requirements following the on-going data collection exercise conducted by ESMA.

In its 2017 Recommendation, the ESRB has also stressed the need for open-ended AIFs to align the fund's strategy with the redemption policy. This recommendation concerned corporate debt and real estate funds, but also funds investing in unlisted securities, loans and other alternative assets[19].

Some commentators have emphazized that the alignment of investment strategies and redemption policies must in priority be achieved in the design and registration phase of funds during which asset managers and NCAs must ensure that the fund characteristics and rules are consistent. Moving away from daily dealing also raises commercial and technical challenges that need addressing. Retail investors tend to prefer liquid funds and advisors are likely to recommend daily dealing funds. Moreover, most fund trading platforms work on the basis of daily dealing[20]. Alternatives include imposing stricter conditions for daily dealing to be possible (e.g. financial penalties that have been proposed for maintaining daily redemptions of real estate funds in the UK; use of liquidity management tools when needed) and for them to be explicitly communicated to investors, as well as improving the functioning and liquidity of the underlying market segments.

The two other priorities proposed by ESMA involve additional regulatory requirements that could be implemented in the context of the AIFMD review underway.

The first proposal is to develop a harmonised legal framework at EU level regarding LMTs in both UCITS and AIFMD frameworks, in order to increase their availability and use across the Union, without necessarily standardising the tools or the way they are used. This proposal was also part of the 2017 ESRB recommendation, which was addressed to the European Commission[21]. Some industry players however point out that LMTs are already widely available in the main EU jurisdictions for fund registrations (i.e. Luxembourg, Ireland, France, Germany) and that an EU framework with more prescriptive rules may reduce the flexibility that is needed in using them. Some industry representatives have also suggested that efforts should

18. Source Speech by S. Maijoor EFAMA investment forum 2020.

19. Recommendation B of ESRB/2017/6.

20. FT 22 June 2020 – Fund suspensions underline liquidity mismatches and ESMA's report (November 2020 – see above).

21. Recommendation A of ESRB/2017/6.

focus on certain LMTs that have limited procyclical effects, such as swing pricing, which ensures that transacting investors bear the cost of liquidity, thereby incentivising requests to be spread over a number of days and removing first mover advantage potential [22].

The second proposal put forward by ESMA relates to the establishment of specifications on how fund profiles should be established and reported, concerning notably the percentage of a fund portfolio that can be liquidated and arrangements with respect to gates and notice periods, in order to support a risk-based supervision of liquidity risks.

4.2. MMF rules

Further areas of improvement have been put forward regarding MMFs. Following its recent assessment of Covid events, ESMA emphasized the importance of stress tests and ensuring that they are systematically conducted according to ESMA guidelines and that scenarios used and results obtained are centralised via the NCAs. Several areas of potential reform of the MMFR to be taken into account in the future review of the regulation have also been identified by ESMA in a consultation launched on 26 March 2021. These potential reforms include: (i) a decoupling of regulatory thresholds from suspensions/gates to limit liquidity stress, and a requirement for MMF managers to use liquidity management tools such as swing pricing; (ii) a review of requirements around liquidity buffers and their use; (iii) a review of the status or an elimination of certain types of MMFs such as CNAV MMFs and LVNAVs; and (iv) an assessment of the need to modify sponsor support rules.

The ECB has moreover suggested that further work on MMFs should focus on enhancing liquidity features and removing incentives for investors to redeem early, considering the unintended side effects of suspending redemptions or imposing gates[23]. Further proposals made by regulators are that MMF liquidity requirements could be alleviated in times of crisis and that the prohibition of sponsor support for MMFs could be reconsidered, given that in the US banks are allowed to provide support to their MMFs.

Industry representatives have however pointed out that the March-April events were mainly due to the absence of liquidity in the underlying money markets and to the significant demand for liquidity simultaneously (e.g. to fund CCP margin requirements) and not to intrinsic flaws in MMF structures. It has thus been suggested that the priority should be to review the functioning of short-term markets, including looking at EMIR rules in order to allow the posting of MMFs as margin, rather than only cash. In addition, while MMFR rules meant that many funds were well-positioned from a liquidity and transparency perspective, many market participants have commented on the need to ensure that liquidity buffers can be used in times of stress by reviewing the requirement to consider redemption fees and gates in case liquidity requirements are breached.

4.3. Macro-prudential toolkit and reporting requirements

ESMA and the ESRB are also supportive of further initiatives to develop the macro-prudential toolkit for investment funds in order to better monitor risks and the interconnectedness of investment funds with the EU financial system and reduce in the future the need for central banks to intervene in a crisis. These tools would complete existing measures that may be used in a macro-prudential perspective such as stress tests, reporting, LMTs and leverage limits. ECB representatives have also suggested that the current macroprudential toolkit should be extended to include ex-ante liquidity management tools such as minimum liquidity or cash buffers and redemption notice periods, as well as a close monitoring of intermediaries' leverage [24].

Although developing a more holistic view of the fund ecosystem and of the connectivity among its different components is generally welcomed, some industry players have emphasized in the past the possible downsides of using certain macroprudential tools such as cash or liquidity buffers or redemption policies at market segment level (i.e. across all or certain categories of funds or asset managers) due to their possible procyclical effects and impacts on end-investors, favouring instead liquidity measures or tools at the individual fund level.

Some regulators have also emphasized the need for more detailed harmonized and consolidated data for achieving this holistic view and also for allowing an appropriate monitoring of investment fund risks at the EU level (e.g. in order to better assess interconnections and risks of asset portfolios). For example at present it is difficult for supervisors to get an appropriate view of the liquidity positions of different fund categories and their recourse to LMTs at EU level. The ESRB has identified several areas where the reporting framework should be improved to allow for an effective monitoring of systemic risks[25]. The ESRB argues that a unique availability of fund identifiers is needed to understand the mapping of the AIFMD data with other sets of data (such as transaction data under the European Market Infrastructure Regulation – EMIR). The granularity of the information provided should also be enhanced as information systems allow to process efficiently big datasets and as a more detailed reporting on investments as well as on investors would be less costly for fund managers, compared to reporting aggregate statistics The need to harmonise UCITS and AIFMD supervisory reporting has also been raised by ESMA in the context of the AIFMD review.

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22. Source Blackrock – Lessons from Covid-19: Liquidity risk management is central to open-ended funds – November 2020.
23. ECB Financial Stability Review November 2020. ECB representatives have also suggested that a review of the liquidity requirements of MMFs and their portfolio composition is needed, especially for LVNAV funds. Source speech by Isabel Schnabel, 9 November 2020.
24. Source Speech by Luis de Guindos, 22 July 2020.
25. ESRB response to the European Commission consultation on the AIFMD review, 29 January 2021.

Moreover the fragmentation of fund supervision may hinder an appropriate monitoring of risks, according to certain regulators and the role of central banks in case of systemic financial crisis may also need clarifying[26]. At present, supervision is often shared among several jurisdictions since the management company may be licensed in a different country from where funds are registered and from where portfolio management is conducted[27]. Some industry players have pointed out that reporting is already extensive[28] and that what is lacking is not data but a better coordination among supervisors i.e. between domestic and EU regulators as well as between securities regulators and central banks, in order to improve the consolidation and use of the data that is already provided by asset managers.

26. Source Speech by R. Ophèle (AMF) at the CMVM annual conference – 8 October 2020.

27. This is permitted by the Management Company Passport aiming to optimize the functioning of management companies across the EU.

28. AIFMs provide liquidity reporting and UCITS also provide detailed statistical data on their positions facilitating liquidity analysis

2

EU BANKING AND CAPITAL MARKET FRAMEWORK ENHANCEMENTS

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IMPROVING THE EU BANK CRISIS MANAGEMENT FRAMEWORK FOR SMALL AND MEDIUM SIZED BANKS OF THE SSM AND THE SRB

Note written by Didier Cahen, EUROFI

Having an effective and integrated framework for managing crises, is essential for preserving the trust of depositors and the public at large, in order to avoid financial fragmentation and to safeguard financial stability.

The EU bank crisis management framework lays out the rules for handling bank failures. The framework was established in 2014 after the global financial crisis and in reaction to the EU sovereign debt crisis. It consists of three EU legislative texts that will be reviewed later this year: the Bank Recovery and Resolution Directive (BRRD), the Single Resolution Mechanism Regulation (SRMR) and the Deposit Guarantee Schemes Directive (DGSD) that all contain review clauses.

The principle is that all banks under SRB remit must be resolvable, and the reason is simple: safeguard financial stability without taxpayers being expected to foot the bill. So far, there is limited experience on the application of this framework that aims at addressing the "too-big-to-fail" issues exposed by the great financial crisis. The management of crises involving small-and-medium-sized banks usually takes place under ordinary liquidation procedures at the national level as, in most cases, they do not raise concerns for financial stability.

However, the experience of these first years of the Banking Union was perceived as showing some flaws in the current framework. In the limited number of cases of the recent years, some national resolution authorities used specific clauses in the crisis framework which led to an impression that "bail out" solutions for failing banks with a negative Public Interest Assessment were used rather than minimizing taxpayer losses. By doing so, these authorities applied more favorable burden-sharing requirements than would have been requested in resolution. This decision has to be seen against the background of potential losses to retail investors and small firms, which seemed to put pressure on the national policy authorities.

Furthermore, the differences between the resolution framework and the State aid rules create incentives to apply the former instead of resolution, which is negative given that the resolution framework was precisely developed to avoid the involvement of taxpayers. Indeed, State aid rules (Banking Communication 2013) have not been updated since they were published and therefore risk clashing with the current BRRD, SRMR and DGSD which came into force at a later stage. This draws attention to misalignment and consistency issues between the various components of the crisis management framework.

In addition, there are significant differences in national legal regimes for the liquidation of banks that do not satisfy the Public Interest Assessment. This generates level playing field concerns that might impair banking market integration and they may stand in the way of a smooth exit from the market for the weakest players.[1] These differences also create additional drawbacks when the SRB carries out the Public Interest Assessment (as it may diverge for banks in a similar position but under different national insolvency proceedings) and when applying the no-creditor-worse-off (NCWO) principle. More generally, it is essential to address the structural issue of the overcapacity of the banking system and to achieve an efficient crisis management framework, which allows an orderly exit of the weakest players from the banking market, thus strengthening the overall capacity of the banking system to finance the recovery of the European economy.

Against this backdrop, a review of the EU crisis management framework is welcome. This note presents the main characteristics and weaknesses of the EU banking crisis regime and proposes a way forward for improving the EU crisis management framework for small and medium sized banks under the remit of the Single Supervisory Mechanism (SSM) and the the Single Resolution Board (SRB).

1. The EU crisis management framework: features & weaknesses

1.1 Main features of the current EU crisis management framework

The EU bank crisis management lays down the rules for handling bank failures. In the Banking Union, unlike in some other jurisdictions, there is a clear distinction between the resolution regime[2] and the insolvency regime. The former is a single EU framework, applying to all banks that are failing or likely to fail and meeting with public interest criteria. This framework and the ensuing extraordinary powers are justified by the overriding interest in preserving financial stability. The failing banks that do not meet these criteria are liquidated through the domestic insolvency regimes, which vary substantially across jurisdictions.

So far, in practice, the EU Resolution is for the few, not the many, if we consider all banks in the Banking Union. Most banks will continue to fall under normal national insolvency proceedings in the same manner as any other failing business is dealt with. However, for 'systemically important' banks - whose failure would have a ripple effect on the rest of the economy – the EU resolution framework

1. A. Enria, Crisis management for medium-sized banks: the case for a European approach, Keynote speech by Andrea Enria, Keynote speech at the Banca d 'Italia workshop on the crisis management framework for banks in the EU, 15 January 2021.

2. The idea of resolution is, put simply, to ensure that a bank that runs into trouble can be dealt with effectively, having the smallest possible impact on the taxpayer - in other words, no more bail-outs - and at the same time, causing the least amount of damage to the wider economy.

applies potentially to all banks irrespective of their size, business model, complexity or interconnectedness. But to date, its application is the exception not the rule. Nonetheless, most banks under the SRB direct remit (122[3] banks) are expected to meet the "Public Interest Assessment" and therefore go for resolution instead of liquidation.

The European resolution framework[4] introduces some constraints on the management of bank failures. Indeed, it not only substantially constrains any possibility of providing public funds for failing institutions, but also imposes a minimum amount of creditors' bail-in - 8% of total liabilities including own funds (TLOF) - as a precondition for the use of the Single Resolution Fund (SRF) for capital support. In addition, all entities that could possibly be subject to resolution must issue a sizeable amount of bail-in-able securities (minimum requirement for own funds and eligible liabilities (MREL)). Indeed, for banks intending for resolution, the MREL requirements are in principle doubling the capital requirements, as the MREL loss-absorption component is complemented by the recapitalisation amount.

Moreover, the state aid rules impose some less stringent restrictions on the use of precautionary recapitalizations. In addition, there is a growing uncertainty on whether preventive interventions by Deposit Guarantee Schemes (DGS), are subject to State Aid conditionality or escape from such conditionality. The Tercas decision actually relaxes the rules and adds additional complexity to the framework.

In the EU, the bail-in tool could be applied to any credit institutions[5] in order to avoid the use of public funds. For that purpose, the BRRD requires banks to comply with MREL requirements that are determined by resolution authorities on a bank-by-bank basis[6] and may include, for banks expected to be resolved and not liquidated, where appropriate, a subordination requirement. The banks that should go into liquidation are subject to an MREL level covering loss absorption. If those banks have losses, someone has to absorb them: the shareholders/creditors (even uncovered depositors) or the national taxpayers (bail out).

In addition, the use of public funds is permitted under article 44 of BRRD in exceptional circumstances after the bail-in of 8% of total liabilities (in case the SRF funds are used for capital support – the 8% bail-in threshold does not apply to liquidity support) and the contribution of the Single Resolution Fund for 5% of the total liabilities. MREL is therefore a cornerstone of the EU resolution regime and the solvency support.

1.2 The weaknesses of the EU crisis management framework are well known

The key impediments are summarized at the beginning of the EC Consultation on the EU bank crisis management and deposit insurance framework (January 2021).

- One of the cornerstones of the current framework is the objective of shielding public money from the effects of bank failures. Nevertheless, this has only been partially achieved. This has to do with the fact that the current framework creates incentives for national authorities to deal with failing or likely to fail (FOLTF) banks through solutions that do not necessarily ensure an optimal outcome in terms of consistency and minimisation in the use of public funds. These incentives are partly generated by the misalignment between the conditions for accessing the resolution fund and certain (less stringent) conditions for accessing other forms of financial support (State, DGS) under existing EU State aid rules and DGSD, as well as the availability of tools in certain national insolvency proceedings (NIP), which are in practice similar to those available in resolution. Moreover, a reported difficulty for some small banks to issue certain financial instruments, that are relevant for the purpose of meeting their MREL requirements, may contribute to this misalignment of incentives.
- The procedures available in insolvency also differ widely across Member States, ranging from purely judicial procedures to administrative ones, which may entail tools and powers akin to those provided in BRRD/SRMR. These differences become relevant when solutions to manage failing banks are sought in insolvency, as they cannot ensure an overall consistent approach across Member States.
- The predictability of the current framework is impacted by various elements, such as divergence in the application of the Public Interest Assessment (PIA)[7] by the SRB compared to National Resolution Authorities (NRA) of the Banking Union. In addition, there are differences among national insolvency frameworks, with some providing tools similar to those available in resolution which has an impact when carrying out the PIA, thereby reducing the consistency of the overall framework. Finally, differences in the hierarchy of liabilities in insolvency across Member States complicate the handling of banking crises in a cross-border context.
- Additional complexity comes from the fact that similar sources of funding may qualify as State aid

3. https://srb.europa.eu/en/content/banks-under-srbs-remit 122 Banks in January 2021.
4. The choice of resolution tools depends on the specific circumstances of each case and builds on options laid out in the resolution plan prepared for the bank. The EU Regulation allows the application of four resolution tools They consist of powers to: (i) effect private sector acquisitions (parts of the bank can be sold to one or more purchasers without the consent of shareholders); (ii) transfer business to a temporary structure (such as a "bridge bank") to preserve essential banking functions or facilitate continuous access to deposits; (iii) separate clean and toxic assets between "good" and "bad" banks through a partial transfer of assets and liabilities; and/or (iv) bail in creditors (mechanism to cancel or reduce the liabilities of a failing bank, or to convert debt to equity, as a means of restoring the institution's capital position).
5. The main aim of bail-in is to stabilise a failing bank so that its essential services can continue, without the need for bail-out by public funds. The tool enables authorities to recapitalise a failing bank through the write-down of liabilities and/or their conversion to equity so that the bank can continue as a going concern.
6. For setting the MREL, the 8% is a benchmark, not a floor.
7. As also explained in detail later, the PIA is carried out by a resolution authority to decide whether a failing bank should be managed under resolution or insolvency according to national law.

or not and that this depends on the circumstances of the case. As a result, it may not be straightforward to predict ex ante if certain financial support is going to trigger a FOLTF determination or not. The recent Tercas ruling by the European Court of Justice, against the Commission 's decision, is a good example.

- The rules and decision-making processes for supervision and resolution as well as the funding from the resolution fund, have been centralised in the Banking Union for a number of years. DGSs remain on the national level, with differences in their functioning and their ability to handle adverse situations. Furthermore, there are some practical difficulties (e.g., when a bank transfers its activities to another Member State and/or changes the affiliation to a DGS). The different transpositions of the DGSD among Member States, with 22 different options and national discretions (ONDs) including relevant aspects such as preventive (Article 11(3) DGSD) and alternative measures (Article 11(6) DGSD), create further unlevel playing and fragmentation concerns.
- Discrepancies in depositor protection across Member States in terms of the scope of protection, such as specific categories of depositors, and payout processes result in inconsistencies in access to financial safety nets for EU depositors[8].

1.3 Small banks under the remit of the SSM and the SRB raise specific resolution challenges in Europe

3 years ago, the Financial Stability Institute stressed that 70% of banks under direct supervision by the SSM were not listed, 60% had never issued convertible instruments and 20% had never issued subordinated debt. F. Restoy explained[9] that those banks are typically too large to be subject to straight liquidation, as they may generate adverse systemic effects, but they might be also too small and too traditional to issue large amounts of MREL-eligible liabilities that could facilitate the application of the bail-in tool in resolution. Thus, the large depositors of such banks might be inordinately called upon in the case of resolution, which could lead to difficult social consequences.

The SRB, in a recent "non paper" on the resolution of this type of bank, concludes that for all the 60 medium-sized banks under its responsibility (with total assets below €100bn at Dec. 2019), the reach of the 8%-bail-in requirement is highly contingent on the level of capital depletion in the run up to FOLTF declaration. Indeed, at the current capital levels, capital support by the SRF would be available for all the banks in sample, assuming that the current level of bailinable liabilities will be available at the resolution weekend, without applying bail-in to uncovered, but preferred, deposits.

However, it is not expected that a bank will be considered FOLTF with capital ratios well above minimum capital requirements, which raises challenges around the use of the SRF for capital support where such banks are reliant on equity financing only. Indeed, in such cases non-covered deposits would need to be bailed-in, which may reduce the franchise value of the bank when applying a transfer tools strategy and create financial stability concerns. Drawing conclusions from the conclusions should be done with caution, given the number of assumptions used. Also, one must bear in mind that we remain in a transitional period with MREL still being built up (with final targets binding in 2024 and intermediate targets in 2022) and the SRB carefully monitoring it. At the same time, the numbers suggest that most banks should be able to raise or maintain the needed MREL, given that de facto most of them comply (albeit with equity).

Similarly, an analysis of a Eurofi member based on public date (Bloomberg) of recent issues by banks with balance sheets of less than EUR 100 billion indicates that even quite small banks (balance sheets of around EUR 20 billion) have issued at very reasonable costs. Of course, apart from balance sheet size, other factors such as ratings and business models also influence the issuing capacity of these banks. In the AT1 and T2 debt category, medium-sized banks in the euro area issued 14.8 bn EUR (74 public issuances) in the last three years, of which 58% were Southern European banks. Over the same period, they issued 11.2 bn EUR of senior non-preferred debt (63 public issuances), which shows that they have indeed started to accumulate the resources needed to meet their MREL objectives

Mainly, only small banks that have a balance sheet size of less than €20bn may have difficulty to raise the needed MREL. An objective assessment of such difficulties would be needed. Therefore, solutions need to be found for the orderly exit of smaller deposit funded banks affected, to safeguard financial stability.

1.4 Lessons to be drawn from the US FDIC experience for improving the EU resolution and liquidation framework of small and medium sized banks under the remit of the SSM and the SRB

It would be appropriate to draw lessons from the FDIC experience as far as the legal and institutional framework relevant for the US can be compared to the situation in the European Union. The FDIC efficiency comes from:

- The fact that the FDIC is a national organization (not 21 Jurisdictions).
- The plurality of options: no hard-wired obligations (8% - 5% SRF thresholds) but a pragmatic, flexible, least cost principle base[10]. Thus, the FDIC takes on the risks of some losses in relation to transferred assets rather than requiring creditors to absorb minimum losses in relation to their claims.
- The FDIC has the capacity to select healthy banks in order to purchase some of the assets of the failing banks.
- The FDIC usually agrees to absorb a portion of future losses on assets because this method produces a better net recovery than an immediate liquidation.

8. While the protection of standard banking deposits by DGSs has been harmonised, exceptions excluding certain deposits (for instance those of public authorities) or extending the protection above the EUR 100 000-threshold are defined on a national basis.

9. F. Restoy, How to improve crisis management in the Banking Union: a European FDIC? Financial Stability Institute, 4 July 2018.

10. Liquidation of banks: Towards an FDIC for the Banking Union? In- depth analysis, European Parliament, February 2019.

- Operations of the FDIC are backed by the unlimited credit line from the Treasury which allows the FDIC to gain time and not be threatened by purchasers which are eager to buy the assets at the lowest possible price.

The experience of the FDIC shows that size is not the major criteria for resolution. What is important is to get the best solution/deal out of an ailing bank. This requires experience, intimate knowledge of the banking system, the capability of negotiating with other banks without being paralyzed by some mechanistic prescriptions.

In the US, the 15 systemic banks have the necessary capital requirements (including TLACs, stress tests, etc....) and the other medium and smaller ones have, de facto, a level playing field which is shaped by the FDIC. FDIC is guided by common sense principles: it is free to choose the best solution, case by case.

However, in Europe there is not even agreement on public guarantees to refinance the backstop in case the SRF has not been able to pay back the ESM[11]. The banking sector would have to refinance the SRF if needed. It seems difficult to make the EU crisis management framework evolve towards the US FDIC model.

2. A way forward for improving the EU crisis management framework for small and medium sized banks under the remit of the SSM and the SRB

Defining the public interest criteria in a single way, identifying the banks under the remit of the SSM and the SRB, which are meeting those criteria and publishing the list of these banks would make more predictable the resolvability of failing banks.

Moreover, it is essential to achieve the right balance between the internalisation of losses and the use of deposit guarantee schemes to finance the transfer tools in order to address the gap for medium-sized and smaller banks which fall between the EU resolution framework and heterogeneous national insolvency frameworks.

2.1 Defining the public interest criteria in a single way would make more predictable the resolvability of failing banks

If a bank does not qualify for the precautionary recapitalization and is declared by the supervisory/ resolution authority to be failing or likely to fail, the choice is between liquidation or resolution. This decision is a prerogative of the SRB for the banks under its remit and it hinges on an assessment of the existence of public interest. In other words, European resolution decisions are strictly binary: the SRB acts only when banks satisfy a strict European public interest test. All other cases are invariably handled at the national level, enabling divergent courses of action to be pursued along national lines.

But resolution and liquidation differ substantially when it comes to the scope of legislation that is applicable to the use of public funds. While resolution is governed by the BRRD, liquidation is regulated by national insolvency laws and will be managed by national authorities.[12] While the use of public funds in resolution would be subject to both BRRD scope and State Aid scope – thus requiring a preliminary bail-in up to at least 8% of total liabilities (for capital support), the use of public funds in liquidation is only subject to State aid burden sharing requirements.

Consequently, since the scope of EU law regulating the use of public money in resolution and liquidation is different, a substantially similar operation conducted under these two different frameworks can lead for similar banks to very different outcomes. These affects (i) the acquiring bank; (ii) the banks' creditors and (iii) the taxpayers.

However, these criteria are vaguely defined in European law and there are currently two definitions of "public interest ": one at the SRB level, and one by national authorities. Indeed, the question of whether the resolution of a bank deemed failing or likely to fail is in the "public interest" or whether such a bank should be liquidated in the absence of public interest has been assessed differently at the EU and at the national levels. Some ailing banks that have been turned down by the SRB were subsequently found to be of public interest by national authorities. Moreover, there is a difference between "public interest" in the sense of BRRD to choose between resolution and liquidation, and the justification of State aid to allow public support.

The Veneto banks[13] cases have made it clear that, depending on national insolvency law, resolution tools may be used at the national level outside the BRRD framework, despite the absence of a 'public interest' determined at the EU level by the SRB. Such actions remain subject to the EU State Aid framework while avoiding more restrictive conditions under the BRRD. This is what Andrea Enria, previous chair of the European Banking Authority (EBA) called "two different definitions of "public interest" [...] one at the EU level and another one by national authorities".

While the definition of critical functions seems clear as regards the SRB's assessment of the existence of public interest, it is not equally clear what role it plays in the EU discipline on liquidation aid, as the 2013 Banking Communication does not include guidelines on how the local effect of liquidation should be evaluated. In the absence of clarity on what constitutes a serious impact

11. If the credit line provided by the European Stability Mechanism (ESM) to the Single Resolution Fund (SRF) is used, it was decided that the SRF will pay back the ESM loan with money from bank contributions within three years, although this period can be extended by up to another two years. Consequently, it will be fiscally neutral over the medium term.

12. In the US, the FDIC will be the managing authority in charge of the insolvency process.

13. The Veneto banks - which did not pass the SRB's 'public interest test' that is required for a bank to be 'resolved' at the EU-level - have been liquidated through a special insolvency procedure under Italian law. That special insolvency procedure involved resolution tools and state aid. Albeit the SRB concluded that the resolution was not warranted in the 'public interest', the Commission indicated that EU state aid rules foresee the possibility to grant State aid to mitigate any economic disturbance at the regional level. Consequently, BRRD bail-in rules were not enforced, the Italian government made available 17 billion euros, and creditors were "in fine" better off than in a resolution which would have entailed a more stringent bail-in of creditors than this liquidation.

on the regional economy, the rules on liquidation State Aid leave room for governments to effectively re-instate at the regional/local level the public interest that the SRB had refused at the national/European level.

One way to overcome this problem, which undermines the credibility of the Europe's resolution framework, could be to ask the SRB to provide an explicit assessment of the impact of failure at the regional/local level, to ensure the assessment is homogeneous.

In any case, the identification and the publication by the Single Resolution Board of the list of significant banks of public interest would make more predictable the resolvability of failing banks.

2.2 Achieving the right balance between the internalisation of losses and the use of deposit guarantee schemes to finance the transfer tools for addressing the gap for small-and-medium-sized banks that fall between the EU resolution framework and heterogeneous national insolvency frameworks

The toolbox for handling failed banks under the SRB direct remit that do not pass the Public Interest Assessment (PIA) should be expanded and rendered more flexible by allocating the SRB administrative liquidation powers including the power to transfer assets and liabilities supported by national DGS. If this mechanism is clearly established and enforced in a clear and stringent way, it could allow smaller banks under the direct remit of the SRB to be submitted to a lower standard level of MREL.

Such an EU flexible approach has the potential to reduce the costs compared to atomistic liquidation, would promote more consistent treatment of banks and should be more feasible in the short-medium term than the complete harmonisation of insolvency regimes. This could be created by amending the BRRD, SRMR and DGSD.

2.2.1 A limited level of MREL for smaller banks that do not pass the PIA for ensuring a smooth exit from the market

Allowing small and medium sized banks under the remit of the SRB not to have MREL above minimum capital requirements raises level playing field issues for failing banks between Significant Banks and hinders wind-ups across the banking union. Losses need to be allocated; there is no cost-free solution.

Whereas MREL and bail-in requirements form a cornerstone of the common EU resolution regime for larger and medium-sized banks (see1.3), the 8% bail-in hurdle within the BRRD is claimed by some to be excessive for smaller banks whose business model relies on retail and SME client deposits. According to some public decision makers, high MREL levels could be very expensive to achieve for many of these institutions.

At the same time, if creditors and depositors of small banks are totally exempted from the consequences of resolution, this contradicts the principles of BRRD and would mean that uncovered depositors in small banks have more rights than taxpayers («bail-out») or stakeholders of the whole banking system (intervention of the DGS). Taxpayers and the DGS would be subsidizing banks that do not issue sufficient MREL. Therefore, it would be desirable to avoid the moral hazard issue of "free-riders" sailing between the two positions, claiming not to have the means to raise MREL, but claiming to be too important locally/nationally to go into insolvency.

Furthermore, it could be argued that the small banks affect the profitability of the entire EU banking system: not only can they sell their financial products and services at a lower price because they do not currently have to charge for the cost of MREL, but they can also force other banks to contribute more to the SRF or DGS to pay for their potential failure. These banks must exit from the market in an orderly fashion in the event of failure. It is in everybody's interest.

In such a context, small Institutions (under the remit of the SSM and the SRM) without public interest, could benefit from lower standards in terms of levels of MREL due to their funding specificities. But they would have to be submitted to a minimum level of MREL in order to absorb possible losses. It is up to the SRB to define this level for each bank concerned notably on the basis of the resolution plan. For instance, in the case of the sale of business tool, the level of MREL should take into account the fact that the buyer will probably have to recapitalize the bank and provide the liquidity the bank may need when opening after resolution. The MREL requirement should cover the loss absorption but it also seems reasonable that the coverage of the recapitalization amount is partially fulfilled by the buyer.

A minimum level should be fixed in the EU legislation (e,g. not less than 6% of total liabilities including own funds) on the basis of appropriate criteria taking into account that these banks are predominantly financed by deposits However, access to the Single Resolution Fund, if needed, would remain subject to prior bail-in of at least 8% of total liabilities and own funds (TLOF).

Such a proposal would reduce potential implicit subsidies enjoyed by these banks, avoid imposing losses on individual households and small firms (since MREL should be subscribed by non-retail investors), facilitate the implementation of the centralized administration liquidation tool financed by the use of national DGS (see below) by reducing these financing needs. It would indeed contribute to address the concerns raised by the absence of EDIS and the misalignments in incentives between decision-making powers at the EU level and financing tools at the national level.

2.2.2 Introducing a centralised administrative liquidation tool

The toolkit available to the SRB could be expanded and equipped with the administrative power to liquidate a bank under its remit when no public interest is identified, including by transferring some of its assets and liabilities to another bank within the Banking Union with the support of deposit guarantee systems to finance such transfer.

The allocation of these powers to a centralised European Authority (the SRB) would ensure consistency in the treatment of banks, could lead to efficient gains and enable the transfer of assets and liabilities to interested bidders in several Member States. Where there is no immediate buyer, assets and liabilities may be transferred to a temporary entity, i.e. a bridge bank.

For these banks to exit the market the focus might need to be on so called "transfer strategies", in particular sale-of-business.

Referring to this tool, E. König stressed that "as a first step, the SRB's toolbox could be enriched with a "pre-liquidation tool", allowing the application of resolution tools to save the good part of a bank without entering into liquidation, or without requiring a specific liquidation regime at the European level"[14].

2.2.3 Conditions to get access to the DGS funds to support early intervention

If the value of the transferred assets is less than the value of transferred liabilities - a scenario very likely in insolvency scenarios -, financial means are required and DGS funds could finance the transaction. One solution could be to grant the SRB powers to expand the use of DGS funds. In other words, the deposit guarantee scheme would become responsible for ensuring the financing of an orderly exit from the market of small and medium sized banks that do not pass the PIA.

This supposes that DGS have reached the target of 0.8% of covered deposits[15] and that the amount available for use in such circumstances be capped at a certain level (e.g. 0,4% of covered deposits) to ensure that public confidence is not lost. It would also imply limits on the amounts raised from other banks to reconstitute the fund, so that such usage would not become a transfer mechanism from healthy banks to failing banks, which would ultimately weaken the entire system.

If these DGS resources are insufficient to address a small or a medium sized bank likely to fail, the SRB should liquidate it and the DGS should borrow the necessary liquidity funding from other DGS or from commercial banks.

In such a solution, according to A. Enria, Chair of the Supervisory Board of the ECB[16], "specific governance arrangements should be designed in order to ensure the adequate involvement of the national resolution authority (NRA) and the national DGS in the SRB decision making process".

DGS funding can already be used for alternative measures under the current framework as an option given to Member States. The amount of DGS resources available for alternative measures under Article 11(6) DGSD is subject to a financial cap based on the least-cost-principle: The cost of the intervention must not exceed "the net amount of compensating covered depositors at the credit institution concerned".

Increasing the capacity of DGS to fund alternative tools must not come at the cost of deteriorating DGS's general position. This is why such an approach must strictly respect the 'least-cost' principle through a method that combines the methods of cash flow analysis with the ultimate loss while taking into account indirect costs up to a certain cap. Indeed, according to many experts, it would not be acceptable that DGS intervene to protect other creditors than protected ones, up to the protected amount. That would be equivalent to upgrading all creditors to the rank of protected deposits.

The least cost test (LCT) should be harmonised at the EU level in order to achieve a level playing field across the Banking Union.

The LCT should set out three conditions that must be fulfilled for the DGS to provide funding for alternative measures:

1. The gross cost of alternative measures does not exceed the gross cost of payout for covered deposits. As for the cash flow analysis, it disregards reimbursements and recoveries and limits the gross amount used for P&A measures.
2. The hypothetical loss resulting from the alternative measures (cost of alternative measures net of funds that would be subsequently recovered, i.e. reimbursement of loans, reimbursement or sale of an equity stake in a bridge bank) does not exceed the hypothetical ultimate loss borne by the DGS in case of pay-out after deducting funds recovered in the insolvency proceeding and adding indirect costs.
3. The indirect cost assumed in case of a pay-out does not exceed a cap determined in terms of the covered deposits.

Last but not least, a review of the use of DGS should not come at the expense of the integration and level playing field within the Banking Union. Indeed, without progress in completing the Banking Union, this could lead to banking sectors becoming "ever more national" rather than integrating across the Banking Union. Moreover, relying only on national DGS to manage banking crisis may amplify the bank-sovereign nexus, and some Member States may be disadvantaged (e.g. because of smaller banking sectors and DGS, lack of bidders etc.).

This is the reason why if such transactions would be monitored by the SRB through an "enhanced" (partial) sale of business tool, there would be the possibility to attract bidders from other countries, potentially attaining better bids (thereby minimising destruction of value and the use of funds).

Of course, this funding mutualisation would warrant an increased SRB role to ensure a level playing field and must be accompanied by measures ensuring that contributions to the DGS reflect everywhere adequately the risks, and in particular take into account the other levels of protection that can be mobilised (preventive mechanisms where there exist, adequate levels of MREL, etc.)

14. E. König, Europe and the Covid-19 crisis, EBI Conference, 5 November 2020.

15. The DGSD requires Member States to raise funds into their DGSs equivalent to at least 0.8% (or in certain cases down to 0.5%) of covered deposits in that Member State. The DGSD, which was enacted in 2014, gives Member States until 3 July 2024 to raise this target level amount.

16. A. Enria, Crisis management for medium-sized banks: the case for a European approach, Keynote speech by Andrea Enria, Keynote speech at the Banca d 'Italia workshop on the crisis management framework for banks in the EU, 15 January 2021.

These issues related to the crisis management framework are part of the wider agenda on deepening the Banking Union. The Banking Union (BU) remains fragmented and incomplete, which weakens the global competitiveness of European banks and raises the risk of dysfunction in the event of a future shock:

- The European Deposit Insurance Scheme (EDIS), third pillar of the Banking Union, is still missing. EDIS would be an effective tool to promote a uniform level of depositor confidence. Through a relatively simple mechanism of liquidity support of national DGS when needed, EDIS could already ensure equal, high quality protection for all depositors across the Banking Union in the case of bank failure, while ensuring some discipline and supporting the development of an BU-wide level playing field. Europe would have more resources than national deposit guarantee funds to cope with large local shocks, which could otherwise overburden national DGSs.

Europe should progress towards EDIS. But we should not believe that the subject is purely technical and can be only resolved by technical measures. EDIS will not miraculously eliminate the following remaining fragmentation issues within the Banking Union that need to be addressed:

- For banks, the Single Market is still fragmented along national lines. There is little progress in cross border lending, especially in retail markets, i.e. lending to households and firms;
- Discrepancies in the regulatory framework reduce the economies of scale for banks operating across borders;
- The “sovereign-bank doom loop” has not disappeared and in certain countries and it has increased in certain EU Countries following the Covid crisis;
- Ring-fencing policies (capital, liquidity, bail-in instruments…) by host supervisors, applied to subsidiaries of transnational banking groups located in their countries, are still persistent; they discourage large EU banks to reinforce and increase the number of their subsidiaries in the EU;
- Such ring-fencing practices prevent cross-border integration and synergies. This is obviously hindering prospects of cross-border mergers and consolidation of the banking sector at European level, called among other by EU authorities, required to reduce EU dependence on third country banks and necessary for reducing the overcapacity in the system;
- The Covid crisis could increase banking risks differently across member states;
- One of the objectives of a true Banking Union should also be to ensure the development of a resilient and profitable banking sector where diverse business models co-exist, diversification participating to overall resilience;
- Finally, the banking union area is suffering from a lack of economic and fiscal convergence and the Covid crisis is increasing economic discrepancies across member states.

It is essential that these well-known fragilities be addressed by EU and national decision makers, which would be required for reaching a balanced agreement on EDIS.

NEW CMU ACTION PLAN: OBJECTIVES, CHALLENGES AND MAIN PROPOSALS

Note written by Marc Truchet, EUROFI

1. Context and objectives of the new CMU action plan

The Commission published in September 2020 a new action plan for completing the Capital Markets Union (CMU), a key initiative launched in 2015 aiming to develop and further integrate capital markets in the EU, in order to diversify the funding of EU enterprises and provide investors with better investment opportunities. These objectives are all the more relevant with the increased funding needed for supporting the post-Covid recovery, the EU Green Deal and digital transformation, which cannot be provided solely through public funds and need mobilising significant private investments.

The new CMU action plan completes two previous action plans, which were adopted in 2015 and 2017 and have been mostly implemented. This new plan has a more specific focus on developing retail investment. It also puts forward stronger ambitions in terms of EU capital markets integration (e.g. addressing controversial fragmentation issues such as insolvency regimes or withholding tax, which hamper cross-border investment), although these latter actions were considered to be more a 'medium term' objective by the Ecofin Council in December 2020. There is also the objective of correcting some existing measures with the improvement of instruments that have not delivered all the benefits expected in the previous stages of the CMU, such as ELTIF funds and STS (simple, transparent and standardised) securitisation and a review of insurance and banking prudential requirements in order to reduce their unintended consequences for long term investment.

2. Proposals of the new CMU action plan and priorities established by the ECOFIN Council

2.1 Proposals and timeframe of the new CMU action plan

Three main objectives were put forward by the Commission in the new CMU action plan (*see detail in Appendix 1*):

1. **Developing retail participation:** financial education, inducements and professional qualification of advisors, pension adequacy;
2. **Fostering a further integration of EU capital markets:** common withholding tax system, minimum harmonisation of insolvency regimes, shareholder rights, settlement services, post-trade consolidated tape (CT), investment protection, supervisory convergence;
3. **Making financing more accessible to European companies in order to support a "green, digital, inclusive and resilient economic recovery":** implementation of a European single access point for corporate information (ESAP), SME listing rules simplification, ELTIF review, prudential requirements review, SME referral scheme, review of the securitisation framework.

These objectives largely build on the proposals of the High Level Forum (HLF), a public / private working group put in place by the Commission at the end of 2019 to make proposals likely to be "game-changers" for relaunching the CMU.

The objective of setting up a CT for equity and equity-like instruments, on which the HLF had not reached a consensus was added by the Commission in the new CMU action plan and was completed at the beginning of 2021[1] by a commitment to set up a bond CT. Some recommendations that the HLF made related to digitalisation (standard contractual clauses for the use of cloud service providers, a harmonised open finance regulatory framework, clarification of the application of existing financial legislation to crypto / digital assets) have not been included in the new CMU action plan, but are being addressed in the context of the Digital Finance Strategy also proposed at the end of 2020.

In terms of implementation, the deadlines fixed by the Commission for achieving the related legislative proposals range over 3 years and several proposals of the new CMU action plan are subject to further assessments due to be conducted in 2021 / 2022.

2.2 Priorities established by the ECOFIN (December 2020)

The December 2020 ECOFIN welcomed the new CMU action plan and considered that the next steps towards a 'genuine CMU' require a clear prioritisation of measures.

A clear priority was put on the third set of measures proposed in the CMU action plan, concerning access to capital, particularly for SMEs, which the ECOFIN has urged the Commission to deliver by the end of 2021.

The development of retail investment and some measures likely to encourage cross-border integration of capital markets within the EU (post-trading and supervisory convergence) were also emphasized as being priorities for the short term.

The second set of actions of the new CMU action plan, designed to foster a further integration of EU capital markets, was given a lower degree of priority and considered more as a medium term objective.

1. Communication on fostering openness, strength and resilience of the EU financial system – January 2021

3. Main challenges facing the CMU

Although the previous action plans have helped to enhance the building blocks of EU capital markets in terms of legislation and products, their effects in the market are largely still to come. This is due in part to the length of the legislative processes needed for putting in place the actions proposed and to a limited political support across the Union so far, for actually making a step change in terms of the development of capital markets in the EU. Another challenge is that no single measure or limited set of priorities seems sufficient for achieving the CMU. CMU is at this stage an evolutionary process addressing a broad range of drivers and building on pre-existing market regulations and market structures, all of which make progress lengthy and complex.

The ECOFIN has taken a different approach to this new action plan, setting short and medium term priorities. It is now essential that the short term actions are implemented in the defined timeframe (by the end of 2021) in order for them to have an impact on the post-Covid recovery, which requires a clear timetable and a strict monitoring of implementation. Further clarity will also be needed on the timetable of the actions concerning retail participation and market integration that have been given a lesser degree of priority, but are essential for the development of capital markets in the EU.

Some of the external challenges that may threaten the success of the CMU will also remain present in the coming months. The possible effects of the current macro-economic and monetary context first need considering. Very low interest rates tend to favour debt financing and to encourage liquidity hoarding at the expense of longer term investment and may also create bubbles. Macro-economic imbalances between EU Member States are also due to persist in the current environment, impeding a further integration of EU capital markets. Finally, Brexit, which introduces new frictions and costs in the access of the EU to the most developed capital market in Europe is a reality now and is both an opportunity and a challenge for the CMU.

Appendix 1: Detail of the new CMU action plan (September 2020)

1. Developing retail participation:

1.1 Financial education: Feasibility assessment of the development of a financial competence framework aiming to develop a common understanding among Member States of financial competence (Q2 2021). Introduction of requirements for member states to promote learning measures supporting financial education in particular in relation to responsible investing (Q1 2022);

1.2 Inducements and professional qualifications: Amendments to applicable rules in the area of inducements in order to ensure that retail investors receive fair and adequate advice (Q1 2022). Introduction of a new category of qualified investors in MiFID II and reduction of the current information and administrative overload for these investors (Q1 2022). Measures to improve the level of the professional qualification of advisors including the introduction of a possible pan-EU competence certificate as part of the MiFID II and IDD reviews (Q4 2021 / Q1 2023);

1.3 Pension adequacy: Development of pension dashboards with indicators for facilitating the monitoring of pension adequacy; development of best practices in the area of pension simulations and tracking (Q4 2021). Assessment of current auto-enrolment practices in occupation pension schemes and identification of best practices across the EU (Q3 2020).

2. Further integrating EU capital markets:

2.1 Withholding tax: Legislative initiative aiming to introduce a common, standardised EU-wide system for withholding tax relief at source, taking into account the OECD TRACE project in particular (Q4 2022);

2.2 Insolvency regimes: Initiative for ensuring the minimum harmonisation or increased convergence of rules in targeted areas of core non-bank insolvency (e.g. definition of triggers, ranking of claims, asset tracing…) (Q2 2022). Regular assessment of the effectiveness of national loan insolvency systems (Q1 2021 / Q4 2022);

2.3 Shareholder rights: Assessment of the possibility of introducing a harmonized EU-wide definition of 'shareholders' as part of the SRD 2 review and of the need for a further harmonisation of rules governing the interaction between investors, intermediaries and issuers (Q3 2023). Assessment of national barriers to digitalisation of this area (Q4 2021);

2.4 Settlement services: Review of the rules concerning the provision of settlement services in the EU in the context of the CSDR review (provision of cross-border services on the basis of CSD passports, conditions under which CSDs are authorised to designate credit institutions or themselves to provide banking-type ancillary services…) (Q4 2021);

2.5 Post-trade consolidated tape: Legislative changes that will support the establishment of an effective

and comprehensive consolidated tape for equity and equity-like instruments in order to create an integrated trading view across the EU and improve competition between venues (Q4 2021);

2.6 Investment protection: Strengthening of the investment protection and facilitation framework in the EU (e.g. rules to ensure protection of intra-EU investments; effectiveness of dispute resolution mechanisms, consolidation of information on rights and opportunities for investors in a single access point…) (Q2 2021);

2.7 Supervisory convergence: Assessment of the need for further harmonisation of capital market rules and further supervisory convergence, possibly through stronger supervisory coordination or direct supervision by the ESAs (Q4 2021).

3. Making financing more accessible to European companies:

3.1 Single-access point to corporate information: Legislative proposal to set up a European Single Access Point (ESAP) for all relevant corporate financial and sustainability-related information in order to make EU companies more visible to cross-border investors. This will entail streamlining EU legislation on the disclosure of company data to the public (Q3 2021). The ESAP platform will to the greatest extent possible build on existing EU and national infrastructure, as well as existing EU initiatives (such as the European financial transparency gateway (EFTG) pilot project and the business registers interconnection system (BRIS));

3.2 SME listing rules simplification: Possible simplification of public listing rules for SMEs on SME growth markets and regulated markets (e.g. consistency of SME definition, simplification of the market abuse regime, provisions for simplifying for issuers the transitioning from SME growth markets to regulated markets) (Q4 2021);

3.3 ELTIF review: Review of the ELTIF legislation concerning e.g. investment limitations for retail investors, ELTIF marketing rules, the redemption policy and lifespan of ELTIFS, eligible assets as well as diversification rules, portfolio composition, limits on cash borrowing (Q3 2021);

3.4 Prudential requirements: Review of Solvency II (risk-margin calculation, valuation of insurers' liabilities, eligibility criteria for the long-term equity asset class…) for promoting long-term investment by institutional investors (Q3 2021). Review of CRR/CRD aiming to avoid the undue impact of Basel III requirements on banks' investment in long-term SME equity and on market-making activities conducted by banks and investment firms (Q1 2021);

3.5 SME referral scheme: Feasibility assessment of a scheme requiring banks to direct SMEs whose credit applications have been rejected to alternative funding providers and vice versa (Q4 2021);

3.6 Securitisation: Review of the STS and non-STS securitisation framework (concerning the appropriateness of disclosure requirements, the prudential treatment of cash and synthetic securitisation, the process for recognising significant risk transfer…) to help banks lend more to the real economy with a particular focus on SMEs and the green transition (Q4 2021).

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Appendix 2: ECOFIN conclusions (December 2020)

The ECOFIN welcomed the new CMU action plan and considered that the next steps towards a genuine CMU require a clear prioritisation of measures.

Highest priority – to be delivered by the end of 2021

The actions, that are important to improve the funding of the economy and particularly of SMEs and have the potential to support a swift economic recovery in the context of COVID-19 pandemic, were deemed most urgent at this juncture by the ECOFIN. They should have the highest priority and should all be delivered by the Commission as soon as possible, but not later than by the end of 2021. These correspond to the third set of measures of the CMU action plan (Making financing more accessible to European companies):

- Facilitating access of corporations, in particular SMEs, to financing on capital markets by streamlining and simplifying the current rules for listing on regulated markets and admission to trading on MTFs and by supporting financial ecosystems that can foster enhanced SME access to equity (3.2);
- Setting up an EU wide «single access point» for financial and non-financial company information. This data hub should include environmental, social and governance (ESG) data (3.1);
- Strengthening the role of insurers, banks and other institutional investors as long term investors and assessing ways to incentivise long-term investments (3.4);
- Reviewing the appropriateness of the current securitisation framework with a view to enable capital markets to absorb more exposure from banks, thus freeing up lending capacities of banks (3.6);
- Improving the regulatory framework for long-term investment vehicles by reviewing the European Long-Term Investment Fund (ELTIF) Regulation (3.3);
- Exploring the benefits and drawbacks of a referral scheme to direct SMEs to providers of alternative funding when their credit application has been turned down.(3.5);

Measures to be delivered as soon as possible:

The measures that are considered most important for mobilising private capital and stimulate more investment activity should also be delivered as soon as possible, according to the ECOFIN.

- Empowering citizens to take well-educated investment decisions through enhanced financial literacy (1.1);

- Enhancing data availability and transparency by further assessing how to tackle the barriers to establish a consolidated tape in the EU (2.5);
- Streamlining existing disclosure rules for the various capital market products and assessing the quality and fairness of investment advice provided to retail investors as well as the benefits and drawbacks of readjusting the current investor categorisation (1.2).

Measures to be delivered in the short term:

The ECOFIN emphasized the need to make tangible progress towards a globally competitive CMU with unhampered cross-border capital movement in order to unlock the potential of a deep integrated capital market that is attractive for the movement and retention of external capital and expertise, to the advantage of investors and capital raisers. These actions should be assessed in the following order:

- Explore options for optimising the investment climate within the single market and to propose a Union framework that clarifies, strengthens and supplements the rules on the protection of cross-border investment within the Union;
- Explore ways to enhance the cross-border activities of post trading infrastructures, particularly in the area of settlement (2.4);
- Promote further supervisory convergence by working towards a more harmonised legal framework for regulated capital market activities. (2.7).

Medium term actions:

The Commission was encouraged by the ECOFIN to look at the more complex and time consuming structural reforms and to deliver the respective initiatives in the medium term, in the following order:

- Assess ways to simplify the withholding tax relief procedure for cross-border investments (2.1);
- Assess legislative or non-legislative initiatives to increase convergence of the outcome of insolvency procedures in different Member States (2.2);
- Assess the need for further action to strengthen the confidence of investors and facilitate cross-border investments by, for instance, evaluating possible deficits in the areas of rules on enforcement of financial reporting of listed companies and supervision or oversight on technology providers in finance (2.6);
- Assess ways to support raising citizens’ awareness as regards their future retirement income by developing best practices for, e.g. national tracking systems (1.3);
- Assess the possible benefits and drawbacks of a harmonised definition of «shareholder» (2.3).

UPDATE ON THE AIFMD AND ELTIF REVIEWS

Note written by Marc Truchet, EUROFI

1. Update on the AIFMD review

1.1 AIFMD objectives and scope

The Commission is currently reviewing the Alternative Investment Fund Managers Directive (AIFMD), which entered into force in July 2011 and became effective in most Member States in 2013 and is considering a range of targeted amendments for improving the functioning of the legal framework.

Alternative Investment Funds (AIFs) are defined in the EU as collective investment funds that are not UCITS. They vary in terms of their investment strategies, markets, asset types and legal forms and include venture capital, private equity funds, real estate funds, hedge funds and funds of funds.

The AIFMD was adopted to address some deficiencies evidenced during the global financial crisis in relation to AIFMs in terms of risk management and transparency and to provide a framework for these activities which are playing an increasing role in the European financial system. Its objectives are to ensure a coherent supervisory approach to the risks that AIFs may pose to the financial system, provide a high-level of investor protection and also facilitate the integration of the EU AIF market.

The AIFMD regulates the activities of the management companies that manage AIFs, whereas AIF products are currently regulated at the domestic level. AIFMD governs the authorisation of AIFMs, allowing them to manage and market AIFs to professional investors across the Union with a single authorisation. It also regulates the operations of AIFMs, imposing notably common risk management and transparency requirements.

1.2 Review process and key themes addressed

A first stage of the review process was completed in June 2020 with the **publication by the Commission of a report[1] on the effectiveness of the AIFMD**. This report concluded that the AIFMD has improved the level of investor protection, facilitated the monitoring of financial stability risks and contributed to the creation of an EU AIF market. The share of cross-border AIFs remains limited but has increased (5.8% of AIFs were registered for sale in 2 or more Member States in October 2019).

Several areas of improvement were identified in this report. These include the AIFMD passporting regime, which is currently impaired by national interpretations and gold plating[2]; the methods of calculation of leverage that need aligning with IOSCO recommendations and further harmonizing across EU fund legislations; reporting and disclosure requirements, which differ across Member States and overlap partly with other EU legislations; and depositary rules which are interpreted differently across the EU and do not accommodate the specificities of all asset classes.

The report also suggested conducting further assessments in two areas that were not included in the AIFMD: the marketing on non-EU AIFs in the EU and the possible need for a depositary passport.

Following this report, **proposals were made by ESMA in August 2020** for improving the AIFMD framework and the supervision of AIFMs in the EU. These proposals build on the conclusions of the June 2020 Commission report and also identify further areas of improvement.

A first additional area identified by ESMA concerns delegation and substance requirements. ESMA recommended a clarification of the maximum extent of delegation that may be allowed for EU AIFs to third-country entities, possibly with quantitative criteria or a list of core functions that cannot be delegated. Legislative amendments to make sure that AIF and UCITS management activities are subject to EU rules, irrespective of the location of the entity to which activities may have been delegated were also proposed by ESMA. A second area is liquidity management tools (LMTs) such as swing pricing, gates or side-pockets which can be used in times of stress to limit liquidity risks or to mitigate their impact. ESMA has proposed to develop an EU legal framework for LMTs in order to ensure their availability across the EU and also clarify responsibilities for supervising their use. Thirdly, ESMA also recommended a clarification of the respective supervisory responsibilities of ESMA and of the national competent authorities (NCAs) concerning the cross-border activities of AIF and UCITS and also a clarification of the obligations for sharing information. Finally, ESMA proposed considering a further alignment of the AIFMD and UCITS regimes in several areas including risk management, liquidity management and delegation.

In October 2020, the Commission subsequently launched a public consultation aiming to gather further input from industry players, investor representatives

1. This report is based on the findings of a study conducted by KPMG in 2019 that included a survey of stakeholders and a fact-finding exercise on the impacts of AIFMD. The study concluded that the AIFMD has been largely effective and has played an important role in creating an internal market for AIFs and in reinforcing and harmonising the regulatory and supervisory framework for AIFMs in the Union. Several areas of potential weakness were however identified, relating to an insufficient harmonisation of rules in areas such as reporting and leverage calculation, the imposition of additional requirements by Member States notably concerning marketing rules and overlapping or overly burdensome reporting and disclosure requirements.

2. Part of these issues have already been picked up in the EU initiative related to the cross-border distribution of funds.

and financial market authorities on potential changes to the AIFMD and on the need for further consistency between the UCITS and AIFMD directives. **The AIFMD public consultation** sought feedback from these stakeholders on a broad range of possible additions and amendments to the AIFMD framework, most of which were identified in the reports mentioned further up published by the Commission and ESMA. Some additional topics were however introduced or further emphasized in the consultation, including: a facilitation of the access of retail investors to AIFs; an introduction of EU-level product rules for certain AIFs such as loan origination AIFs; and a mandatory consideration of ESG factors and sustainability risks in the investment process and in the disclosures of AIFs.

1.3 Initial feedback from industry stakeholders

In their feedback to the AIFMD review consultation, industry representatives generally expressed strong support for the current AIFMD framework, which is considered to have achieved its main objectives in terms of risk mitigation and EU market integration and also helped to create an international footprint for EU AIF funds.

They do not see the need for significant changes to the current Level 1 framework:

- They are first in favour of maintaining the current approach of the directive at manager level. Most industry representatives indeed consider that developing EU level product-specific requirements for AIFs (e.g. for loan-origination funds) would be difficult to implement in an exhaustive way given the diversity of the AIF universe and is not essential, given that AIFs are already widely available at the domestic level.
- Moreover they are in favour of maintaining the current focus on professional investors. Possible additional requirements for retail investors (e.g. specific disclosures or passporting regime) are not considered to be necessary because cross-border demand for AIFs is relatively low and UCITS funds offering a wide range of investment opportunities are usually more suitable for retail investors than AIFs. In addition, a retail regime for AIFs may complicate the approach for professional investors and possibly blur the objectives of the AIFMD directive. Suggestions were also made that the ELTIF structure, once appropriately amended, would be more appropriate for retail investors ready to invest in longer term assets. Some changes may nevertheless be needed in terms of investor classification to ensure that more sophisticated retail investors such as High Net Worth Individuals (HNWI) or family offices can access AIFs more easily, but this may be achieved through the upcoming MiFIDII/MiFIR review.

In a number of other areas industry stakeholders believe that current AIFMD rules should be maintained.

- There is no real support for creating a depositary passport at this stage. Some players are favourable to the concept, which seems consistent with the objective of completing the AIF single market, but do not believe that it is worthwhile reopening the level 1 text for accommodating such an evolution. Many players reject this option, considering that allowing depositary functions to be conducted on a cross-border may reduce legal certainty for investors, potentially reducing their level of protection and may also make the supervision of depositary activities more difficult.
- A review of existing delegation rules in the context of Brexit is also considered to be unnecessary by most asset managers. They instead support an enforcement of existing rules, considering that current AIFMD delegation rules completed by the ESMA 2017 legal opinion are sufficiently clear and robust for defining appropriate delegation and avoiding “letter box” entities in the EU.
- Although there is support for increasing the availability of liquidity management tools (LMTs) in all EU jurisdictions, industry players caution against prescriptive rules at Level 1 in this area that may reduce the flexibility that is needed in using them. Some players also point out that these tools are already available on a domestic basis in the main fund jurisdictions.

Many industry representatives consider that the key issue for enhancing the effectiveness of the directive is to ensure a more consistent enforcement of existing AIFMD rules and to avoid different national interpretations, in order to improve the consistency of rules applying to AIFMs across the EU. This requires Level 2 harmonisation efforts and greater supervisory and enforcement convergence. They however do not believe that granting additional competences and powers to ESMA in the context of AIFMD, beyond those already attributed following the ESAs review, is necessary for achieving this. In addition, more effective data sharing among supervisors is called for, as well as an elimination of overlaps between existing reporting requirements.

Moreover, although consistency could be improved in some areas of the UCITS and AIFMD directives, industry representatives generally do not believe that a complete harmonisation, let alone a merger of the AIFMD and UCITS frameworks, would be appropriate due to their differing investor bases and policy approaches (i.e. manager vs product approach).

Finally while ESG is a major trend in the asset management sector, the suggestion to make ESG and sustainability considerations mandatory for AIFMs (e.g. imposing a quantitative assessment of sustainability risks) is considered to be premature until the new requirements of the EU sustainability framework are fully defined and implemented.

2. Update on the ELTIF review

2.1 Development of the ELTIF market

The European Long-Term Investment Funds Regulation (ELTIF) adopted in April 2015 is a pan-European framework for AIFs that invest in longer term real economy assets such as listed and unlisted SMEs and sustainable energy, transport and infrastructure projects and entities. The ELTIF regime is intended to facilitate investment in these assets by EU and third-country pension funds, insurance companies and professional investors mainly. ELTIFs may also, under

certain conditions[3], be marketed to retail investors under a pan-European passport.

The objective of the ELTIF regulation is to provide the EU economy with an additional source of long-term non-banking finance. This is essential for the funding of non-listed SMEs in particular in a context where the EU suffers from a chronic lack of late stage venture capital financing compared to the US in particular[4]. A diversification of funding sources is also needed for infrastructure projects, with the increasing indebtedness of Member States, reducing their capacity to finance such projects. ELTIF moreover provides investors with new opportunities for investing in real economy assets with a long-term maturity. In this respect, ELTIFs have the potential to become an important driver for the Capital Markets Union (CMU) and may also play a key role in the post-Covid EU recovery.

The ELTIF Regulation lays down uniform rules for the authorisation, investment policies and operating conditions of ELTIFs, completing AIFMD requirements with more specific product rules. ELTIFs are closed-ended funds that do not offer redemption rights before the end of the fund's life. To qualify as an ELTIF, a fund must be managed by an authorized AIFM, invest at least 70% of its capital in ELTIF eligible assets, follow diversification and concentration rules, not engage in short selling and observe strict limitations on its use of leverage and derivatives. The regulation also sets out disclosure requirements and transparency obligations.

The success of ELTIFs so far is however quite limited. Only a small number of ELTIFs (approximately 28) have been launched with a relatively small amount of net assets under management (total AuM below ~EUR 2 billion) and a number of Member States have no ELTIFs[5].

2.2 Objectives of the ELTIF review

Reviewing the ELTIF framework is one of the objectives of the new CMU action plan published in September 2020. A review proposal is due to be published by the Commission by Q3 2021[6].

The objective of this review is to enhance the effectiveness of the ELTIF regulatory regime and improve its capacity to channel funding to long-term investment projects and SMEs, while maintaining adequate investor protection. The review is among other things looking into: (i) the main areas where the functioning of the ELTIF framework needs improving; (ii) the extent to which eligible assets and qualifying portfolio undertakings should be updated, as well as diversification, portfolio composition rules and limits on cash borrowing and leverage; (iii) the measures needed for improving the participation and access of retail investors to ELTIFs; (iv) redemption rules and the maturity of investments; (v) distribution and cross-border marketing rules; (vi) fragmentation and gold plating issues; and (vii) mandatory disclosures.

2.3 Initial feedback from industry stakeholders

In their feedback to the ELTIF review consultation, industry representatives generally agreed with the Commission that ELTIFs could potentially play a strong role, alongside UCITS and AIFs, in achieving the objectives of the CMU, provided the framework is amended in order to make ELTIFs more attractive for institutional and retail investors.

Many industry players suggested a broadening of eligible asset classes with a wider variety of fund structures, physical assets and companies that ELTIFs may invest in[7], in order to facilitate diversification. A lowering of the minimum % of eligible assets in which ELTIFs need to invest (70% at present) was also proposed. Some commentators have however pointed out that the main focus of the ELTIF investment universe should remain on long-term assets, such as infrastructures and SMEs, in order to avoid overlaps with other fund frameworks.

The opportunities associated with a development of retail investment in ELTIFs were also emphasized by many industry representatives, for investors looking to invest in less liquid real economy asset classes as a source of diversification. This would require putting in place appropriate safeguards given the illiquid nature of many assets that ELTIFs invest in. Suggestions have been made that ELTIFs could be split into two versions – a retail one and an institutional one – with adapted regulatory protections and minimum investment amounts for each type of investor[8]. The creation of an open-ended retail ELTIF regime with adjusted subscription and redemption terms and a removal of

3. The fund rules must contain a principle of equal treatment for all investors and the ELTIF must not be structured as a partnership. During the subscription period and at least two weeks after the subscription, retail investors must be able to cancel their subscription and have their money returned without penalty. Moreover the ELTIF regulation requires that ELTIF managers should conduct a suitability test to confirm that investment is suitable for retail investors and provide retail investors with "appropriate investment advice". In addition the manager must ensure that a retail investor with a portfolio of up to € 500,000 does not invest more than 10% of his / her portfolio in ELTIFs.

4. Source: Final report of the High Level Forum on the CMU – June 2020.

5. Source: European Commission ELTIF review consultation document.

6. The CMU High Level Forum (HLF) had previously identified the review of ELTIF as one of the potential "game-changers" for the CMU. Two main areas where amendments are needed were identified by the HLF. The first is tackling the barriers to investment, particularly for retail investors, created by ELTIF rules, such as the long lock-up period of ELTIFs, which are closed-ended products and the relatively high entry ticket of 10,000 €. The second issue is the scope of eligible assets which was considered to be too restrictive, preventing ELTIFs from financing certain types of SMEs and infrastructures. The lack of adequate tax incentives was also emphasized by the HLF – e.g. tax exemptions on dividends or capital gains – although this is mainly a matter of domestic policy.

7. The suggestion was made that eligible assets could be broadened to include other types of funds besides ELTIFs, EuVECA and EuSEF funds, as well as non-listed financial start-up companies. Other proposals have been made such as considering lowering the current €10 Mio threshold for investments in 'real assets', redefining the notion of 'qualifying portfolio undertakings' to include financial undertakings, raising the current maximum €500 Mio market cap threshold defining 'qualifying portfolio undertakings' to at least €2 Bio – Source EFAMA's response to the ELTIF consultation.

8. Possibly lowering the current 10,000€ minimum investment to 1000€ for retail investors

current life cycle limitations (the life of current ELTIF funds is currently limited to its longest-dated assets) has been proposed by certain market players. Others have suggested that using closed-ended publicly-traded structures, such as those that exist in the US or UK[9], could be an alternative worth considering for retail investors.

Proposals have also been made for improving the taxation of ELTIFs, including a guarantee of the tax neutrality of the ELTIF structure and possibly a coordination of approaches to tax incentives for ELTIF products at the EU level.

9. Such as US Business Development Company (BDC) funds or UK investment trusts, the shares of which can be bought and sold by retail investors on national securities exchanges.

3

ESG AND DIGITAL FINANCE POLICY DEVELOPMENTS

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THE INTERNATIONAL HARMONISATION OF ESG STANDARDS: A CHALLENGE AND A NEED

Note written by Jean-François Pons, Alphalex-Consult

1. The international «alphabet soup» of ESG standards and disclosure requirements

Today the international landscape of ESG (Environment, Social and Governance) reporting, including on climate change, is complicated and may even seem confusing.

1.1 There is a proliferation of ESG standards and disclosures requirements developed by a number of standard setters

Most of them are based on international private initiatives, with sometimes the participation of the United Nations (the UN Sustainable development goals are a source of inspiration for most of the standard setters), notably the Global Reporting Initiative (GRI), the International Integrated Reporting Council (IIRC), the Carbon Disclosure Project and the Climate Disclosure Standards Board[1].

The most important standard-setter in the United States is the Sustainability Standards Accounting Board (SASB)[2], which has an international reach and has developed international activities, in particular by the creation of the Value Reporting Foundation with the IIRC.

In the European Union, ESG disclosures have been regulated for some time both at national and at EU level. The Non-Financial Reporting Directive (NFRD) was adopted in 2014 and currently applies to large public interest entities (listed companies, banks and insurance companies); it does not establish reporting standards but only some principles and leave the choice of standards to the corporates. The EU's legal framework has recently been developed under two regulations: the Sustainable Finance Disclosure Regulation (SFDR) was adopted in 2019 and applies to financial market participants, such as asset managers, and to financial advisors. Further ESG disclosure requirements flow from the Taxonomy Regulation adopted in 2020.

In China there are only reporting requirements for certain high-polluting listed firms.

1.2 There are significant differences between the USA and the EU on ESG standards

First, there is no definition of «sustainability» in US law and no ESG focus on US financial regulation, contrarily to the EU legal framework.

Secondly, SASB standards, which are merely voluntary, are different from EU disclosure requirements on two key aspects:

- they are based on comparability inside one industrial sector and not on an intersectoral basis.
- they rely on an assessment of ESG risks for the firm (simple materiality), when in the EU there is also an assessment of the impact of the firm on its environment and stakeholders (double materiality).

The source of these differences is probably because the US framework is still focused on the financial and economic performance of the firm, whereas the EU framework includes also the ESG perspective.

These differences are a challenge for European firms, given the weight of US investors in Europe, and vice versa.

1.3 As for the specific standards and disclosure requirements on climate change, there have been three major international developments

The first positive international development has been **the endorsement by the G20 of recommendations of the Task force on Climate-related Financial Disclosures (TCFD)**, which are more and more implemented by the biggest financial actors, but which contain more recommendations on governance and methods than on standards. The TCFD's recommendations are likely to be the basis for further development of climate-related disclosures in most jurisdictions and seem to have broad support within key international fora such as the Financial Stability Board and the central banks represented in the Network for Greening the Financial System.

1. Private international standard-setters:

- The Global Reporting Initiative (GRI), created in 1997, is an organisation based in Amsterdam, regrouping NGOs, corporates, accountants and in relationship with the United Nations. Its sustainability reporting framework provided by the GRI Standards is said to be the world's most widely used and trusted framework. It has been adopted by the world's largest corporations and referenced in policy instruments and stock exchanges.
- The International Integrating Reporting Council (IIRC), created in 2010, is a global coalition of regulators, investors, companies, standard setters, the accounting profession, academia and NGOs, incorporated in the United Kingdom. The coalition promotes communication about value creation, preservation and erosion as the next step in the evolution of corporate reporting.
- Carbon Disclosure Project (CDP) and Climate Disclosure Standards Board (CSDB) are part of the same group:
  - CDP, founded in 2000, is an international non-profit organization, registered in the UK, that runs a global disclosure system for investors, companies, cities, states and regions to manage their environmental impacts;
  - CDSB, also based in London, is an international non-profit organization, created in 2007 by the CDP. It is a consortium of business and environmental NGOs, amongst them SASB, which offers companies a framework for the integration of climate change-related information into mainstream financial reporting;
  - CDP acts like the secretariat of CSDP.

2. The Sustainable Standards Accounting Board (SASB) is an American non-profit organization, founded in 2011; its stated mission «is to establish industry-specific disclosure standards across ESG topics that facilitate communication between companies and investors about financially material, decision-useful information. Such information should be relevant, reliable and comparable across companies on a global basis.».

Secondly the EU has taken the lead with the regulation on taxonomy of climate change adaptation and mitigation which will be finalized soon. This regulation contains also a «no do significant harm» principle in the ESG field.

Thirdly, following the last American elections, **the political priorities of the US, the EU and many other countries are now aligned** on climate change policy and a convergence seems possible.

1.4 The Green bond market and the Social bond markets are rare examples of relative harmonisation of standards

The Green bond market, which has grown very quickly in the recent years (305 B $ in 2020), is based on Common principles created in 2014 and regularly updated by the International Capital Market Association (ICMA). These principles are used by over 95% of issuers in the European and international markets (including China which has created its own regulatory standards). There is also a complementary market-based green taxonomy provided by the Climate Bonds Initiative that are sector specific, developed by scientists and industry experts.

The Social bond market is another example of relative harmonisation of standards on the model of the Green bonds. Its development is more recent but has been very significant in 2020, particularly after the start of the pandemic, reaching 148 B $.

The European Commission has undertaken to publish a legislative proposal on an EU Green Bond Standard in 2021.

2. The need for convergence

2.1 Both the financial and non-financial sectors are negatively impacted by this «alphabet soup» of ESG standards and disclosure requirements

The number of different standards is a real burden for European corporates, which have, for instance, to answer too many different questionnaires from financial investors and ESG rating agencies. It raises costs, both financially and in human resources, which is deeply resented by Small & Midcaps.

Moreover, it does not favour comparability, the public sharing of ESG data and finally a real ESG transparency.

A recent report of the Boston Consulting Group (BCG) commissioned by the Global Financial Markets Association (GFMA) sees «ambiguity and lack of clarity» as a major obstacle to sustainable finance[3]. The report deplores «inconsistent and incomparable ESG-data, limited mostly to large corporates», «the lack of common definitions and taxonomies for climate/sustainable finance» and «the unclear understanding of sustainable financial products and solutions, and unclear labelling».

Most of the standard-setters and regulators also regret this situation. IOSCO is concerned by the lack of comparability of the information of the investors, underlined in a communiqué in February 2021: «for its work on issuers´ disclosures, IOSCO has observed that investor demand for sustainability-related information is currently not being properly met. For instance, companies often report sustainability-related information selectively, referencing different frameworks»[4].

2.2 A minimum level of convergence would be a very strong supporting factor towards global sustainability

It could allow the establishment of a framework that guarantees the high quality, reliability and accessibility of ESG and climate data, which is essential to accelerate the implementation of a sustainable economy, leveraging digital platforms as much as possible. This would reinforce the incentive for corporates to accelerate their transition and would provide a better transparency to investors who are increasingly keen to understand and monitor the sustainability impact of their investments. The dissemination of comparable ESG data would also help the development of best practices.

As for climate change, the report by the GFMA and the BCG underlines the necessary and huge structural financial changes to fight climate change and stresses in one of its key recommendations: "We recommend mandatory disclosure of corporate-specific, financially material, decision-relevant data relating to climate risks and opportunities". For GFMA and BCG, consistent global disclosure frameworks should be developed in consultation with industry participants and with adequate runway for implementation.

3. The possible roads to convergence

3.1 Many standard-setters have started to work on this issue

Last September, five standard-setters — the Sustainability Accounting Standards Board, the International Integrated Reporting Council, the Global Reporting Initiative, the Carbon Disclosure Project and the Climate Disclosure Standards Board — came together to announce plans to align their climate standards more closely. Since then, SASB and IIRC announced plans to merge together into a group called the Value Reporting Foundation by the middle of 2021, and CDSB may be joining them as well.

The IFRS Foundation plans also to develop climate standards before the end of the year. And IOSCO has decided to support this project[5].

At the EU level, a taskforce of the European Financial Reporting Advisory Committee (EFRAG) published mid-March 2021 a report calling for «promoting a mutually reinforcing cooperation between EU standard-setting efforts and international efforts or fora». the taskforce recalled that «the EU is by tradition and by construction among the jurisdictions which are the most open to international cooperation and convergence» and recommends cooperation and partnership with

3. The Global Financial Markets Association and the Boston Consulting Group: « Climate finance markets and the real economy », December 2020.

4. IOSCO: « IOSCO sees a need for globally consistent, comparable and reliable sustainability disclosure standards and announces its priorities and vision for a Sustainability Standards Board under the IFRS Foundation », February 2021.

5. EFRAG European Reporting Lab: « Proposals for a relevant and dynamic EU sustainability reporting standard-setting », February 2021.

international partners and initiatives but «without slowing down the momentum achieved in the EU». Indeed, it stressed that «international initiatives cannot in the short term match the speed and scope of EU's level of ambition».

GRI has positively commented this report, saying that it sees clear alignment with EU's sustainability standard setting efforts and is ready to assist. CDSB was more nuanced: it welcomed recommendations on international co-construction and digitalisation but cautioned around areas of duplication that can be avoided.

In the United States, the SEC has just launched a public consultation on climate change disclosures[6].

3.2 To avoid confusion, the international convergence regarding ESG disclosures should be led in priority by the G20 and the FSB

There is a need for simplification and for speed, notably for the climate change standards. Public authorities at the international level should be in the lead and that is the normal role of the G20 and the FSB, especially now that the new US administration should support them.

At the same time, the EU should play a major role in this convergence:

- by building on its experience based on the Non-financial Reporting Disclosure Regulation and on the Sustainable Finance Disclosure Regulation.
- and through the international platform on sustainable finance which it has created.

As for climate change, the EU is in pole position with the development of the taxonomy regulation. The international platform, which was created at the EU initiative, has a working group on non-financial standards which has started to work on the EU taxonomy.

The NGFS (Network for Greening the Financial System) of central bankers and financial supervisors could also help the convergence in this field.

3.3 On climate change, significant progress seems possible

Indeed, due to its political priority in the EU and many other countries, and now that the US is back, willing to engage into an ambitious transition to a zero-carbon economy, significant progress seems possible.

The COP 26 in Glasgow, under the UK's Presidency, is an opportunity which should not be missed.

Building on last year B20's recommendation to "promote alignment on disclosures across ESG factors to enhance reporting by publicly traded corporations", the G20 should mandate the FSB to step up its ambition in the work of the Task Force on Climate-Related Disclosure with the view to make key climate disclosure mandatory as soon as 2025 for all listed corporates in all jurisdictions.

The creation of a Global climate taxonomy should be a common goal of standard setters. It is supported by the GFMA/BCG report which notably recommends "a regional and temporal flexibility" and "the inclusion, beyond the zero or near zero carbon activities, of transition or enabling activities which are scientifically eligible activities".

This Global taxonomy could be built on the work already done by the EU, which is in the process of finalizing its regulation with a high level of detail. The European Commission should increase the exchanges about the climate taxonomy with its partners in the international platform before its implementation in Europe.

3.4 On the other parts of ESG, convergence risks to be slower

In this field, we could quote Kierkegaard: "it is not the path, which is difficult, it is the difficult which is the path". Given the differences of standards between constituencies like the EU and the United States (cf. 2 above), only a significant involvement of the SEC could make US-EU convergence easier.

In this background, bodies like IFRS/IASB cannot achieve much, since US apply their own standards and the EU is contemplating the opportunity to have its ESG standard setter.

However, to support international convergence, the EFRAG TF recommends that the EU develops a regular outreach to other international standard-setting bodies by communicating regularly on its work-plan, share progress reports, open consultations to non-EU comments and offer the outcome of its work as a contribution to international convergence. It also recommends to «consider joint projects to develop new standards under clear terms of reference» and suggests that «dialogue with the IFRS Foundation be organised once the Foundation has set a possible course of action».

A possible goal for convergence would be an agreement on an international grid of minimum standards, but, for Europeans, supported by the GRI, the «double materiality» should be part of this grid.

Conclusion

Financial and non-financial actors ask for as much international harmonisation of ESG standards and disclosure requirements as possible.

Today convergence seems possible for climate change standards which has become a priority also in the United States, as evidenced by the public consultation recently launched by the SEC. The COP 26 in Glasgow could be a catalyst in this process, where it seems possible to build on the work already made, notably by the European Union.

Convergence would be also needed on other ESG standards, but where the differences seem more difficult to be reduced and where the political priorities are lower outside the European Union.

6. SEC: « Public Input Welcomed on Climate Change Disclosures », March 2021.

DIGITAL FINANCE STRATEGY AND DIGITAL FINANCE PACKAGE: OBJECTIVES AND MAIN PROPOSALS

Note written by Marc Truchet, EUROFI

1. Opportunities and challenges associated with digitalisation

The European Commission proposed in September 2020 a Digital Finance Strategy (DFS) aiming to support the digital transformation of the EU financial sector. The objectives of the DFS initiative are to adapt the financial regulatory and supervisory framework to the increasing digitalisation of the EU financial sector, identify measures that may support a further digitalisation of the sector, remove potential obstacles to digitalisation and also address possible new risks and level playing field issues related to this digital transformation.

Digitalisation is indeed a key driver of innovation, agility and efficiency in all areas of the financial sector, allowing an optimisation of the products, services and funding sources proposed to customers, facilitating their distribution at a lower cost and supporting operational and process improvements, as well as enhanced collaboration and partnerships along financial value chains. Digitalisation may also help to further integrate EU financial services by reducing the cost of cross-border expansion and facilitating cross-border transactions.

Digitalisation is also bringing major changes to the financial ecosystem, with a fragmentation of value chains, an increasing role played by third-party technology service providers and new forms of competition that potentially require adjustments to the existing EU policy framework. Some challenges are also gaining in importance with the use of new technologies in the financial sector, such as those related to the availability and sharing of data, cyber-security or the fairness and accountability of recommendations with the use of Artificial Intelligence-based (AI) systems.

A number of regulatory and non-regulatory barriers to the further digitalisation of the financial sector also need tackling. First, differences across domestic regulatory requirements may hinder the cross-border development of digital financial services. This may include differences in rules applying to financial services[1] or financial data[2] and differences in supervisory approaches across the EU. Secondly some rules may not be adapted to digital channels or prevent their optimal use (e.g. regarding disclosure, information provision, regulatory approvals). Finally, non-regulatory obstacles have also been identified, including challenges related to data quality, legacy IT systems and insufficient IT skills.

2. Priorities of the Digital Finance Strategy proposal

The DFS communication builds on previous EU policy actions concerning digitalisation in the financial sector such as the 2018 Fintech action plan and work conducted by the ESAs and the European Parliament (e.g. regarding cloud services, crypto-assets…), as well as initiatives put in place by several domestic authorities in these areas. It also completes, with a more specific focus on financial services, horizontal policy proposals previously made by the Commission concerning artificial intelligence (AI), data[3] and cybersecurity in particular.

The DFS is structured around four main priorities supported by key actions. These are due to be implemented by 2024, with some first steps to be achieved by the end of 2021 or by 2022:

- **Removing fragmentation in the Digital Single Market for financial services and improving its functioning.** A first objective is to facilitate the access of customers to digital financial services on a cross-border basis and their on-boarding[4] with a proposed harmonization of KYC / AML rules, a simplification of customer due diligence processes and a framework for managing digital identities on a cross-border level across the EU[5]. A second objective is to foster the scaling up of digital services provided by financial firms operating in Europe with an extension of passporting rules to areas of digital finance not yet covered (such as non-bank lending and activities related to crypto-assets) and efforts to enhance supervisory convergence and the cross-border cooperation between private and public stakeholders, building on the experience gained with domestic sandboxes and innovation hubs.
- **Ensuring that the EU regulatory framework is fit for the digital age.** This involves adapting existing financial legislations to new developments such

1. e.g. differing Know Your Customer / Anti-Money Laundering (KYC / AML) requirements, rules applying to financial products and services applied in different ways…
2. e.g. variations in the way GDPR rules are interpreted, different data location requirements, third-country legal requirements that may impact EU users…
3. The White Paper on AI and the European strategy for data published in February 2020
4. In this perspective, the EBA is invited to develop by Q3 2021 and in cooperation with the other ESAs, guidance about how to ensure greater convergence of the elements needed for on-boarding processes and about the conditions under which financial services providers are allowed to rely on customer due diligence processes (CDD) carried out by third parties. Secondly, the Commission will further define and harmonise CDD requirements as part of the new upcoming AML / CFT framework proposals, in order to allow for seamless cross-border financial operations, which require in particular facilitating the use of innovative technologies in this context and specifying elements such as which ID documents are needed for on-boarding and which technologies can be used to check ID remotely.
5. This framework will be determined in the context of the e-IDAS regulation review (framework for electronic identification and trust services for electronic transactions)

as crypto-assets, the use of Artificial Intelligence (AI) and cloud services and reviewing them on an on-going basis to ensure that there are no new obstacles to further digitalisation. In order to achieve this objective, the Commission has proposed as part of the broader Digital Finance Package (*see section 3 of this document*) two new EU legal frameworks for crypto-assets (MiCA) and DLT (the DLT pilot regime), as well as the Digital Operational Resilience Act (DORA), which aims at mitigating ICT (Information and Communication Technology)-related risks. Additional measures are proposed for facilitating the use of cloud services and AI in finance, building on the horizontal data and AI strategies[6]. The Commission is moreover proposing to ensure that potential material regulatory obstacles to digital innovation stemming from existing financial services legislation are removed and to provide interpretative guidance with regard to the application of legislation to new technologies on an on-going basis.

- **Establishing a common European financial data space to facilitate data sharing and promote data-driven innovation, building on the European data strategy**[7]. Firstly, measures are proposed for facilitating the sharing of existing financial information provided through national registries (e.g. corporate disclosures) and of information released under EU financial regulations, as well as actions to facilitate the use of new technologies (including RegTech and SupTech) for supervisory reporting and the sharing of this information. Secondly, the Commission is proposing the establishment of an "open finance" framework by mid-2022[8] aiming to facilitate broader data sharing among market stakeholders in order to allow e.g. the offering of more personalised products and services based on AI systems.
- **Adjusting financial regulatory and supervisory approaches in order to address the challenges and risks associated with digital transformation.** The Commission is finally proposing to identify areas of financial regulation that may need updating in line with 'same activity, same risk, same rules' principles in order to take into account the increasing role played by technology companies in the provision of financial services and the related changes in the financial ecosystem, while preserving financial stability and customer protection[9]. The Commission will moreover assess whether and how customer protection rules may need updating to take into account new digital ways of providing financial services and is proposing a new EU framework for strengthening digital operational resilience (*DORA – see details in section 3*).

3. The broader scope of the Digital Finance Package

The DFS is part of a broader Digital Finance Package proposed by the Commission that also includes MiCA (the regulation on Markets in Crypto-Assets), a pilot regime for DLT market infrastructures, DORA (the Digital Operational Resilience Act) and a Retail Payments Strategy.

3.1 MiCA (the regulation on Markets in Crypto-Assets)

MiCA proposes a new EU legal framework for crypto-assets that do not fall under existing EU legislation[10] and also for the entities that issue these assets and those that provide services related to them.

MiCA aims to provide legal certainty and clarity for crypto-asset issuers and providers and establish uniform disclosure and transparency rules related to crypto-assets. MiCA also puts forward passporting rules for crypto-asset operators, requirements for the offering and marketing of crypto-assets to the public and a certain number of safeguards for crypto-asset holders (including capital requirements, rules concerning the custody of assets, complaints procedures and investor rights, as well as provisions for the supervision of issuers of significant asset-backed crypo-assets - so called global stablecoins). The Commission is moreover considering the updating of prudential rules for financial firms holding crypto-assets and the implementation of measures for encouraging the use of DLT for SME capital-raising operations. Further work is also being conducted by central banks, in particular the ECB, on the possible issuance of retail central bank digital currencies.

3.2 The DLT pilot regime

The DLT pilot regime is designed for market infrastructures that trade and settle transactions in financial instruments that are in crypto-asset form and in crypto-assets that already fall under existing EU

6. The European data strategy proposes notably the development of a European cloud rulebook and of a European cloud services marketplace by the end of 2022. Building on the horizontal White Paper on AI, which applies to all sectors and the upcoming proposal for a new regulatory framework for AI planned in 2021, the Commission is inviting the ESAs and the ECB to explore the possibility of developing specific regulatory and supervisory guidance on the use of AI applications in finance.
7. The EU data strategy rests on 4 main pillars: (i) rules on data access, use and sharing which are defined in the Data Act, (ii) the development of EU data infrastructures and related rules (EU cloud rulebook, setting up of an EU cloud services marketplace); (iii) the enhancement of individual data rights concerning machine-generated data such as IoT; and (iv) the development of sectoral European data spaces including for financial services.
8. This initiative will be coordinated with a review of the Payment Services Directive (PSD2). PSD2 opens access to bank account data in order to allow the development of new payment services, but does not offer the reverse i.e. access to data held by non-financial firms such as online platforms, creating an unbalanced level playing field, according to certain financial players and limiting the overall flow of data. Some other specific issues such as the current issues faced by payment services providers when trying to access certain mobile platforms for effective contactless payments will also be addressed.
9. A certain number of areas and issues that may need adjusting were identified by the Commission including: (i) the payment services and e-money directives; (ii) the way more fragmented value chains and new providers of financial services may be supervised in a cooperative way e.g. by a supervisory college for the ecosystem of a given financial services value chain; (iii) the supervision of conglomerates with the FICOD Conglomerates Directive; and (iv) the micro and macro risks stemming from potential large-scale lending operations by firms outside the banking perimeter.
10. For example utility tokens that provide access to a service, stablecoins that can be used for payments and claim to maintain a stable value.

financial services regulation and will remain subject to that legislation[11].

The pilot regime establishes limitations in terms of DLT transferable securities that can be admitted to trading or recorded by DLT market infrastructures such as trading venues or CSDs. It adopts a 'sand-box' approach with temporary derogations from existing rules for these market infrastructures, so that market infrastructures can test and learn more about the rules in place and regulators can gain experience on the use of DLT in this area, while ensuring an appropriate monitoring of risks. This proposal also sets additional requirements for tackling the novel forms of risk raised by the use of DLT in market infrastructures and proposes amendments to rules that restrict the use of DLT in market infrastructures, with the objective of improving legal certainty for DLT infrastructure users.

3.3 DORA (the Digital Operational Resilience Act)

DORA's objective is to ensure that the necessary safeguards are in place to mitigate ICT-related risks for all financial market participants, given the increasing dependence of the financial sector on digital processes and software and the expanding volumes of personal and financial data held by financial firms.

The proposed legislation imposes common ICT risk provisions that all participants of the EU financial system should be subject to on a domestic and cross-border basis in a proportionate manner, in order to ensure that their operations can withstand ICT disruptions and threats of all types, including cyber-attacks. The proposal also mandates the implementation of dedicated ICT risk management capabilities, the reporting of major ICT-related incidents, digital operational resilience testing, the management by financial entities of ICT third-party risk and information sharing among financial entities concerning cyber-threats in particular. DORA moreover introduces an oversight framework for critical ICT providers such as cloud service providers in the context of an increasing use of outsourced services, as well as a harmonisation of key contractual aspects in order to facilitate the monitoring of ICT third-party risk by financial firms.

3.4 The retail payments strategy (RPS)

The RPS aims to ensure that the EU's payments market fully reaps the benefits of innovation and the opportunities offered by digitalisation. This strategy endeavours to make instant payments and EU-wide payment solutions more accessible and cost effective for citizens and businesses across Europe and particularly in cross-border situations, while maintaining a high level of consumer protection and safety. The EU retail payments market is indeed still very much fragmented across national borders and many domestic instant payment solutions do not work cross-border, thus consumers often have no choice other than to use services provided by the main international card schemes or large internet platforms.

The RPS is designed around 4 main pillars covering the main components of the payments ecosystem. The first pillar focuses on the promotion of cross-border EU payment solutions and notably the roll-out of instant payments as the 'new normal', with the objective of a full uptake of instant payments in the EU by end-2021. The second pillar is the development of a competitive and innovative EU retail payments markets ensuring a high level of consumer protection, building on the forthcoming review of PSD2 - aiming to remove the main obstacles to the implementation of open banking principles - and its further alignment with EMD2 (Electronic Money Directive). The third pillar seeks to improve the access of payment providers to payment and other technical infrastructures and reinforce the inter-operability of infrastructures processing instant payments. Finally, the fourth pillar aims to improve international payments between the EU and other jurisdictions which are considered to be too expensive and inefficient, by supporting links between payment systems in different jurisdictions and reducing the time to process transactions.

11. For example some crypto-assets qualify as financial instruments and are therefore subject to EU securities market legislation (e.g. MiFID)

Notes

ABOUT EUROFI

The European think tank dedicated to financial services

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

OUR OBJECTIVES

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

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

OUR APPROACH

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

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

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

OUR ORGANISATION AND MEMBERSHIP

Eurofi works on a membership basis and comprises a diverse range of more than 65 European and international firms, covering all sectors of the financial services industry and all steps of the value chain: banks, insurance companies, asset managers, stock exchanges, market infrastructures, service providers... The members support the activities of Eurofi both financially and in terms of content.

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

OUR EVENTS AND MEETINGS

Eurofi organizes annually two major international events (the High Level Seminar in April and the Financial Forum in September) for open and in-depth discussions about the latest developments in financial regulation and the possible implications of on-going macro-economic and industry trends. These events assemble a wide range of private sector representatives, EU and international public decision makers and representatives of the civil society.

More than 900 participants on average have attended these events over the last few years, with a balanced representation between the public and private sectors. All European countries are represented as well as several other G20 countries (US, Japan...) and international organisations. The logistics of these events are handled by Virginie Denis and her team. These events take place just before the informal meetings of the Ministers of Finance of the EU (Ecofin) in the country of the EU Council Presidency. Eurofi has also organized similar events in parallel with G20 Presidency meetings.

In addition, Eurofi organizes on an ad hoc basis some meetings and workshops on specific topics depending on the regulatory agenda.

OUR RESEARCH ACTIVITIES AND PUBLICATIONS

Eurofi conducts extensive research on the main topics on the European and global regulatory agenda, recent macro-economic and monetary developments affecting the financial sector and significant industry trends (technology, sustainable finance...). Three main documents are published every 6 months on the occasion of the annual events, as well as a number of research notes on key topics such as the Banking Union, the Capital Markets Union, the EMU, vulnerabilities in the financial sector, sustainable finance.... These documents are widely distributed in the market and to the public sector and are also publicly available on our website www.eurofi.net :

- Regulatory update: background notes and policy papers on the latest developments in financial regulation
- Views Magazine: over 190 contributions on current regulatory topics and trends from a wide and diversified group of European and international public and private sector representatives
- Summary of discussions: report providing a detailed and structured account of the different views expressed by public and private sector representatives during the sessions of the conference on on-going trends, regulatory initiatives underway and how to improve the functioning of the EU financial market.

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