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THE
EUROFI
MAGAZINE

APRIL 2021

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Minister of State for Finance,
Portugal

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EUROFI POLICY NOTES

PUBLIC AND PRIVATE SECTOR VIEWS

THE EUROFI VIEWS MAGAZINE

APRIL 2021

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

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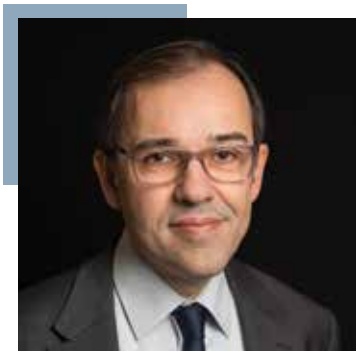
DIDIER CAHEN



MARC TRUCHET

JEAN-MARIE ANDRES

The April 2021 Eurofi High Level Seminar organized virtually in association with the Portuguese EU Presidency and the publication of this Magazine are taking place at a particularly challenging time, since the pandemic is not over in the world and in Europe.

The responses to the Covid-19 crisis, how to relaunch growth in the EU and the role that the financial sector may play in this regard will provide major topics of discussion during this event and this Magazine offers a wide range of views on the related challenges and opportunities.

The "Next Generation EU" Recovery plan in particular is a significant step towards more fiscal cohesion and solidarity, but money alone will not ensure recovery. One particular challenge at this point in time is the relaunching of productive investment and sustainable growth in the EU. Indeed, major investments are needed for supporting the post-Covid recovery, the EU Green Deal and digital transformation. However real Gross Domestic Product growth and productivity gains in the euro area have failed to catch up with the US, China and Japan over the past two decades and lasting low interest rates develop a preference for liquidity over productive investment among potential investors.

Potential risks to global and European financial stability are another challenge. Near term financial stability risks are contained by massive monetary, fiscal, regulatory and supervisory support. But we are not out of rough waters. At the top of the list of threats lie high levels of public and private debt in a number of Member States, which cannot be alleviated by monetary policy. In addition, pushing too hard and too long on the monetary pedal may generate further vulnerabilities and eventually create the conditions for future crises. More structural policies are also needed in order to enhance fiscal sustainability.

In terms of opportunities, major EU initiatives launched before the Covid crisis, such as the Banking Union, the Capital Markets Union, the sustainable finance taxonomy and new initiatives such as the Digital Finance Strategy have the potential to provide the EU with the vibrant single market for financial services that is needed for funding the EU economy. However, these projects still need to become a reality. How to implement these initiatives in an effective way will be at the centre of the discussions of this event.

In preparation for these debates, the Eurofi secretariat has prepared several papers on these issues that can be found in the April 2021 issue of the Eurofi Regulatory Update and the speakers participating in this event have been invited to express their views on these questions in this Magazine.

We are grateful to the 180 public and private sector representatives who have provided us with input on these issues, and we are sure that you will read their thoughts and proposals on these challenging questions with great interest.

DAVID WRIGHT

President of Eurofi

Sadly, it is not possible for EUROFI to meet in person in Lisbon given the prevailing pandemic situation in Europe. However, it will not prevent us from having many thought-provoking debates virtually as at our previous event in Berlin and, as usual, it will be a very busy and intense two days and a half.

I would like to thank the Portuguese Presidency for their excellent cooperation and assistance in helping prepare this event and our EUROFI members and partners for continuously supporting our unique events which is thoroughly appreciated. We have over 200 distinguished speakers from the public and private sectors participating this time all of whom I also thank for their dedication, their time and their effort. And we are expecting over 1000 people to be listening to our debates.

My message for this edition of the EUROFI meeting is simple. It is this. Given the gravity of the health, economic, financial, environmental and social challenges facing the European Union we have to accelerate decision taking now across the board. What Philip Stephens of the FT has described as the continuance of "...defensive incrementalism..." is simply inadequate to deal with the size and multitude of the tasks the European Union faces today. Piece by piece, drip by drip policy making, surely, we cannot meander timelessly along as if we are in normal times which can only result in the European Union falling further and further behind the United States, China and other Asian countries in the global development and competitiveness stakes. This is what is happening. The United States, for example, is projected to grow twice as fast as the EU this year, possibly even more.

Of course, I do not advocate not respecting our Treaty based and National democratic processes, not at all. What I am advocating is material, substantive acceleration, using emergency procedures where available, fixing trilaterally between the European Commission, European Parliament and European Council ambitious dates for delivering the necessary policy measures and rigorously tracking the delivery of them. Nothing in my view could galvanise the European Union more than such bold policy making in these exceptional, stressful times. Citizens will witness an EU evidently on-the-move; investors will see and seek more opportunities to invest; EU leadership on sustainable development will be assured; uncertainty about the EUs' near-term future will decline, confidence will grow and European identity will be strengthened. The key ingredient needed is political leadership and much more of the solidarity that delivered the impressive European Recovery Programme.

What are the vital areas to accelerate? I have five to suggest:

1. Vaccination

This of course depends on supply where there have been evident difficulties but assuming the supply situation will improve over the spring and summer the inoculation process should be 24 hours a day, around the clock, the equivalent of top military planning with fair dosage distribution to all Member States. This is essential for economic recovery and the return to normalcy.

2. Banking Union

How many more years will be needed to complete the job? These delays are seriously hampering the structural reform, scaling up and competitiveness of European banks who provide the vast bulk of European corporate and consumer financing. A delivery date should be set.

Banks must also prepare and provision responsibly now for the expected increase in NPLs expected in the months ahead as public COVID support measures taper off.

3. Capital Markets Union

The Commission has a good new 16-point plan on the table. But the December 2020 ECOFIN Council conclusions only state that about 1/3 of the measures are priorities for the

Commission to make a proposal on by the end of 2021. The rest are on even slower timeframes - some are "medium term", like making progress on insolvency procedures or simplifying withholding tax administration which investors always point to as hampering and seriously damaging EU capital market development.

In short this is all too slow after years of stasis. And it really does matter because the European Unions' laudable top political objectives - leading on sustainable development and the green economy, digital renovation, massive infrastructural investment, pension reform and social cohesion, CANNOT be delivered without a vibrant ecosystem of EU capital markets, integrated and local. This is what is at stake. In the last few weeks alone, continuing the trend of decades, we have seen some brilliant, new, dynamic SMEs founded by some outstanding Europeans from different Member States head off, once again, to the U.S to list or to seek big amounts of development capital. With it goes the business and European intellectual property. These new frontier SME businesses must be developed in the EU in the future, many on public markets, to become world-beaters.

Real CMU should translate also logically into reviewing the hub and spoke distribution of regulatory and supervisory powers between the ESAs and National Competent Authorities, including the enforcement needed for a single rulebook.

4. Post Covid structural reform

Building on rigorous Member State plans to deploy efficiently and urgently EU Recovery Funds, a continuous effort has to be made for many years thereafter to build Member state economic resilience, sustainable control of public expenditure, along with a renovated Eurozone growth and stability pact that needs to be respected at all times by all EUROZONE members. EUROFIs' distinguished Honorary President Jacques de Larosière has commented elsewhere in this edition on these crucial policy issues.

5. Sustainable development

The EU has carved out impressive leadership on many aspects of sustainable development and the future green economy. But more actors are entering the scene so the EU needs now to cement its policy leadership quickly - on disclosure rules, the application of the ESG parameters, sustainable finance, green bonds and its essential, impressive taxonomy work. As in many policy areas, many countries in the world will want to follow the EU if its standards are timely and the best in class. The EU must seize this immense opportunity and not let it slip from its grasp.

Finally, BREXIT

Sadness is hardly the right word to describe the deteriorating state of relations between the EU and the United Kingdom. It is urgent, politically and economically to stop this dangerous bickering which is already causing some serious collateral damage and to settle down rapidly to cooperative decision-making based on trust, confidence and in full conformity with the Trade and Partnership Agreement negotiated. Including on financial services where a policy vacuum is neither healthy, nor will facilitate economic growth, nor help spread new economic opportunities to all segments of society.

I favour an open, predictable approach to building Capital Markets Union but one which ensures that the real, potential systemic risks to the EU are managed inside the EU and the same for the United Kingdom. I believe this approach will result in the quickest and best CMU possible drawing on optimal international best practice and encouraging inward investment into the EU.

Finally, I do not think future EU-U.K. financial services relations can be built solely on the recently negotiated MOU and 2 way, independent equivalence determinations. More certainty is needed and more imagination, including consideration of a longer-term, cooperative Treaty based solution in the economic and financial interest of both sides.

Q&A

JACQUES DE LAROSIÈRE

Interview of Jacques de Larosière conducted by Didier Cahen on 30 March 2021

Views on the responses to the Covid-19 crisis

A little over a year ago, China sealed off the city of Wuhan. This was the starting point of an exceptional global health and economic crisis. One year later, what is your perspective on this crisis?

It is a crisis that has been exacerbated by our unpreparedness. Many expert reports had been highlighting the high probability of a pandemic for decades. But short-term concerns prevailed over long-term ones. We had not taken any preventive measures. As a result, we have approached this crisis like all the other major health crises in history, including the Middle Ages. With the same tools. The focus was on trying to contain the risk of contagion, confining the population as much as possible, managing the availability of hospital beds even if it means arresting the economy.

This extraordinary crisis has been treated not in an extraordinary way but mostly in an ad-hoc way like a crisis of the past. That said the scientific community has reacted impressively fast to develop vaccines, but their distribution is now provoking some ugly nationalism and greed.

Can we measure the damage caused to the world economy at this point of time?

Again, we reacted because we had not sufficiently acted preventively. Many companies stopped trading, with very high economic cost. The State has stepped in to pay workers. We have an unprecedented budgetary shock, commensurate with our unpreparedness. Overall, global GDP has fallen by almost 3.5% in 2020, according to the latest OECD estimates (March 2021), with three groups of countries:

- Some advanced countries that have seen their GDP fall sharply, by around 10%, include France (-8.2%), Italy (-8.9%), Spain (-11%) and the UK (-9.9%).

- Other advanced countries that have experienced a decline half as strong, such as Germany (-5. 3%) and the United States (-3. 5%).

- And emerging countries, with GDP down 2.4% apart from China, the only major country to have maintained some growth last year (+2.3%).

For the year 2021, there are still too many uncertainties to make solid forecasts: mutations of the virus, effectiveness and distribution of vaccines, social reactions, etc. But economic activity will generally remain below the pre-crisis level in 2022, or even 2023 for the most vulnerable countries. However, taking official forecasts projected growth in the U.S this year will be nearly twice that of the EU.

Why has the economy suffered so much more in some countries than in others, notably emerging ones?

For one simple reason. Although emerging countries have taken advantage of globalization to expand their exports, they are less integrated into globalization, and the virus has often been less prominent or percolating in their countries. They have also been protected from a very different "virus" attacking advanced countries: financialization.

Over the past 30 years, credit has grown faster than business, a development that will eventually be understood to be dangerous. Emerging and developing countries have not had the luxury of catching this "virus", as markets do not lend money easily to them.

Why is the economic performance different between advanced countries, such as Germany and France, as well?

Germany is an industrialised country, France a country in the process of de-industrialization. In 20 years, the share of manufacturing industry in France's GDP has fallen from 15% to 10%, while it has remained at almost 25% in Germany. In a pandemic crisis, however, an industrialized economy is more resilient, relying on cutting-edge technologies. This is not the case with a service economy, which has been affected by a shutdown of normal neighbourly activities, such as tourism in all its forms: airlines, hotels, hospitality industries etc with major knock-on and negative economic multipliers. Because of de-industrialization, de-specialization, distribution rather than production, the Covid crisis has accelerated the weakening of the French economy – the consequence of "forty years of bewilderment."

What role does the pandemic play here?

It is a triptych revelator, accelerator and eye-opener.

Let's take the case of France: on the soft pillow where we too often rest, we were under the impression that we had an economic system capable of withstanding any exogenous shock having a very efficient health system. The coronavirus has been a rude awakening. Secondly, it is an accelerator, because the epidemic affects have impacted less on a healthy economy than on an obese one. With a public debt of around 100% of GDP and a ratio of public spending to GDP of 54% at the end of 2019, France is in the obese category compared to Germany at 60% and 44% respectively. It is the condition of the patient before the pandemic struck that is important.

How can we explain that EU countries have suffered more from the crisis than the US and China and are slower to get back on track?

Indeed, the economic crisis is more severe in Europe than in the US, and China which are now bouncing back more strongly than in the EU. China quickly contained its health crisis with fairly radical methods. As for the United States, the economy remains very flexible and the State has been very active in its federal interventions (including vaccination).

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How can we encourage a return to healthy growth in a zero-interest rate environment, in European economies that are often over-indebted? What role for monetary and fiscal policies?

A priority is to re-establish financial markets that function on the basis of market forces and not according to the prescription of zero-interest rates. We must therefore stop advocating an indefinite period of zero interest rates if we want to revive economic growth. History (notably during the 19th century) shows that growth always implies work and the remuneration of risks: Adequate remuneration for risk is of the essence for fostering long term investment. Fiscal policies can also be used to promote investments for the future (research, infrastructure programmes, ...) but to do so, it is necessary to have the means to do so, i. e. to reduce non-productive current public expenditure.

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

We can see how much the policy, particularly in Germany, of reducing the public debt-to-GDP ratio to the level prescribed by the Maastricht rules, has paid off. Starting with 60% of public debt, compared to more than 100% in other countries, Germany has been able to embark on a massive programme of aid to the economy while its neighbours did not have the same margin for maneuver. Furthermore, the German economy is projected to return to its pre-pandemic size much sooner this year than for example Italy and Spain.

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

As in 2008, central banks have been at the forefront of this crisis. Have they performed well?

I have said for a long time that the excessive issuance of money is leading us to an unsustainable situation. If interest rates are to remain at zero for an indefinite period of time, a depressed view of society is created. Let me explain: few people have noticed it, but for several years now, productive investment has been collapsing. Why, when you can borrow money for nothing? The reason is investment project managers are discouraged from investing in a zero-rate environment synonymous with low growth; they tend to focus on remunerative, buy-backs and speculative assets.

Moreover, as a result of zero interest rates, household savings in Europe have shifted to liquid, non-risky assets, mainly bank accounts. This makes perfect sense when making investments no longer earn any interest because of zero interest rates and taking into account that retail savers in Europe are risk adverse. This is what Keynes already called the "liquidity trap". The decisions made have resulted in no longer remunerating investor risk and so turning away from risky long-term projects. Today's monetary policy makes tomorrow's economic decline. A society that no longer invests is a society with no future.

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

You have previously emphasized the dangers of monetary policies that remain accommodative for too long. Can you remind us of those dangers?

The impact of excessively accommodative monetary policy - with interest rates at zero or even negative for a long time - on the stability of the financial system is unfortunately too well documented:

- enhanced incentives to borrow more and increase financial leverage;
- weakening of the banking system;
- deterioration of the accounts of pension institutions whose liabilities remain subject to contractual obligations but whose fixed-income assets no longer yield sufficient returns;
- proliferation of zombie companies in an environment where interest rates no longer play their necessary, selective "quality signaling" role;
- a strong disincentive for governments to undertake structural reforms since borrowing "no longer costs anything".

Let us not underestimate the importance of this loss of benchmarks - zero interest rates blur risk premiums (one of the characteristics of the 2008 crisis). In such a monetary environment, the market does not play its allocative function among different types of assets due to the massive asset purchase of the central bank. Indeed, the universal buying of sovereign securities eliminates the normal functioning of market forces between savings and investment and brings interest rates to levels close to zero which, as we have already seen, encourages the holding of liquidity to the detriment of productive investment.

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

And regarding financial stability?

The present situation does not augur well for financial stability.

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.

A monetary policy that massively increases indebtedness as a response to insufficient inflation accumulates all the disadvantages: it is paradoxical to hope that inflation ("business") will take off again not so much on the basis of favourable economic expectations but as the result of even more public and private debt. However, given the extremely high levels of this debt, it is illusory that an additional dose of over-indebtedness will result in an increase in investment projects. This could lead to an increase of delinquencies and through a contagious "Minsky process" to broader contagion.

Another disadvantage is that the natural result of money creation in an environment of over indebtedness and depression due to the prospect of zero interest rates for a very long time, is the spiking of financial assets, not real assets.

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

What threatens the break-up of the zone is the disparity of the economic policies and performance of the Member States and their lack of coordination. The Covid crisis is amplifying these disparities between northern and southern members of the Eurozone.

This is something which is very obvious and is connected with the structure of economies, the weight of the services sector, of tourism, or the average size of companies. Another additional element is the fact that the fiscal space available was different in every country at the start of the crisis.

This heterogeneity, these structural fault lines are bound to increase with the further increases in public spending during this crisis. If Member States whose public debts are already excessive do not make a more serious effort to reduce public expenditure not justified by imperative and urgent needs, the problem of the Eurozone' centrifugal forces can only worsen.

For the time being the ECB equalizes interest rates through very heavy interventions. But if structural reforms are not implemented in the "southern" countries, it will be difficult for the Central Bank to intervene forever, which should not be allowed by the Maastricht Treaty.

What mechanisms can Europe use to correct the growing heterogeneity of economic performance between euro area countries?

The Next generation EU recovery package is a significant fiscal deal and a welcome EU step forward. But the EU mechanisms to correct this growing heterogeneity remain limited and the name of the game for mitigating the risk of further economic divergences will remain national. It needs to be implemented quickly.

This means implementing structural reforms to strengthen productivity and lift potential growth rates, mitigating failures of healthy firms, ensuring a smooth re-allocation of resources, improving the functioning of markets and public administration, reorienting fiscal policies towards sustainable and digital investment....

When should the ECB prepare the markets for a normalisation of its monetary policy and what are the expected benefits?

Once the health crisis is truly under control, the ECB must prepare the markets for a gradual normalisation of its monetary policy.

Central banks would become more flexible and would regain room for manoeuvre: public opinion would begin to realise that zero interest rates for an indefinite period (perhaps a decade or two) would become unrealistic; in so doing, the illusory dynamic: "zero interest rates for an indefinite period, supposedly a factor in the recovery of investment" would be replaced by a more effective and more traditional paradigm: "the markets remunerate savings invested over the medium and long term in accordance with the supply of, and demand for, capital".

Finally, financial stability can only benefit from such a normalisation of monetary policy because asset bubbles should tend to stabilise or shrink.

Does such monetary normalization require a revision of the inflation target of the central banks?

Indeed, central banks should relax their inflexible inflation targeting of 2% inflation, assuming that it has been below its target in recent years, as break-even inflation is more likely to be around 1%.

Failure to meet the 2% target should no longer be an excuse for mechanistic monetary easing. It should also be clear that the systematic purchase of bonds should not become a means of enabling governments to finance large stimulus packages without ex-ante conditions, including spending efficiency.

Wouldn't such a normalisation of risk lead to a bond crash?

Such a normalisation can only be gradual and explained to the markets. Moreover, they seem to have understood this before any explanation. The increase in long-term interest rates remains very modest to date.

Shouldn't such standardization be agreed at an international level?

Of course. This is an essential part of the success of the operation. All monetary policies are interconnected, exchange rates react immediately to changes in interest rates: in order to avoid the "beggar thy neighbour policy", international cooperation is needed, as was the case until the 1990s.

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At what point should Member States withdraw the exceptional fiscal support that has been granted to companies and households? What precautions should be taken in this regard?

Given the scale of the recession caused by the pandemic crisis and given the direct and extensive role played by governments in supporting companies and activities, this budgetary support will have to be maintained for some time. But the quality of expansionary fiscal policies must be improved without delay. The continuation of excessive current expenditure appears very dangerous.

A public debt rate of 120% does not have the same effects if it covers current expenses or if it finances productive investments that will generate future revenues. In the first case, the budget sinks into cumulative deficit. In the second case, the deficit eventually stabilizes or even narrows in line with investment income.

The sustainability of public finances requires that fiscal policy really should take into account this improvement in the quality of public expenditure in the coming years. This criterion should be a guiding element of the reform of the Stability and Growth Pact (see below).

How can Member States and the financial sector increase equity support for highly indebted but viable companies?

A broader concern in all EU economies – and in particular in France and the Netherlands- is the high level of debt, especially corporate debt, with private sector debt service burdens at or above their level during the global financial crisis despite historically low nominal interest rates.

Although some firms have used borrowing to build up sizeable cash buffers since the onset of the pandemic, high leverage could moderate new investment. According to the OECD, the debt service ratio of the private non-financial sector of adjusted sector gross disposable income is 22% in France, 15% in the US and 10% in Germany.

Two cases will arise: companies whose business model are very seriously threatened and who are unable to assume their debt and, secondly, companies whose fundamentals offer hope.

For the latter, it will be necessary to provide for the transformation of debt into equity (equity loans and investment funds with a guarantee for investors). For the former, it will be necessary to carry out structural transformation (mergers and acquisitions) or liquidations. A pan-European system for dealing with these companies in difficulty under current conditions should be established, including for NPLs.

Another essential policy ingredient is a fully functioning Eu-wide banking and capital market. In the EU, these projects like banking and capital markets Union are moving too slowly hampering the emergence of a more dynamic economy able to finance more flexibly and quickly companies and individuals.

What is the future for the Stability and Growth Pact (SGP)? Should it be reformed before it can be implemented again? When should we consider a return to these rules?

We can always envisage improvements, but the reality is unfortunately very simple: when the percentage of GDP devoted to public expenditure is too high, it must be reduced and brought closer to the average of the eurozone if we want to achieve a degree of homogeneity in budgetary performance, which is essential for the proper functioning of any monetary union.

It is all the more important to strengthen the common discipline the system has put on the backburner during the crisis. Those rules are the cement to keep together the eurozone [and let us be honest they have never been properly applied].

As long as it is not sufficiently understood, notably in indebted countries (France, Italy, Spain etc), that excessive debt is a source of under-competitiveness, the economic situation in these countries will continue to deteriorate. Only domestic structural reforms can resolve structural issues and increase productivity and growth. It is an illusion to try to solve the structural problems of our economies by prolonged increases in public or private debt or by using money creation. Yet this is what has been too often tried by pursuing lax fiscal, monetary and political policies that will inevitably pose systemic risks to financial stability and therefore to future growth.

Do the rules of the SGP need to be amended (3% deficit, 60% public debt compared to GDP) or completed (e.g. with a rule regarding the evolution of public expenditure in relation to GDP)?

When the facts are proven, some ratios, notably the 60% public debt/GDP ratio, appear to be problematic. Firstly, they have not been respected in the past and secondly the heterogeneity of Eurozone economies do not fit well with single ratios. The following are some guidelines that could inspire reform:

(a) For countries with debt levels of 100% or more, it is essential to maintain their ratings, which requires that public debt be stabilised. The way to do this is to achieve a primary surplus (without taking into account the interest on the public debt) as a number of European countries such as Italy understood before the crisis.

This is important because the markets are probably guided more by dynamics than by absolute numbers in determining country spreads. The economic literature has shown that non-resident investors are extremely sensitive to the slope of government debt. However, if we accept that monetary policy will not always be there to buy all the new sovereign issues, it will be imperative to reassure the markets by gradual fiscal normalisation policy. From this point of view, the updated rules should include special monitoring of the primary balance by prohibiting primary deficits.

(b) Insist in these future rules on the importance of the quality of public spending, as Mr. Draghi emphasised in his Rimini speech. We have become accustomed to considering a deficit of 3% of GDP to be normal, regardless of the quality of the expenditure. This has led Europe to tolerate deficits that have essentially financed current expenditures that have no capacity to generate future revenues. It is time to focus on public investment spending that creates future revenues and that balances the equation in the medium term. This requires a strong shift from the present situation where public investment is only a tiny part of public expenditures.

The quality of public spending should be an important criterion for assessing fiscal policies. Countries that tend to perpetuate very high ratios of public spending to GDP should be discouraged from doing so, and these Member States should be encouraged to maintain investment spending for the future.

We have to recognize that this shift towards more productive public investment will require very substantial political effort because presently public investment only accounts for some 4% of GDP while current - non productive expenditure - represent almost all public expenditure. So, in order to make room for a significant improvement of public investment, we will have to reduce in parallel the overwhelming share of current expenditures.

In order to achieve the two objectives above, ie primary surplus and shift towards public investment, a set of EU mechanisms will be required. We need to establish, country by country, the appropriate levels of primary surplus and rigorously monitor the progress towards a better quality of public expenditure.

c) Put in place early warning mechanisms to prevent unsustainable public finance trajectories: a country whose share of public expenditure reaches record levels in relation to the European average should be subject to special discipline: it is more serious to have 54% of public expenditure/GDP (before Covid) when the European average is 8 to 10 percentage points lower than to have public debt above 60%.

Of course, all of the above could be completely unimplemented, as was the case with the old rules of the Stability and Growth Pact. The sanctions originally provided for were never implemented. If this drift were to continue, we would end up making the virtuous countries pay for the slippage. This is the definition of a non-cooperative game where most players try to avoid their obligations by shifting the cost to those who observe them.

If this were the case, the logical result would be an inevitable, major, new crisis of the euro zone.

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Q&A

JOÃO LEÃO

Minister of State for Finance,
Portugal

We must spare no efforts until we achieve a sustainable and inclusive recovery

What are the priorities of the Portuguese EU Presidency in the economic and financial area for facing up to the economic crisis?

More than one year has passed since the COVID-19 outbreak, and the pandemic continues to take a toll on our lives and economies. Europe's resilience has truly been put to test. The widespread uncertainty and extreme vulnerability created the need for unified action. The EU did not fall short of its obligations. We have stood strong in our coordinated response to fight against the unbearable social and economic losses of this crisis. Our work is, however, not done yet.

We must spare no efforts until we set the grounds for a sustainable and inclusive recovery. Now, more than ever, we must keep a united front. Coordinating our policies will be of essence. We must keep emergency support measures for as long as necessary.

Once the health situation allows us to alleviate social restrictions, we should pursue timely targeted temporary measures towards the most vulnerable sectors, together with growth-enhancing policies. A key instrument in this common endeavor will be the Recovery and Resilience Facility.

The Portuguese presidency is determined to deliver a timely implementation of the Recovery and Resilience Facility and the swift and smooth approval of as many Recovery and Resilience Plans as possible. These plans represent a unique opportunity for growth-enhancing investments and reforms that will create jobs, while supporting the green and digital transitions. Now is the time to make our efforts reach the real economy. Indeed, the motto of the Portuguese Presidency is: "Time to deliver". We want to deliver a fair, green and digital recovery. This is our top priority, around which we will organize all our efforts.

What are the main implications for the financial sector of growing public indebtedness in some Member States? When should the Stability and Growth Pact be restored and does it need reviewing once the crisis is over?

The financial sector has played a key role in mitigating the economic impact of the pandemic crisis. Banks went from being part of the problem in the previous crisis, to being part of the solution this time around. We intend to keep it this way. The broad-based support measures adopted have indeed intensified the interlinkages between sovereigns, the financial and the corporate sectors. Banks enter this crisis much better prepared than last time around: better capitalized and in a better liquidity position. Now, we face the risk of non-performing loans increasing markedly with the gradual unwinding of support measures.

We believe, however, that with coordinated well-thought policies we can maintain a virtuous cycle between sovereigns, banks and firms. Keeping targeted support for as long as necessary will be crucial to avoid insolvencies, and the activation of the General Escape Clause has been providing us the needed flexibility to do so. On the other hand, the Next Generation EU funds are the cornerstone that will allow us to kick-start our economies without burdening further our public finances, decoupling sovereign's public indebtedness from the capacity to promote growth-enhancing policies.

These vulnerabilities and interdependencies also make the case for the need to strengthen the EU architecture, including the need to rethink our fiscal surveillance framework, to become better prepared for the challenges of tomorrow. We will have to reflect on whether our current framework remains fit for purpose in a post-COVID 19 world. We must take into account member state's high debt levels, after two unimaginably large economic recessions, as well as the lasting low interest rate environment.

We need a transparent Stability and Growth Pact that increases both public awareness and national ownership of the rules. These rules should guarantee sound public finances, while protecting productive investments and pushing for improved quality of expenditure.

What are the priorities of the Portuguese EU Presidency in the area of private risk sharing? What progress can be made on the Banking Union and the Capital Market Union by the end of June?

The current crisis makes the case for a fully-fledged banking union. Its completion should be part of our efforts to ensure a sustainable recovery and to increase the resilience to future shocks. Although the completion of the banking union is anything but straightforward, the Portuguese presidency is working on advancing discussions on the holistic approach, in particular, regarding the European Deposit Insurance Scheme and crisis management.

Simultaneously, advancing the work on a well-functioning and integrated Capital Markets Union is also critical to support the economic recovery and is closely linked to the digitalization of the economy. In this regard, we will strive to advance the discussions on the Digital Finance package which will contribute to boost innovation and competitiveness in the financial sector. We are aiming at making substantial progress on the Commission's regulatory proposals for crypto assets, hopefully to reach an agreement at the Council.

Is ensuring the financial sovereignty/ independence of the EU a relevant objective in the current macro-economic and political context (e.g. Brexit) and if so what does it imply in terms of public policy?

Strengthening the financial sovereignty of the EU is key, even more so, in the current geopolitical landscape. The pandemic crisis has highlighted both the importance of autonomy and the need for a coordinated European approach. To increase EU's sovereignty, we need sound coordinated policies, like the ones taken at the outset of this crisis. The pandemic pushed us to consolidate the European project at an unprecedented speed. We should capitalize on our efforts during this last year and continue the work towards a more integrated and resilient EU.

Another key priority to reinforce our strategic autonomy is to strengthen the international role of the euro, which is closely interlinked with the EU architecture. Indeed, to make our currency even more attractive to investors and boost its global usage, we need to deepen further the European Monetary Union, by making further progress on the Banking Union and the Capital Markets Union. In its turn, a strong euro can add resilience to our financial sector and to the European Monetary Union. The issuance of large amounts of euro-denominated bonds under the Recovery and Resilience Facility will also represent a key milestone for the EU capital markets. Hopefully, the issuance of green bonds under this instrument will reinforce the euro as a reference currency for sustainable financing, while also strengthening the EU's position as a key global player in the fight against climate change.

Q&A

MÁRIO CENTENO

Governor,
Banco de Portugal

Building upon the integration leap we experienced with the crisis

What are the implications of prolonged monetary policy easing in terms of financial stability?

Given the pandemic's abrupt, intense, persistent and asymmetric effects on economic activity it has justified the adoption of massive and timely policy support. These measures redistribute, across agents and over time, the costs of the pandemic. This is easier to implement this time because we have abundant liquidity and no moral hazard concerns. However, risks persist and have even been magnified by the crisis; its asymmetric nature. The policy action should proceed, now more targeted, in order to minimize this impact, allowing for an appropriate adaptation and phasing-out of existing measures.

It is hard to argue that this prolonged period of monetary easing has had a material and perilous effect on any of the dimensions referred.

First, one should notice that these very low nominal rates (short and long) have not corresponded to very low real rates, at least not in historical terms. This, coupled with the estimated natural real rate that has followed a downward path over the last decades, means that the stimulus provided is not has strong as suggested by the historically low nominal rates.
Second, there has been a response to those potential vulnerabilities from targeted macroprudential and microprudential policies, directed at banks and borrowers. Nonetheless, improvements are welcome: the enhancement of cross-country coordination mechanisms, or a focus on other parts of the financial system are dimensions deserving further development.

Third, monetary policy has been carefully designed to avoid undue distortions. For instance, to mitigate the effects of the proximity to the so-called reversal rate, the ECB has implemented a two-tier system for remunerating excess reserves, whereby a multiplier of required reserves is exempt from the negative deposit facility rate. All in all, it is conceivable that adverse side effects will tend to become more manageable, no matter for how long monetary accommodation persists.

A generalized backtracking in monetary policy may be ill-advised. Assessing the precise frictions that are at work, fine tuning the monetary policy instruments in view of those frictions or suggesting a relevant role for other policies seems more adequate. At the time of evaluating the success of our policies, it is perhaps useful to imagine the counterfactual scenario without a strong monetary response, both conventional and unconventional. In this case, the materialization of a disruptive scenario would be ever more likely, making the potential trade-offs we now face quite limited when compared to the welfare losses incurred in such scenario.

When and how should the Stability and Growth Pact rules be reactivated and should they be reviewed?

The crisis impacted severely on public finances. That was both inevitable and desirable. Moving forward, the focus for fiscal policy should be on the composition and the quality of public finances, prioritizing the implementation of growth-enhancing policies. The responsible use of the EU funds, also targeted at promoting investment in technologies, is crucial in this respect.

Over the cycle, active fiscal policy that goes beyond the impact of automatic stabilisers should be limited to bad economic times. This, however, requires achieving fiscal space and creating adequate buffers in good times.

An institutional framework that reliably creates the proper conditions for fiscal policy to operate is of utmost importance.

Although there is wide consensus on the need to simplify the Stability and Growth Pact, attaining a compromise solution on the design of the rules will be challenging, both technically and politically. Ideally, the debate on European fiscal rules should be concluded at the moment the decision to deactivate the general escape clause is adopted. Until then, the fiscal stance should continue to be supportive, taking into account the strength of the recovery and phasing out measures in a way that mitigates the social and productive impacts of the crisis.

Some sort of policy support will be needed as long as economies do not go back to full employment, as it is clear from the policy debate in other economic regions, most notably the US.

How can Europe correct the growing heterogeneity of economic performances among euro area countries? What impact is expected from the "Next Generation EU" package?

Divergences in productivity and GDP per capita are not desirable. The converge process shall remain high on our agenda. Before the pandemic crisis EU countries agreed on the first embryo of an Eurozone budgetary instrument. The so-called Budgetary Instrument for Convergence and Competitiveness (BICC) made already clear that the priority for convergence was adopted, and the crisis made it even more relevant.

The discussions that took place in the Eurogroup on the BICC were crucial for Member-States to better understand and assess the importance of convergence and the best way to support its promotion. They paved the way for the agreement on the Next Generation EU (NGEU), which over the next six years will leverage the digital and climate transitions and increase potential GDP growth rates across member countries. The size of the NGEU is not of an embryo anymore. Furthermore, the NGEU also represents an historical agreement on joint debt instruments. It is the response to the challenge outlined in the EG agreement exactly one year ago. This step forward should be stressed. It is an integration leap of major importance. Going forward, it is crucial that solidarity remains, and that domestic and EU level policies do not hurt the level playing field that characterizes the single market and its ability to promote growth. It is imperative that EU citizens benefit from the positive loop between growth and integration, also with a view of keeping public debt ratios on a sustainable path. Going back to the old days of mistrust and extreme moral hazard debates is something that we need to avoid at all costs.

Are further measures needed for enhancing the contribution of the EU banking industry to economic recovery in Europe? What role do the profitability and the competitiveness of the EU banking sector play in this regard and how may they be improved?

A bulk of measures adopted to mitigate the economic and financial impacts of the crisis were based on banks financing households and non-financial corporations. Measures ranged from prudential and macroprudential to fiscal and monetary. Different in nature but aligned in their objectives. Many are still in place and their phasing out should be carefully assessed. As we move to a phase in which a more targeted and state-dependent approach is needed, notably on the fiscal side to support viable, if financially stressed, firms, regulators and supervisors need to continue monitoring the risks to financial stability closely and take further actions if needed.

Banks profitability also plays an important role. The challenges that were already noticeable became more evident with the crisis. In addition to the increased competition in financial intermediation from new players, often using new technologies, the low interest rate context is challenging for banks. It is of utmost importance that banks continue the restructuring process that started in the aftermath of the previous crisis to become more efficient. Even if, in the short term, this may have a negative impact on profitability, banks need to continue investing more on the use of new technologies to decrease costs and assess (new) market opportunities.

Consolidation of the banking sector should also play a role. It delivers cost savings through economies of scale, in particular in less concentrated banking markets, and revenue synergies. However, the risks underlying the emergence of "too big to fail" or "too-complex-to resolve" institutions should not be disregarded. Also, it is necessary to distinguish domestic from cross-border consolidation in what concerns potential effectiveness in dealing with the overcapacity of the banking sector in member states and the impact in an incomplete Banking Union. The completeness of the Banking Union is a key condition to achieve a more sustainable process of cross-border bank consolidation in Europe.

What have been the impacts of the Covid crisis on the EU banking sector and in terms of financial stability? What are the prospects of the Banking Union in this context?

The COVID-19 crisis has led to an unprecedented, coordinated policy action in Europe. The various action taken were timely, coordinated and forceful, including in financial regulation and supervision. I do not think that the COVID crisis has further fragmented the Banking Union. It has made more evident the need to progress towards a complete Banking Union.

The EU banking sector is now in a more favourable situation than before the previous crisis, notably in terms of the quantity and quality of capital held. This represents a significant improvement in banks' capacity to absorb the potential losses of this crisis. But, as I have mentioned, the financial stability risks underlying the current crisis have not disappeared yet. The measures adopted were key to mitigate the liquidity shortages of households and firms and indirectly limited the impact on the banking sector. However, the risks of a less pronounced recovery may lead to more acute solvency issues. These need to be addressed in the non-financial sector, to avoid a significant increase of losses in the financial sector.

As financial stability risks underlying the current institutional framework persist, both in the euro area and in Member States, it is key to move forward with the Banking Union. Procrastination is not a possibility. The Banking Union must be completed in the next couple of years.

Q&A

VALDIS DOMBROVSKIS

Executive Vice-President,
EU Commissioner for Trade,
An Economy that Works for People,
European Commssion

Building a better future for Europe: using the recovery to adapt our economies for new challenges

To what extent will the EU's new €750 billion recovery fund contribute to addressing the economic priorities resulting from the pandemic and the impacts of the Covid-19 crisis on the Monetary Union?

Socio-economic integration and convergence lie at the heart of the European Monetary Union. While the pandemic continues to affect all EU countries, some economies have been hit much harder than others.

These national differences are largely caused by the severity of the pandemic, stringency of containment measures and the relative importance of sectors more affected by the restrictions, such as contact-intensive services.

In addition, due to their own structural challenges, some EU countries are comparatively less resilient to shocks. All this means that the Covid-19 crisis threatens the progress made in reducing economic divergences.

At the same time, economic and financial spill-overs tend to spread quickly through the single market and EMU. So taking a common EU approach to tackling the pandemic's economic impact is in the interests of individual countries and the EU as a whole.

The NextGenerationEU instrument will not only help to repair the immediate damage from the pandemic and support the recovery, but also allow EU countries to address their long-standing structural challenges and prepare better for future challenges.

Countries which were in a weaker starting position and whose economies were hardest hit by the pandemic receive a proportionally larger share of EU funding. This will help to promote economic and social integration and reduce the risk of more divergences.

Reaching agreement on NextGenerationEU demonstrated a high degree of commitment to European solidarity. It has also strengthened trust in the future of monetary union.

Its centrepiece instrument, the Recovery and Resilience Facility, will provide €672.5 billion to support investments and reforms in Member States. National recovery plans must be well prepared and ambitious, meeting the green and digital mainstreaming targets and be in line with country-specific recommendations of the European Semester.

This will ensure that they facilitate the transition to a greener and more digital European economy, stimulate long-term economic growth and help to boost the sustainability of public debt.

What are the major threats to the effectiveness of this EU Recovery package? How may they be overcome?

Now that the Recovery and Resilience Facility has become law, its funding must flow as soon as possible to support a strong and lasting recovery.

However, to access the funds, Member States must first submit high-quality reform and investment plans to the Commission for assessment and approval.

The Commission is in intensive contact with all Member States to give guidance for this, using the country-specific challenges in the European Semester as a strategic compass.

Growth-enhancing reforms are essential for complementing the major efforts being made to stimulate investment. That includes reforming a country's business environment, public procurement rules or public administration as a means to reducing obstacles to investment flows.

The Commission will take all this into account when assessing each plan.

The regulation establishing the Recovery and Resilience Facility contains many safeguards to make sure that the money is well spent on projects that provide genuine added value and can drive potential growth up for years to come.

It will also be important to invest in sectors that can generate quality jobs. Workers also need to acquire the right skills to navigate the green and digital transitions. We should not allow the lack of a skilled workforce to hold up growth.

Before the RRF funding can flow, the Commission needs to be legally empowered to borrow on the markets, and this means that all Member States must first ratify the decision on own resources.

It is only then that the RRF funds, including the 13% pre-financing, can be disbursed to help people and businesses overcome the economic consequences of the pandemic.

When the COVID-19 crisis is over and the recovery starts, what should be the EU's economic and financial priorities?

The EU has taken unprecedented measures to protect people's jobs and to support companies. This was our short-term response to mitigate the worst effects of the pandemic. And it has been successful.

The fiscal measures cushioned the impact on GDP by around 4.5% in 2020.

Both this year and next, we will need to continue to provide support to the economy.

The support measures must remain temporary and targeted. This will allow them to be withdrawn gradually when the time is right, helping a return to more prudent fiscal positions in the medium term.

Once health risks reduce and we move into a post-crisis phase, Member States will be able to move from short-term emergency support into measures promoting a resilient and sustainable recovery.

We should make most of this situation to adapt EU economies to face new challenges and create new areas of potential growth - like green and digital.

This means investing in people and skills, particularly for working in the green and digital economy, and helping businesses – particularly smaller ones - to stay competitive in this new environment.

We need to choose our measures well and improve the quality of public finances, prioritising investment. This is where the RRF will help a great deal.

Member States should make good use of the substantial economic impulse that will come from the RRF, without causing higher deficits and debt.

Lastly, Europe's financial sector also has a role to play in the recovery phase, including by contributing to the twin green and digital transitions. While it has shown its resilience throughout the crisis, there is room to make it more resistant to future shocks.

We particularly need to make good on completing the Capital Markets Union and Banking Union. Our revamped CMU action plan from last autumn will help to make our economic and financial system more resilient and efficient.

It will help companies to stay solvent by giving them a more stable and diversified funding structure. It will also help to finance the twin transitions and contribute to a more inclusive society.

How and when may the Stability and Growth Pact rules be reactivated? Do they need reforming?

In March 2020, the EU decided to activate the General Escape Clause (GEC) in the Stability and Growth Pact for the first time. EU governments needed to be able to do what was necessary to deal with the immediate, severe socio-economic of the pandemic.

Activating the GEC permitted the EU to carry out a timely, forceful and coordinated response to a fast-evolving crisis. It allowed EU countries to depart - temporarily - from the normal requirements of EU fiscal rules at a time of major economic downturn.

At the same time, the priority throughout this period has been not to endanger medium-term fiscal sustainability.

It will clearly take some time for our economy to return to normality. In the meantime, the decision on whether or not to maintain activation of the general escape clause will depend on the overall state of the EU and euro area economy and will be based on quantitative criteria - in particular, economic output reaching its pre-crisis level.

Our current economic forecast points to the GEC remaining active in 2022 and no longer in 2023. A final decision will be taken in spring.

Once the recovery takes hold, the debate on the reviewing the economic governance framework will be relaunched. We need to build consensus, because a fiscal framework can only be effective if there is strong political commitment to adhere to it.

One significant area to examine is how best to make sure that it brings about sustainable fiscal positions in all Member States. We need a credible debt anchor that is adhered to, especially during better economic times in the future.

Second, the framework has become too complex. One way to simplify it would be to move away from indicators that are not directly observable, such as the output gaps and structural balances.

Regardless of whether we still have the current or new rules by the time the GEC is deactivated, we will continue to take country-specific situations into account. The Stability and Growth Pact provides the necessary flexibility to do this.

Q&A

MAIREAD MCGUINNESS

Commissioner for Financial services,
Financial Stability and Capital Markets Union,
European Commission

Strengthening the European financial system after Brexit and the Covid crisis

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

The EU financial sector has shown its resilience during the pandemic. Banks and other institutions started the crisis with strong capital positions and liquidity. Markets and infrastructures proved robust and efficient. It's thanks to the great efforts by industry, regulators and supervisors over the past decade, learning the lessons of the global financial crisis. This strength has been vital. Lending and other forms of finance grew considerably throughout the crisis, helping the economy to bridge liquidity needs.

The Commission has supported these efforts, maximising banks' capacity to lend and absorb losses with its Banking Package and making it easier for capital markets to help businesses recover with the Capital Markets Recovery Package. We want to maintain the strength of our financial system so that it can finance the recovery.

Against this background, we must make sure that our financial industry:

- *Remains stable.* While navigating the gradual reduction in public support, banks should continue to measure risks in an accurate, transparent manner. Banks must also be able to address the likely rise in non-performing loans and keep space on their balance sheets to finance new projects. We will swiftly implement December's Action Plan on non-performing loans.
- *Develops market-based channels to complement bank finance.* Capital markets will be key for the re-equitisation of companies, so we will need to implement our Capital Markets Union (CMU) Action Plan of September 2020 effectively.
- *Accelerates its support for the transition towards a low-carbon, circular and sustainable economy, while preserving its stability.*
- *Embraces the digital revolution to guarantee the sustainability of business models in a post-pandemic world where customer behaviour has changed.*

Has the Covid crisis further fragmented the Banking Union? Which measures are needed to address banking overcapacity challenges and reduce the fragmentation within the Banking Union?

Activating flexibility in fiscal and state aid rules allowed Member States to provide a decisive, coordinated response to the COVID crisis. Fiscal support in 2020 is estimated at 8% of GDP in the euro area, in addition to liquidity schemes of about 19% of GDP. And the flexibility provided by supervisors and regulators to banks has helped them channel funds to affected households and businesses. However, the heterogeneity of national support measures may have unevenly shielded the banking sector from eventual losses.

This situation, combined with varying exposure to sectors most affected by the crisis, might lead to increased market fragmentation if left unaddressed. The quick implementation of the NextGeneration EU recovery plan will be important to reinforce cohesion.

This year will be important as we move towards completing the Banking Union. In December 2020, the Euro Summit invited the Eurogroup to prepare a stepwise and time-bound work plan on all outstanding elements needed to complete the Banking Union, which includes market integration. In parallel, the ongoing work on revising the crisis management and

deposit insurance (CMDI) framework and creating a stronger financial safety net (European common deposit insurance) will result in a first package of measures later this year.

Our framework could be improved to cater for the failure of smaller and medium-sized banks. In practice we've seen that these banks may be more prone to failure than large, diversified banks. The review of the CMDI framework will aim to ensure that the failure of any bank (irrespective of size or business model) can be managed without recourse to taxpayer money and while fostering financial stability, a level playing field and depositor confidence.

This review, and progress in setting up a European Deposit Insurance Scheme, should be a precursor to completing the Banking Union in the longer term and unlock further reforms, including on reducing market fragmentation. Importantly, measures touching on the home-host balance need to be accompanied by credible, enforceable safeguards for host Member States to ensure the right balance between integration and financial stability.

What is the state of progress of the CMU initiative and what results have been achieved so far? What are the key next steps and priorities?

Since its inception in 2015, the CMU has delivered results on several fronts. For example, it has simplified access to capital market finance for companies with measures such as the new Prospectus rules and targeted legislation to facilitate SME access to public markets with the SME Listing Act. We also strengthened the supervisory framework, including with the European Supervisory Authorities review.

Our new CMU Action Plan from September 2020 builds on earlier work and aims to make progress in all areas where barriers to the free movement of capital still exist. It raises the ambition in areas like long-term investments, the quality of investment advice and rules for listing on public markets. It also expands into new fields such as company data, company law and financial literacy.

In the short-term, we will table a legislative proposal for a European Single Access Point this year to provide investors with seamless access to company data. We will review the framework of European long-term investment funds to encourage more sustainability-related and digital investments, as well as investment in infrastructure. We will revise the prudential treatment of insurers to foster the re-equitisation of businesses. And in the context of our Markets in Financial Instruments Regulation (MiFIR) review, we will deliver on trade transparency and consolidation of data to further integrate our capital markets.

Also this year we will report on supervisory convergence within the EU and the functioning of our Single rulebook for Capital Markets. And we will continue to work on financial education. Structural measures, such as non-bank insolvency procedures and cross-border taxation procedures, require more preparation but we remain determined to act on them.

To succeed, the CMU requires strong cooperation from all stakeholders including EU institutions and market participants. We need to tackle structural barriers to the free movement of capital embedded in national legal systems or behaviour patterns across Member States.

Do the post-Covid situation and Brexit developments create any new challenges in this respect?

The COVID crisis has shown that deep and efficient capital markets are more necessary than ever. Given possible difficulties banks may face in providing credit and rising corporate debt levels, firms need to tap into equity and other capital market instruments.

Post-Brexit, we will continue to strengthen the efficiency and robustness of the EU's financial system by advancing the Banking Union and the CMU, deepening the integration of the Economic and Monetary Union.

At the same time, we're continuing to monitor the significant level of interconnectedness between the EU and the UK to ensure we avoid any level of dependency that would undermine the stability of the EU's financial system.

Is ensuring the financial autonomy of the EU a relevant objective in the current macro-economic and political context (e.g. Brexit) and if so what does it imply in terms of public policy?

Recent global trends point to an increasingly multipolar geopolitical context and a departure from multilateralism.

The withdrawal of the UK from the EU was a fragmenting event that has highlighted some of the vulnerabilities of EU capital markets, such as dependence on UK market infrastructures.

Against this backdrop, the EU remains open to the rest of the world and continues to advocate for multilateralism and rules-based global economic governance. The EU financial system is globally interconnected via credit and financial markets, as well as payment systems. We want to continue enjoying the benefits of openness. But we cannot be naïve. We are determined to develop a stronger, more resilient EU economic and financial system commensurate with the size of the European economy.

This is in essence the concept of 'open strategic autonomy' that the Commission presented in its January communication, "The European economic and financial system: fostering openness, strength and resilience".

First, we will work towards strengthening the Economic and Monetary Union, building on the Banking Union and the CMU. This will increase the resilience of our financial system by diversifying funding sources for EU businesses, including for innovative and sustainable investment projects. This will also help bolster confidence in the euro and contribute to reducing stability risk at international level, thanks to greater currency diversification.

Second, we need to make EU financial market infrastructures more resilient to ensure uninterrupted provisions of critical financial services in the EU. For instance, in the area of derivatives clearing, we will identify impediments and incentives to scale back EU market participants' exposures to UK central counterparties (CCPs).

Lastly, we will protect EU operators by acting against the unlawful extra-territorial application of sanctions by third countries, while also ensuring more effective implementation of the EU's sanctions regime.

Q&A

ELISA FERREIRA

Commissioner for Cohesion and Reforms, European Commission

Reforms and investment needs for the European recovery

Why has the Eurozone been impacted more in terms of lost economic growth by the pandemic in 2020 (-7.2%) than the United States (-3.4%), Japan (-5.1%) or China (+2.3%) and why are the future growth prospects for 2021 lower as well?

Several factors help explain these differences. Due to its nature, the Covid-19 crisis has disproportionately hit economies reliant on physical contact such as industry, transport, culture and hospitality. Some countries also had the misfortune of being exposed to the virus earlier and more severely than others, which resulted in stricter containment measures and further economic disruptions (e.g. Spain and Italy had an above-average GDP contraction of 11 and 8.8% respectively in 2020[1]). So there are significant differences between regions and countries to consider.

Three additional elements may explain the lower economic performance of the euro area as a whole compared with the United States (US). First, the greater openness of the European economy[2] acted as a drag when cross-border trade and global supply chains were disrupted. Second, given its older population structure[3] and higher population density[4], Europe was more vulnerable. Finally, Member States immediate stimulus responses were different in magnitude and speed.

By putting in place an unprecedented recovery package called NextGenerationEU (NGEU), the European Union (EU) responded decisively. In particular, the new Recovery and Resilience Facility (RRF) will take into account the different economic impact of the pandemic in Member States and contribute that we emerge stronger and more resilient from the crisis.

The EU recovery plan may be rolled out less rapidly than the US stimulus checks, but is calibrated to support long-term growth and address the challenges posed by the green and digital transitions.

Moreover, one should not overlook the role of national automatic stabilisers (enabled by the triggering of the SGP escape clause) and other important measures taken at European level to support employment and cushion the social impact of the crisis, such as the emergency aid by the Structural Funds, the SURE initiative, the temporary framework for state aid rules and the Pandemic Emergency Purchase Programme of the ECB.

What are the main structural impediments which hinder productive investment in Europe? What are the most urgent reforms to be carried out in the EU for fostering productive investment and sustainable growth?

The EU's ambition is to accelerate the recovery through growth-enhancing reforms together with future oriented and environmentally sustainable investments. The joint and coordinated impact of the multiannual budget (2021-27) with the NextGenerationEU, notably the RRF is a unique opportunity to trigger it. The new Technical Support Instrument (TSI) will complement the RRF, offering Member States expertise to design and implement reforms.

Reform needs are specific to each Member State and are detailed in the country-specific recommendations emanating from the European Semester. Three horizontal reforms are very dear to me: innovation; public administration, including digitalisation; and economic, social and territorial convergence. Building an economy fit for the next generation requires change, capacity to look ahead and adapt. The EU needs to invest in people to boost innovation and creation of value. Investments and reforms must encourage research and innovation. In order to benefit from cutting-edge technologies, we need to stimulate interactions between the business and research worlds fostering knowledge transfer. European capital markets

are needed to make sure that the most innovative companies have access to capital to grow and compete on a global scale.

Efficient public administration is a key enabler for innovation, quality investment and growth enhancing reforms. Public administration may become a hindrance to growth if it doesn't keep up with organisational developments. Efficiency of public administration, namely through digitalisation and simplification of procedures is thus vital for competitiveness.

Finally, the economic recovery must reduce imbalances within the EU and within Member States. The RRF will have an important role to play in combination with the new cohesion policy. Reforms and investment must take into account regional and local specificities to facilitate convergence, without which, economic, social and political fractures will be inevitable.

How will the EU's new €750 bn recovery fund contribute to addressing the post-Covid economic recovery of the EU and Eurozone?

National allocations under NGEU's largest instrument, the RRF, should contribute to make European economies and societies more resilient and better prepared for the challenges of the green and digital transitions. In addition, the Recovery Assistance for Cohesion and the Territories of Europe (REACT-EU) extends the crisis repair measures delivered through the Coronavirus Response Investment Initiatives (CRII and CRII+) until 2023.

Thanks to its redistributive effects, these funds will contribute to a less divergent recovery of the euro area economies, and act (temporarily) as an anti-cyclical instrument, badly needed when, in a Monetary Union, national automatic stabilisers are structurally constrained. Long term bonds issued by the Commission to finance the NGEU will create a truly pan-European safe asset, contribute to financial stability and increase the recognition of the euro as an international currency. Importantly, the EU will become the world's biggest issuer of Environmental, Social and Governance (ESG) bonds and the benchmark for such instruments globally.

What are the major threats to the effectiveness of the Next Generation EU (NGEU) package? How to overcome potential "blockages" and ensure that the funds are well spent and go hand in hand with effective reforms?

There are two critical steps for the implementation of the NGEU package, the first of which is the ratification by all Member States of the Own Resources Decision, which will allow the Commission to borrow funds on the capital markets. Then, to be able to access the RRF, Member States need to prepare Recovery and Resilience Plans (RRPs) that have to be approved by Commission and Council.

Disbursements from the RRF will be based on the achievement of pre-defined and agreed milestones or targets. The capacity by Member States in identifying the right reforms and investments, but also the operative means for their implementation, both public and private, is therefore paramount for ensuring the good use of the funds. Reforms, in particular, must address structural bottlenecks to development.

A key success factor will be countries' broad ownership of these plans. Despite the urgency, Member States must engage with national stakeholders to bring out the best reform ideas and investment projects. This dialogue will also improve the quality of the implementation process.

Some countries of the EU have been unable to spend efficiently European structural funds over the period 2014-2020. Will the national plans presented in the context of the NGEU recovery instrument make better use of European funds this time round? Do all Member States have sufficiently effective administrative capabilities to manage the mass of projects needed to absorb these funds?

The unprecedented amounts of funds available under the NGEU and the new 2021-27 EU budget will be challenging also in terms of absorption capacity. The Commission is well aware of persisting issues in implementation and continues its efforts to address them. A significant effort of simplification was made in the legislation for the new EU cohesion policy for the 2021-2027. However, similar efforts are necessary from the Member States themselves as national "gold plating" is frequent.

As referred above, the quality of public administration is a critical factor not only for the absorption of funds but, more generally, for the success of all public policies. The TSI through which Member States can request technical support from the Commission to devise and implement policies, including to upgrade their public administration can play an important role. Having the possibility to finance the reform of public administration is, in itself, a major occasion to improve general efficiency including better management of the funds.

Above all, the need for a sustained and fast recovery will be the best stimulus to a good use of this unique historical opportunity.

1. Commission's Winter 2021 forecast
2. Trade openness of 26% of GDP in the U.S. vs. 88% for the euro area according to World Bank data.
3. 21% of inhabitants over 65 in the euro area vs. only 16% in the U.S. according to the Commission's AMECO database.
4. 36 people per sq. km of land area in the U.S. vs. 127 in the euro area according to World Bank data.

Q&A

ASHLEY ALDER

Chair, Board of the International Organization of Securities Commissions (IOSCO) & Chief Executive Officer, Securities and Futures Commission, Hong Kong

Key issues for global regulators post-Covid

Are there increasing signs of financial fragmentation at the global level? Which activities are most affected and what is the appropriate way forward for addressing this situation?

In recent years, a key focus for international policymakers and standard setters was on harmful market fragmentation as an unintended consequence of regulatory changes following the global financial crisis, potentially undermining the effectiveness of the G20 reforms. IOSCO and the Financial Stability Board (FSB) promoted greater global consistency in the implementation of reforms, for example by establishing international standards for prudential requirements and setting out governance arrangements and technical guidance for over-the-counter derivatives clearing and trade reporting. However, local variations became all too apparent, and fragmentation also affected cross-border resolution regimes.

COVID-19 was an example of how a market crisis could be triggered by unanticipated events outside the financial sector, but where close communication and coordination at the international level helped to support synchronised policy responses. The initial outbreak put global markets under considerable strain, leading to a flight to safety followed by a severe liquidity crunch in core funding markets. The pandemic's spread and the containment measures to combat it created the conditions for increased fragmentation risk in the Eurozone and elsewhere.

However, central banks and other financial policymakers took very swift, coordinated and effective action to provide liquidity and other support across markets and to the real economy. Securities regulators were quick to acknowledge the risks and allowed a measure of regulatory flexibility to ensure that markets continued to function in an open and orderly manner. The overall level of cooperation was in fact of a high order, although there were inevitable differences; short-selling bans and dividend restrictions are cases in point.

Brexit has been another extraneous event which has important implications for the European Union's (EU) financial system as well as for global capital markets. For example, the UK's departure from the EU has led to fragmentation concerns in both trading and clearing activity. Changes to the rules for passporting rights for UK-based activities as well as delegation rules could also affect funds managed from Asia.

IOSCO has carried out a significant amount of work on cross-border regulation, including its 2015 Report on Cross-Border Regulation and 2019 Report on Market Fragmentation and Cross-Border Regulation. Last year, IOSCO published another report which identified good practices for establishing and operating deference, recognition or equivalence processes which are outcomes-based, risk-sensitive, transparent, sufficiently flexible and backed by strong cooperation. Fragmentation in the securities and derivatives markets remains one of IOSCO's top priorities, with its current two-year work plan focusing on ways to strengthen regulatory cooperation to support deference mechanisms and assist regulators in addressing areas where harmful market fragmentation may be taking place.

In the increasing incorporation of ESG criteria in financial decisions calling for more standardization in this area at the global level? What are the priority areas concerning reporting in particular?

Governments worldwide have committed to achieving net-zero emissions targets and recent surveys show that more investors are incorporating ESG issues into their investment and capital allocation decisions. Companies with strong ESG practices have outperformed during the pandemic, prompting a growing number of businesses to recognise the value of ESG and sustainability disclosures for investors as well as for a wider community of stakeholders.

A top priority for global regulators is to agree on a set of standardised sustainability reporting standards. The recommendations made by the FSB's Task Force on Climate-related Financial Disclosures (TCFD) are a good start, but it is crucial that they are adopted and further developed globally. This will help firms embed a broadly accepted framework for reporting on climate-related financial risks into their governance and risk management processes as well as their communications with stakeholders. The UK, Switzerland, New Zealand and Hong Kong have all pledged to align their disclosure requirements with the TCFD recommendations.

In Europe, major steps have already been taken to accelerate the implementation of non-financial reporting frameworks, such as requiring large firms to publish regular reports on the social and environmental impact of their activities. Whilst we are moving towards more consistent, comparable and reliable sustainability reporting, difficult issues such as differing standards and the availability of reliable data and agreed industry-specific metrics will remain, as will the risk of greenwashing and inconsistent ESG ratings. IOSCO working groups are very actively tackling all of these areas.

The important proposal by the International Financial Reporting Standards Foundation (IFRS) to establish a new global sustainability standard-setting board (ISSB)—similar to the International Accounting Standards Board (IASB)—is a very positive step. IOSCO strongly supports the IFRS proposal to create a comprehensive and harmonised reporting framework, starting with climate. IOSCO played a pivotal role in the establishment of the IASB around 20 years ago and will play a similar role in relation to sustainability reporting under a new ISSB. IOSCO will be closely involved in the design and ongoing supervision of a suitable governance framework and, ultimately, will create a mechanism to endorse ISSB sustainability standards for use globally, as it did with the IASB. This will require building more specific disclosure standards around the core TCFD elements, which are mainly to do with governance, risk management and strategic decision-making. An alliance of private sector standard setters has published a joint "prototype" standard for climate reporting which, together with the TCFD recommendations, should give the ISSB proposal a running start.

In the meantime, the EU and China are working on a Common Ground Taxonomy which can provide a common cross-border standard for identifying environmentally sustainable activities. Taxonomies are vital to the sustainable finance effort as they enable capital to be allocated to the right places to support the transition to a greener economy. In the long run, this could provide more transparency for investors and firms, reduce transaction costs and, ultimately, facilitate greater green capital flows across border.

What are the main vulnerabilities exposed by the COVID crisis in the fund sector and more broadly in NBFI (Non Bank Financial Intermediation) activities? What are the underlying issues and are further measures needed to mitigate such risks?

The COVID-19 crisis demonstrated the deep and complex interconnectedness between the capital markets and the wider financial system as well as potential structural and regulatory vulnerabilities in the activities of non-bank financial institutions (NBFIs).

The unprecedented demand for liquidity in March and April 2020 amidst the "dash for cash" created considerable strains across core funding markets, and especially in short-term markets, which placed investment funds in the spotlight. There was a major deterioration in funds' liquidity profiles and increases in redemption pressures, particularly those open-ended funds invested in riskier and less liquid corporate credit. Mismatches between the liquidity of funds' underlying assets and redemption requests can expose funds to vulnerabilities. A particular area of stress was experienced in money market funds exposed to short-term commercial paper. In addition, leverage in some investment funds, especially hedge funds, may make them more sensitive to sharp swings in asset prices. Funds may be forced to sell assets to obtain liquidity and deleverage during periods of market stress.

The funds sector and the broader financial system nevertheless proved to be resilient. However, issues in NBFI have now been brought to the fore amidst questions as to whether unprecedented central bank interventions were as much about vulnerabilities in underlying core funding markets as they were about structural vulnerabilities in NBFI. One question is how the higher capital requirements introduced as part of the reforms following the global financial crisis may have led to structural changes in the financial system and contributed to the rapid growth of NBFIs and associated vulnerabilities amidst compressed risk premiums after years of low interest rates, quantitative easing and "reach for yield" behaviour.

Authorities should proceed with caution when considering policy options to address lessons learned from the stresses of last year. One key consideration is how to ensure that NBFI activities are sufficiently resilient, but to do so in a way which does not stifle investment flows and hence their contributions to the real economy, especially during times of stress.

Financial stability risks arising from NBFIs is one of IOSCO's key priorities in its current work plan. We are working with the FSB on a number of policy areas, including the resilience of money market funds, liquidity risk management for open-ended funds, leverage in investment funds and the provision of liquidity in corporate bond markets.

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POST-COVID CHALLENGES AND PRIORITIES

ISSUES AT STAKE

One year into the Covid-19 pandemic, high uncertainty surrounds the global economic outlook. The decline in activity due to the COVID crisis is much greater in Europe than in other regions (US, Asia). The COVID crisis is also amplifying the heterogeneity of economic performance across Member States.

In July 2021, the European Council reached an historic fiscal 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.

Many issues however hinder productive investment in Europe: fragmented financial markets, savers' preference for risk-free investments, very high levels of public or corporate debt, lasting zero interest rates, regulatory environment...Structural reforms are needed for tackling these issues and also mitigating the risk of further economic divergence across Member States.

POST-COVID ECONOMIC AND FINANCIAL PRIORITIES

KLAUS REGLING

Managing Director,
European Stability Mechanism (ESM)

Post-pandemic fiscal priorities for the euro area

The Coronavirus pandemic came as an unprecedented common external shock, it has been the most severe and widespread economic contraction of our lifetime. Countries have spent huge amounts on healthcare, and on containing the economic consequences of the pandemic.

To support countries' efforts and avoid growing divergences between Member States, the EU rolled out a huge package to support workers, businesses and countries. As part of this, the ESM offers all euro area countries a precautionary credit line to cover direct and indirect healthcare costs related to the pandemic. Additionally, the extraordinary €750 billion 'Next Generation EU' recovery fund was designed to mitigate the impact of the pandemic on economic growth and to provide further financial assistance to the most affected countries.

Without these public sector measures, the recession would surely have been deeper and there would be a greater risk of divergences between countries within the euro area. When the EU makes this comprehensive public funding available, we need to ensure its efficient use. All the more so, as the fiscal situation will remain challenging for many countries in the medium term amid uncertain future economic developments.

I see four additional risks for future growth:

First, the potential growth rate is likely to be lower than before the crisis unless the recovery fund is highly successful.

Second, companies may survive in the short term by taking out loans, but high debt loads may impair their future ability to invest. An increase in insolvencies seems unavoidable.

Third, banks, although safer than in the past financial crisis, are still struggling with persistent low profitability and may see an increase in non-performing loans due to the pandemic. So, although encouraged to continue to support the economy, they may not have the capacity to continue providing sufficient credit for investment going forward.

And finally, higher public deficits and debt are a necessary response to the crisis, but it will not be easy to reduce fiscal deficits over the next few years to sustainable levels. Given these challenges, government measures need to be targeted, cost-effective and focus on longer-term growth. Next Generation EU rightly fosters competitiveness and investments while supporting the greening and digitalisation of the economy to create a stronger, more innovative and sustainable EU.

Furthermore, EU fiscal rules are rightly suspended until next year to accommodate the large increase in government spending and the decrease in revenues. Let me stress that the Stability and Growth Pact has worked better than widely believed. Just before the pandemic, the euro area was doing significantly better in fiscal terms than the rest of the world, providing more budgetary leeway when the crisis broke. However, the pact needs to be reformed to make it less complex and to improve its implementation.

> ...the agenda for deepening the Economic and Monetary Union remains even more valid than before the crisis...

Nowadays, the capacity of governments to service debt is higher than the levels envisaged in the EU Treaty, although by how much is a matter for debate. Like many others, I would argue that we have to rely more on observable variables. It would be useful to have an expansion path for expenditures, for example, to prevent public expenditures from growing faster than trend growth. I would also argue that the overall 60% debt limit could be reconsidered while the annual 3% deficit limit remains relevant.

The discussion has been overshadowed by the ongoing pandemic crisis, but we must take the opportunity to think ahead, about how our fiscal rules can help governments, parliaments and markets understand how fiscal policies will evolve in future.

As a final point, the agenda for deepening the Economic and Monetary Union (EMU) remains even more valid than before the crisis: completing banking union, creating a capital markets union, setting up a fiscal capacity for macroeconomic stabilisation and implementing the ESM reform. All this serves the longer-term objectives of creating a safer, more robust euro area and of promoting the international role of the euro.

ANDREJ SIRCELJ

Minister of Finance, Slovenia

Post Covid-19 Recovery Plan for Europe

The EU should continue with the coordinated political reaction, enhancing the EU added value.

In the current times, we are rethinking our health systems and business and economic practices. Achieving a successful recovery will require harnessing all the potential of the green and digital transitions.

The COVID-19 pandemic has led to a need for emergency liquidity in large parts of the economy to cope with the economic consequences. Many insolvencies, bankruptcies, and redundancy of workers were prevented by the support measures. But eventually, we will have to switch to the recovery measures. This means that some companies might also exit the market. However, we need to create conditions for new entries and provide viable companies with an access to R&D stimulations, upgrading employee skills, and flexible working schemes.

The historic agreement on the EU fiscal stimulus is a starting point for the recovery. Hence, efficient implementing of the investments and reforms envisaged in the recovery plans is the top priority. A successful recovery will provide the best basis for discussions on the fiscal stance. Designing the appropriate path to the recovery and sustainability is parallel to the top priority. An agreement on dynamics is required. With smart investments, we need to design a path to a sustainable recovery, look beyond 2022, and not repeat the mistakes from the previous crisis. But the recovery cannot happen overnight. After 2022, we should focus on simple but politically sensible solutions.

As restoring debt to pre-crisis levels is essential in the short term, it requires a better market ecosystem for issuing new equity. Government support packages and monetary policy and regulatory flexibility have in many ways ensured that short-term finance is available to businesses, but further steps are needed. Guaranteed loans have covered emergency liquidity needs for companies, but solutions to restore solvency must also be provided. Yet, in such a demanding COVID-19 environment of elevated public debt, it is paramount for sovereigns to improve the risk metrics and the debt structures. In this context, in the environment of strong demand for duration and given elevated funding needs, the long-term funding is the logical choice.

To make our economies more efficient, competitive, and sustainable, the access to funding, especially non-banking, must become easier. Our aim should be to improve Europe's capital market effectiveness and increase its resilience while keeping it competitive and attractive to market participants. The importance of a rapid recovery should not neglect the importance of an adequate risk management, systemic stability, and resilience while ensuring better protection for customers and investors.

Hence, one of the priorities is the revision of the Basel III standards in the EU banking legislation, which will provide improved rules to further reduce banks' exposure to risks: credit, operational, market, and other risks. It is important that banks maintain their capital adequacy for the real economy, especially for SMEs. Securitization of loans would allow the banking sector to free up bank capital for further lending, allowing a wider range of investors to finance the economic recovery.

The EU should continue with the coordinated political reaction, enhancing the EU added value.

The revision of Solvency II framework is among the most important steps toward the completion of the Capital Markets Union. Improvements to prudential rules are necessary to provide further implementation of a risk-based prudential regime. Therefore, we need to complete the Banking Union and the Capital Markets Union. Compromises will be necessary to achieve these goals, but if we take a constructive approach, we will be able to fulfil the vision and move on to even more ambitious goals to achieve higher levels of prosperity, innovation, and environmental sustainability.

We are entering a new reality of rising inflation, low interest rates, high debt, and different forms of economies facing large investment needs to further improve our health systems and to pursue our goal to prepare Europe for the green and digital transitions. Thus, the EU should continue to work together – a prosperous future lies in the strength of unity, and this is an opportunity that we must not miss.

WERNER HOYER

President, European Investment Bank (EIB)

Recovery and cohesion through green and digital transformation

Europe needs to wake up to the potential for digital technologies to achieve sustainable growth. The digital revolution has already transformed industries, production processes and ways of living and working, but many of these shifts are only just beginning. Most European firms surveyed by the European Investment Bank (EIB) think that the COVID-19 pandemic will accelerate the use of digital technologies even further.

On digital adoption, however, Europe lags behind other regions, notably North America and Asia-Pacific. With the "winner takes all" tendency of digital technologies and digital platforms, Europe risks being left behind for good. After the pandemic, Europe will need a digital transformation to underpin its green transition.

The adoption of digital technologies by EU firms is growing, but it has not yet closed the gap with the United States. In 2020, 37% of European firms had still not adopted any new digital technologies, compared with 27% in the United States. There is a risk of polarisation within Europe, too, because its small businesses are creating the lag. And while some countries and regions are at the global forefront, others risk being left behind. The downside risks to jobs and growth from both automation and the climate transition are not evenly spread. In fact, some of Europe's least developed regions are most at risk, often aggravating structural weaknesses.

But digitalisation is mainly an opportunity, not a threat. Our data shows that digitalised firms are more productive and foresee higher wages and more employment growth. By taking action to help firms, notably SMEs, to adopt the new technologies they need to thrive, we can spur sustainable growth and help close the divides that exist within Europe and strengthen cohesion.

Innovation will also be vital. Unfortunately, the United States still dominates in the sphere of digital innovation, with China – not Europe – catching up. But Europe has a chance, thanks to the green transition. Digital technologies will play a critical enabling role in the green transition, and Europe is a global leader in green innovation. We lead specifically at the intersection of green and digital, latest data showing that we registered 76% more patents combining green and digital technologies than the United States. This lead is fragile. Building on it will be critical for future sustainability and competitiveness.

To accelerate the pace of digital innovation and adoption, we need above all three things: an enabling ecosystem, the right kind of financial support and a European vision to counter the imbalances across our Union. The EIB Group plays an important role in all three regards.

Skills and management capabilities are proving key barriers to digital adoption. Digital innovation hubs, such as those supported by the Innovation Finance Advisory service of the EIB's European Investment Advisory Hub, can be game-changers in overcoming these barriers. At the same time, access to very high capacity digital infrastructure (i.e. 100 Megabits/second or above) is critical, not only in urban but also in remote areas. 16% of European firms say that lack of digital infrastructure is still a major impediment to digitalisation, compared to only 5% in the US. Data show that digital adoption rates are higher where local municipalities claim good digital capacities and infrastructure.

> After the pandemic, Europe will need a digital transformation to underpin its green transition.

The constraints facing municipalities are financial and technical, requiring the combination of advisory services with adequate financial instruments. The EIB has financed telecom infrastructure projects with €10 billion over the last four years. The Bank estimates that the total investment needed to achieve the European Commission's goal of Gigabit Society is about €380 billion, but the market can deliver only about one third of this. An investment gap of €50 billion per year remains. This may be exacerbated by COVID-19.

Digital innovation by firms, meanwhile, requires risk-absorbing finance that is still hard to obtain from private investors in much of Europe. Here again, the EIB Group is part of the solution. We spur innovation through our RDI lending, and the European Investment Fund catalyses the Europe-wide market in equity finance and venture debt. This is just what the continent's most innovative and growth-enhancing firms need.

PABLO HERNÁNDEZ DE COS

Governor, Banco de España
and Chair, Basel Committee on Banking Supervision (BCBS)

Securing a robust recovery: how can banks be part of the solution?

Much has been said about how the banking system has remained broadly resilient thus far during the pandemic, and how banks have not been part of the "problem" to date in exacerbating the economic crisis. This is in no small part due to banks entering the pandemic on a much more resilient footing than was the case during the Great Financial Crisis (GFC), thanks to the initial set of Basel III standards and ongoing cooperation among Basel Committee members. In addition, the unprecedented range of fiscal and monetary policy measures to support the real economy have largely shielded banks to date from losses and the crystallisation of risks.

While the trajectory of the pandemic continues to be highly uncertain, it is clear that risks to the global banking system may heighten over the coming period. Bank losses could begin to materialise as a result of the unwinding of support measures and broader macroeconomic dynamics. The potential permanent economic "scarring" from the crisis, alongside rising debt levels, could increase the longer-term structural fragilities of banks' balance sheets. It is therefore critical that banks and supervisors remain vigilant to these risks.

Looking ahead, how can banks and authorities best ensure a robust and sustainable recovery?

A crucial factor to achieving this outcome is the full, timely and consistent implementation of the outstanding Basel III reforms. These reforms tackle some of the glaring shortcomings in the banking system exposed by the GFC, including the excessive degree of variability in banks' modelled capital requirements, the lack of robustness in mitigating banks' operational risks, and, ultimately, the credibility of banks' reported capital ratios.

Recall how, at the peak of the GFC, investors lost faith in banks' published ratios and placed more weight on other indicators of bank solvency; when asked to model capital requirements for the same hypothetical portfolio, banks' capital ratios varied by 400 basis points. In a similar vein, banks' operational risk models lacked robustness, with losses incurred by some banks far exceeding their estimated capital needs.

Covid-19 has only further reinforced the importance of addressing these fault-lines. It has underscored how a functioning banking system is one that is resilient and capable of absorbing shocks instead of amplifying them. A banking system underpinned by prudent global regulatory standards is also better placed to maintain the provision of critical services to households and businesses. Yet structural flaws and frailties in the banking system would remain unaddressed if jurisdictions do not implement Basel III in full and consistently.

The Basel III reforms have benefited from an extensive consultation process with a wide range of stakeholders. They are by design a compromise that reflect the different views of our members. They have been calibrated based on rigorous quantitative analyses and meet the Committee's objective of not significantly increasing overall capital requirements at the global level; capital requirements would increase by less than 2% in aggregate. Of course, some "outlier" banks may face higher requirements as a result of aggressive modelling practices, for example. Even in those instances, the implementation timeline includes sufficiently long transitional arrangements: the final element of these reforms will be implemented by 2028, fully 20 years since the GFC.

Frailties in the banking system would remain unaddressed if Basel III is not fully implemented.

And it is increasingly clear that the Basel III reforms will have a positive net impact on the economy, as highlighted by a growing set of robust empirical studies. Safeguarding the resilience of the banking system through prudent and credible global standards will help reduce the likelihood and impact of future banking crises. Moreover, as the current crisis reminds us, it is healthy and well-capitalised banks that are best able to support the recovery by lending to creditworthy households and businesses.

Combatting infectious diseases and safeguarding financial stability are both global public goods which know no borders and require collaboration among countries. It is in all of our collective interests to lock-in the benefits from the Basel III framework by implementing the outstanding standards in a full, timely and consistent manner.

EU RECOVERY PACKAGE IMPLEMENTATION

HARALD WAIGLEIN

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

RRF will address structural reform needs, but key problems remain unresolved

The European Recovery Instrument, with the Recovery and Resilience Facility (RRF) at its heart, provides an unprecedented opportunity to foster structural reforms in Member States, while addressing investment needs of the green and digital transition. A lot depends on the EC's guidance to Member States during the preparatory phase, in particular the extent to which the EC insists on ambitious reform agendas, on the one-off nature of expenditures included in Recovery and Resilience Plans (RRPs), their relevance, effectiveness and efficiency, and the way the DNSH principle is applied.

Our impression so far is that the EC takes its job very seriously, steering national authorities towards making the best of the use of the funds, including via structural reforms, and pointing to areas in which further work needs to be done to make the Plans eligible for financing. We are thus confident that the RRF addresses the short-term economic priorities resulting from the pandemic, and medium- to long-term structural challenges identified during the past two years, including the green and digital transition.

Three factors support our view that the conditions are in place for effective use of RRF funds: First, the EP has taken an important role in improving the governance framework, addressing some of the weaknesses of the original proposal in the areas of monitoring the overall impact of the Facility on common EU targets. The Recovery and Resilience Scoreboard that is being developed by the EC until the end of the year will reflect to which extent RRF funds are living up to their expectations. Second, the EC seems to have learned from experience with the SURE Instrument, which unconditionally supports Member States' measures to protect incomes of workers and the self-employed during the COVID crisis.

> Once the recovery is on track, we have to focus attention on debt stocks, public and private.

Without doubt, many of the measures that are being financed via SURE would not comply with the criteria for RRF funding with regard to relevance, effectiveness and efficiency. The high level of detail in the RRF Regulation, together with the assessment criteria and minimum ratings, provide assurance that only the best projects can benefit from RRF funding. Third and perhaps most importantly, we all know that if the RRF goes wrong, the idea of a common budget is dead.

The governance framework is ambitious and promising, but also work-intensive. The preparation of high-quality national plans requires huge administrative efforts on the part of Member States and the EC. Given the many requirements for RRPs, not all national Plans may be ready for submission by end April. The pay-out of funds may thus be delayed. However, liquidity is not a major constraint to any Member State right now, and a somewhat delayed approval of RRPs shall not be a concern if this comes in exchange for high-quality plans.

Yet a fundamental problem of the euro area remains unresolved. That is extremely high levels of public and private debt in a number of Member States. The measures to address the fallout from the pandemic crisis are adding to debt stocks, while NGEU and the ECB's monetary policy are changing some of the parameters determining debt sustainability. Public support is imperative in the current situation, but we need to be mindful that the problem of high debt is being shifted into the future and partially onto the EU level. It will hit back at some point at the younger generations, who are at the same time taking the largest hit on their personal economic trajectories due to COVID.

Once the recovery is on track, we have to focus attention on debt stocks, public and private. Efficient insolvency mechanisms are key to avoid that capital remains trapped in unviable firms. We need to be aware that not all of the support that is being granted now, with or without EU support, will be used efficiently, as some firms may have been unviable even without COVID.

The urgency of support during the current crisis has not always allowed proper assessments of every firm, so there will be sunk costs that put pressure on public balance sheets. During the past decade, we have accumulated sufficient experience with unsustainable debt to image the potential consequences for individual euro area Member States. The fact that today's increases in debt stocks are policy-driven does not reduce the risk related to it. And markets will not be calm forever.

EMMANUEL MOULIN

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

Delivering on the EU recovery fund

Right after the emergency response to the crisis, France, jointly with Germany, strongly advocated for an ambitious recovery fund to make Europe bounce back stronger than before the crisis. The Commission's proposals followed suit and their formal approval at the July 2020 European Council was a historical breakthrough and a step towards deeper economic integration of the EU in many regards.

Indeed, the Commission had already borrowed on financial markets in the past to on-lend the funds to Member States requesting financial assistance. The latter remained however entirely and ultimately liable for these back-to-back loans. With NGEU, the Commission will still issue bonds – though at a much larger scale - which means Member States will again benefit from the Commission's good credit rating.

Yet, this time, common indebtedness (through a temporary and exceptional increase of the own resources ceiling for tackling the Covid19 crisis) - combined with a long grace period before redemption of principal kicks in - allows for swiftly raising significant amounts of money to fund the recovery in the short term while only incurring the costs down the road when growth has returned and is solidly entrenched.

The other defining feature of NGEU is that 390bn€ out of the 750bn€ raised will be passed on to Member States in the form of grants via EU budget programs, and in particular via the new Resilience and Recovery Facility.

The allocation criteria ensure that the size of the shares each Member State will receive will depend, to some extent, on the severity of the crisis. As such shares may end up differing from the countries' eventual contributions to the reimbursement of these sums, this mechanism will lead to money transfers to the benefit of Member States most hit by the crisis.

However, several safeguards were attached to this mechanism to insure its legal soundness and political acceptability. First, the instrument is meant to be temporary, one-off and designed exclusively to deal with the effects of the Covid19 crisis. The introduction of new own resources to refund NGEU bonds will also be critical in avoiding an undesirable increase in Member States' contributions to the EU budget between 2028 and 2058. Second, the money will finance, to a large extent, investments in the green and digital transitions and reforms to boost resilience and competitiveness.

> The EU agreed on a borrowing-for-spending mechanism to tackle the Covid crisis. We must now strive to implement it thoroughly and swiftly.

In this respect, we now need a swift implementation of the RRF to ensure it effectively contributes to the recovery. This is the main challenge ahead and the clear priority. Third, the governance of the RRF was extensively discussed as part of the political agreement. The solution that has been crafted ensures that the Commission and the Member States have a say on the implementation of those measures, while ensuring national ownership in the design and the implementation of national policies. Respecting these principles is key to success.

The implementation of the RRF will help maintain a supportive fiscal stance in the coming years and achieve a more balanced policy-mix after the crisis. Indeed, in the wake of the 2010 sovereign debt crisis, the EU embraced fiscal consolidation too soon, hence hampering the return of growth.

This time, backed by the activation of the General Escape Clause in 2021 and its likely extension in 2022, Member States ought to keep in place support measures as long as necessary and coordinate fiscal policies to maintain an expansionary aggregate fiscal stance. The Commission should also address differentiated fiscal guidance to Member States namely to encourage those with fiscal space to invest in support of domestic demand.

Finally, we must foster strong and well-supervised European financial actors and deeper capital to help fund the recovery and also promote the international role of the euro. Therefore, we must strengthen the Capital Markets Union by simplifying and bringing closer our 27 legal frameworks and make our Banking Union more credible by simultaneously advancing crisis management, EDIS and cross-border integration.

The issuance of NGEU bonds is also an opportunity to create a euro-denominated safe asset which will help in propping up the international role of the euro.

JÖRG KUKIES

State Secretary,
Federal Ministry of Finance,
Germany

NGEU and RRF – Implementation will be key

In a historic step, EU leaders decided in July 2020 to establish the temporary European Recovery Fund Next Generation EU (NGEU) worth 750 bn Euro – more than 5% of EU GDP in 2019. In its autumn forecast 2020, the EU Commission showed that the EU package could contribute to a significantly quicker and more sustainable recovery, resulting in an up to 2% higher GDP in the coming years. The Recovery and Resilience Facility (RRF) is going to be the main distributing instrument of NGEU with a volume of up to 672.5 bn Euro, representing 90% of total NGEU.

The disbursement of funds is conditional on the implementation of reform and investment packages by Member States, set out in individual national Recovery and Resilience Plans (RRP). Member States are currently drafting their RRP that should be submitted to the EU Commission by end of April.

We are, hence, at a crucial moment of the RRF process. Member States should now set up ambitious plans in line with the conditions laid down in the RRF regulation. Those include in particular a climate target of 37% and a digital target of 20% of RRF funds. This means, in total around 250 bn Euro of the RRF will be spent on the green transition in the next years, and over 130 bn Euro on the digital transition. A big step towards making our economies more resilient and fit for the future. Furthermore, the RRF aims at strengthening economic and social cohesion while enhancing the growth potential in the aftermath of the crisis.

That requires a country-specific approach. Therefore, Member States will have to address their national challenges and priorities identified in the European Semester. Comprehensive national reforms in combination with investments in key policy areas create a unique chance to emerge substantially strengthened from the crisis.

> The RRF is the right instrument at the right time. Joint efforts are needed to make it work properly.

Challenges for Member States arise inter alia from the time constraints under which adequate reforms and investments need to be identified now. However, Member States that already took decisive steps towards their recovery before the creation of the NGEU (i.e. since February 2020) are allowed to include those in their plans. This will help to make funds flow as soon as possible.

Meeting predefined milestones and targets is a prerequisite for the payout of the funds. Given the highly uncertain economic outlook as well as internal imponderables, including possible bottlenecks and absorption problems, there is a risk that some of them might be missed, especially further down the timeline.

However, timing is key to support the recovery effectively. That is why all funds have to be allocated by the end of 2023 and disbursed by the end of 2026. Member States will have the possibility to update their national plans in 2022, when 30% of the RRF funds are newly distributed based on the latest economic data. While necessary, calculating plausible cost estimates and ensuring effective control and audit procedures is also not an easy task.

Against this background, it is important to minimize impediments for the proper functioning of the instrument wherever possible. This means inter alia, that milestones and targets should be defined in a way that avoid frequent amendments of the plans. Attention should also be paid to the administrative burden for Member States when drafting their plans and implementing their projects. At the same time, this is precisely the moment for Member States to not only invest but also address reform bottlenecks.

Member States can make requests for payments twice a year, leading to up to over fifty requests per year. Given that, it will be important, that the Commission and the Economic and Financial Committee (EFC), representing the Member States, handle the assessment of the requests in a pragmatic way. The fact that the process builds on well-established structures of the European Semester should help in this regard.

The EU recovery package is the right instrument at the right time. Making the best out of it requires joint efforts from all sides.

GERT-JAN KOOPMAN

Director-General,
DG Budget, European Commission

Making the recovery work: NextGenerationEU as a game changer on the capital markets

2020 was an extraordinary year in EU policy making. The EU was hit by an unprecedented crisis. Politicians and policy-makers had to act quickly and comprehensively to find and offer solutions.

NextGenerationEU – a game changer

The EU provided a very concrete response. At the heart of this was an unpreceded €1.8 trillion package – backed by the EU budget - to support the economic recovery and build a greener, more digital and more resilient future. To finance a part of it - the €750 billion NextGenerationEU instrument - the EU will borrow on the capital markets.

The European Commission, on behalf of the EU, has been present on the capital markets for years. We have been running lending programmes to support EU Member States and third countries.

In 2020, the Commission also started borrowing for SURE – the up to €100 billion instrument to help protect jobs. As of mid-March 2021, we had raised 2/3rds of EU SURE funds in 5 very successful issuances. All EU SURE bonds benefit from the social bond label.

NextGenerationEU is a game-changer. With volumes of €150-200 billion per year, it will make the Commission one of the biggest issuers in euro, at par with the largest sovereigns.

Facing the growth challenges

This has called for a fundamental change in our approach. Given the volumes, frequency and complexity of the borrowing, the Commission will have to act like a sovereign borrower.

We will, therefore, implement a diversified funding strategy. This will allow more flexibility in the timing of funding transactions and the choice of funding instruments and maturities. As part of this, we will also be using short-term debt instruments – EU-Bills. Recourse will also be given to auctions as an issuance channel, in addition to syndication. The Commission intends to raise 30% of the funds as green bonds.

Our ambition is to have a regular presence on all parts of the yield curve with large, liquid and safe EU-Bonds.

In this way, we will be able to reconcile the demands and constraints of the NextGenerationEU funding, and deliver all funds as required on the most advantageous terms for the EU.

Next steps

The Commission intends to start issuing funds under NextGenerationEU in the summer of 2021.

For this to happen, two key conditions have to be met. First, Member States need to complete the ratification of the Own Resources Decision, the piece of legislation that will enable the Commission to borrow. Good progress is being made and we expect the process to be completed in due course. Second, for Member States to received funding under the €672.5 billion Recovery and Resilience Facility (RRF), their Recovery and Resilience Plans need to be submitted and approved, with all relevant details settled. The RRF accounts for 90% of the funds under NextGenerationEU, the rest will go to several EU programmes that will all be up and running in the summer. Once the plans have been approved, the Commission will be able to start disbursing the first funds.

The big picture

NextGenerationEU gives an ambitious answer to an unprecedented crisis. It demonstrates solidarity at difficult times. It has shown that the EU can and will stand together to face challenges. It will help transform our economies and societies for the better.

There is more. NextGenerationEU – building on the success of SURE – will turn the EU into a major player on the global capital markets. The EU bonds represent safe financial instruments in euro, which are appealing for international investors as we see in the huge oversubscription rates of our recent issuances. Financial market participants tell us that they will look at the EU-B yield curve as they price other paper. Should this materialise at scale, then the issuances will further the EU capital market integration. Finally, the bonds are making euro denominated paper a much more attractive investment destination and, in the process, strengthening the international role of the euro.

The EU SURE social bonds and the future NextGenerationEU green bonds are making the EU one of the biggest Environmental, Social, and Corporate Governance (ESG) issuers – which is inspiring others to choose this approach.

The big challenge now is to make all of this start on time. The Commission is working hard to that end – and we count on the support of all interested stakeholders. Together, we stand stronger.

IRENE TINAGLI

Chair, Committee on Economic and Monetary Affairs, European Parliament

Three challenges for the implementation of Next Generation EU

Next Generation EU (NGEU) has rightly been hailed as a paradigm shift in EU governance, or at least the first step that hopefully will not fade with the pandemic. NGEU is not just the money made available to Member States. It represents also a paradigm shift in terms of defining the cornerstones of future economic development and the role of public policies in the next decade.

There are three keywords to frame the NGEU method: programming, direct intervention, resource allocation. The accompanying documents of NGEU define a lot of detail required in the control and in the governance of the processes, and this represents an ambitious challenge for all Member States. National governments have to present national plans aimed at two objectives: recovery and resilience.

The first is a shorter-term objective that requires well-designed fiscal measures aimed to reduce as much as possible the economic and social damages created by the pandemic, and to restart economic activity. The second is a longer-term objective concerning the ability to favour structural changes in the economic system. Obviously, the two objectives, and the related tools, are and must be interconnected, but they also require diversified approaches and tools, and each will have to be evaluated with appropriate criteria.

I see three risks here. The first relates to the recovery. This recession is peculiar because it simultaneously affects the demand and supply side. But the implications for the recovery of this aspect - and of other no less relevant ones - are usually not adequately discussed. Attention seems to be focused almost exclusively on what are considered the structural problems pre-existing to the pandemic. This is not wrong, but it may not be enough if the specific structural effects of the recession on production methods, on the composition of aggregate demand or on expectations for the future are also hampering recovery. These new structural effects must also be considered.

The second risk relates to the link between recovery and resilience. Structural problems to be removed are rightly the core of the current discussion, but few seem to care about the intensity and speed of the effects such projects may have on economic recovery and their ability to remove the additional structural obstacles created by the recession itself. Delaying and weakening recovery can have devastating effects in the long run, especially for those young people to whom we all pay great attention.

> Recovery and resilience are and must be interconnected, but they also require diversified approaches and tools.

As numerous studies show, delayed entry into the labour market or an entry in a depressed state of the economy has negative effects on the entire (working) life of young people. This does not seem to be a secondary effect and it would be good to take it into account in a conscious and responsible decision-making process. Here our challenge is how to combine reform and recovery in national plans, and what is the best sequence of reform and recovery interventions.

The third risk relates to the long-run sustainability of the recovery. Too often we talk about recovery by focusing entirely on aggregate variables. However, this approach is insufficient and dangerous. If GDP returns to pre-crisis levels but inequality in income and wealth distribution is even greater than before the crisis, this risk jeopardizing the economic and social sustainability of the recovery itself, undermining the European long-term growth. Therefore, when preparing national plans, we should also take this dimension into account.

As European Parliament, over the next years, we will be vigilant to ensure that the Commission carries out the tasks assigned in appropriate ways so that the facility reaches its objectives, especially in terms of digital and environmental transformation, social impact and the Next Generation policies that we have envisaged for the Union.

RICARDO MOURINHO FELIX

Vice-President and Member of the Management Committee, European Investment Bank (EIB)

Challenges and opportunities of the new Recovery and Resilience Facility

The European Union's (EU) package for supporting the recovery of a European economy devastated by the coronavirus crisis is a very bold step. It is totally unprecedented.

The Recovery and Resilience Facility (RRF) will contribute to the EU's economic recovery, supporting productive public investment and the implementation of structural reforms. Despite being a temporary policy, the RRF impact should be a permanent oneand will contributeto an increase in productivity and to sustainable growth prospects. Governments and companies have the duty to seize this opportunity to change gears and foster a greener, smarter and more resilient economy for the EU citizens. A more inclusive economy with lower inequality and ready for the forthcoming challenges, leaving no one behind. This is an imperative!

The COVID-19 crisis led to an extraordinary financial support to the economy by EU governments, in the context of temporary waivers of the State Aid rules, and by central banks. These support schemes have taken the form of public guarantee schemes, debt moratoria and direct support to some firms via outright state aid. Central banks expanded their balance sheets further through asset purchase programmes ensuring the maintenance of liquidity, and micro- and macro-prudential supervisory rules for banks were temporarily loosened.

While this support has been crucial to keep the economy afloat, it has invigorated a debate on whether such policies are appropriately targeted at economically viable firms hardly hit by the crisis, or if their broad base may induce the risk of some "zombification" of the European economy.

Resources are scarce, so any support to the economy should be targeted at viable companies. Lending and supporting non-viable companies on the back of public guarantees erodes the public purse, artificially preserves firms with no future and retains their workers, instead of putting their productive capacity at the service of viable value-added projects. Support to companies should never be a substitute for unemployment insurance schemes, which were long ago designed to ensure a better job matching. Schumpeterian creative destruction is a critical part of a sound and competitive internal market and key for a green and smart recovery that boosts productivity, growth and generates well-being for our citizens.

> The RRF paves the way for future growth by supporting innovation, promoting viable companies and, thereby, contributing to a green and smart recovery.

The RRF opens up new opportunities to leverage the scarce public resources. Achieving an effective and efficient allocation of resources is of the essence, and it is intrinsically linked to several factors.

Firstly, the rigorous selection of the most productive public investment projects and an effective implementation of reforms will determine the overall economic impact of the RRF. Secondly, the successful combination of the conventional EU programmes, as Cohesion policy, and the RRF and the institutional and administrative capacity of the Member States to put in place high impact projects quickly. Thirdly, additionality. The RRF funds must enable the deployment of investment projects that would not be possible to deploy otherwise. If RRF grants are simply used to finance investment that already has other funding sources or to crowd out private investment, then the RRF will simply be a missed opportunity.

The RRF Regulation provides the opportunity to deploy and use resources through financial instruments. Financial instruments increase the overall impact of the resources, thus fully unleashing the growth potential of the EU economy above pre-crisis levels.

The extensive experience of the EIB Group in delivering financial instruments and our technical assistance platforms can act as important levers for Member States to evaluate investment needs, assess barriers and setup the most adequate financial instruments. The advisory capacity of the EIB can support the design and the development of funds and financial instruments under RRF, including national recovery funds or the implementation of financial instruments through the national compartment of the Invest EU.

The EIB stands ready to provide its support, its expertise and its capacity to governments and companies that want to fully seize the opportunities of the new RRF. As the EU bank, we stand together with the other EU institutions to deliver on the Union policy priorities to grant citizens a future of Freedom, Solidarity and Prosperity.

VITTORIO GRILLI

Chairman of EMEA Corporate and Investment Bank, J.P. Morgan

Strengthening the internationalisation of the euro and the EU's future competitiveness through common debt issuance

The unprecedented EU recovery package was a milestone for deeper fiscal integration, with extraordinary measures enacted to support Member States grappling with the fallout of COVID-19. Common debt issuance is a potential game-changer for Europe's economic growth dynamics through the Recovery Fund, with the potential to strengthen the internationalisation of the euro and the EU's future competitiveness.

The recovery package's focus on investment could lift Europe out of secular stagnation. Average annual (inflation-adjusted) growth in EU investment declined from c.3.4% (1999-2007) to c.2.6% (2011-2019), whilst the euro-destabilising variance in investment across Member States has been even more dramatic across the same period. Italy, Greece, and Portugal have experienced negative average investment growth, and even France and the Netherlands saw a decline in investment growth of nearly half. The package could help hard-hit Member States improve levels of investment which could bring GDP growth in-line with the rest of the EU and thus strengthen the entire compact.

If the EU were inclined towards the creation of a "safe asset", common debt issuance could contribute to this goal, possibly facilitating ECB monetary policy. There is likely appetite for a safe asset since debt issued by highly-rated EU countries represented only c.29% of outstanding sovereign EU debt as of end-2020; with €750bn, that would increase to c.35% of 2020 debt. Continued, regular issuances and a liquid curve will also be necessary for the full development of a safe asset.

Though implementation of investment and reform will remain critical, a safe asset coupled with a more dynamic, balanced and cohesive EU economy could lessen concerns of tail risks and thus support the international role of the euro.

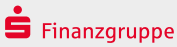
Common debt issuance is a potential game-changer for Europe's economic growth dynamics through the Recovery Fund.

SURE has proved a successful instrument for debt issuance due to the clear communication to the market on deal sizes, tenors, timetable and "what" investors would be buying, as well as co-ordination with other supranationals. The use of a Social Bond Framework proved fruitful given the thematic dominance of ESG amongst global investors, whilst the general market backdrop was favourable and led to record order books for SSA issuers in recent months.

J.P. Morgan was delighted to be appointed as joint-lead on a SURE transaction and we endeavour to continue supporting SURE and the deployment of the Recovery Fund. We have operated in the region for close to 200 years and our commitment to companies and our clients remains unwavering.

As the Recovery Fund goes live and with a view to a common debt instrument, we are confident the EU will continue to work with best-in-class arrangers to be well-positioned for successful issuance in different market conditions. This will allow access to a diverse and increasingly global investor base, in terms of type and geography, and the broadest possible market intelligence for future transactions. It would be reinforcing to see more EU countries making use of these programmes.

We thank **the partner institutions** for their support to the organisation of the Eurofi April 2021 Seminar

FOSTERING MORE INVESTMENT IN THE EU

MARKUS FERBER

MEP, Committee on Economic and Monetary Affairs, European Parliament

Setting the right incentives for private investments

The world as we know it as well as our economies are changing rapidly. To deal with this change, the European Union has given itself an ambitious agenda and identified two major challenges to prepare for: the twin transitions towards a more digitised economy and towards are less carbon-intensive economy.

Particularly the latter one will require massive amounts of investments as it implies a fundamental remodelling of our energy infrastructure from energy generation to energy transmission.

Unfortunately, those investments are not easy to finance. Even before the Covid-19 pandemic struck, we had a consistent and substantial investment gap in the European Union, which the European Union attempted to address with the European Fund for Strategic Investment (EFSI) and later the InvestEU programme.

Even the European Commission has concluded in its "Sustainable Europe Investment Plan" communication that reaching the "old"2030 climate target of a 40% reduction in greenhouse gases would require an additional 260bn EUR in investments. That was arguably before the European Union decided to substantially increase its 2030 level of ambition and before the impact of the Covid-19 crisis.

The pandemic has hit public finances hard and has directed both, public funds and attention away from climate issues and towards immediate crisis relief. The economic fallout of the pandemic will therefore have only increased the investment gap. Part of that delta might be compensated for by the EU's Recovery and Resilience Facility that comes with specific spending targets for digital and climate expenditure.

> If we want to plug the investment gap, we cannot rely on public money alone.

Nonetheless, in light of a higher level of ambition and additional pressure on public finances, the investment gap has probably increased rather than narrowed. That leaves one major conclusion: If we want to plug the investment gap, we cannot rely on public money alone. Even in times of an exceptionally favourable interest rate environment, public finances are stretched. The debt-to-GDP ratio in the Eurozone will likely surpass 100% this year and getting back towards somewhat sustainable debt levels, will leave little fiscal space for grand expenditure programmes.

Ruling out the public sector as a big driver of overall investment, leaves private investment as the key contributor. Private companies will not finance the EU's policy priorities out of the kindness of their heart though, but because they expect a reasonable return. The underlying pre-condition for that is a favourable and predictable regulatory regime, which we have a hand in influencing.

This year, we do have a few chances to get the incentives right: We have three big files that will allow us to set the tracks into the right direction. Firstly, we have the implementation of the Basel III finalisation package, which will determine in a major way how and under what conditions European companies will be able to finance themselves through banks. At a time, when we want European companies to make productive investments, we should be very careful to calibrate the new Basel framework in a way that is conducive to that goal.

Secondly, we have the review of MiFID II, which sets the ground rules of how financial markets in Europe work and how European companies can tap into those markets. We should work on this recast with a view to strengthening EU financial markets, cutting red tape and facilitating market access for both companies and investors. A smart review of MiFID II will go a long way in bolstering up companies' equity base and will allow them to invest in profitable business ventures.

Thirdly, we have the review of Solvency II, which governs how insurance companies can operate across the single market. Insurers are the perfect long-term investors. They have a long-term time horizon and predictable cash-flow needs, yet they currently invest too little in long-term projects, which is due to regulatory reasons. With the Solvency II review, we have a shot at fixing that issue.

If we want to bridge the investment gap, we need to get the legislative framework right to incentivise private investments.

DECLAN COSTELLO

Deputy Director General, DG for Economic and Financial Affairs, European Commission

Next Generation EU: a pillar of the recovery

More than a year after the outbreak of the Covid-19 pandemic in Europe the economic recovery is yet to gain ground. The breakthrough in vaccine development in the autumn and the start of mass vaccination campaigns are a game-changer that significantly brightens the economic outlook. But in the meantime, renewed waves of the pandemic have forced many Member States to reintroduce or tighten containment measures.

As a consequence, economic activity has remained subdued in the first months of the year. In its winter interim forecast, the European Commission projects only a mild uptick in economic activity before summer. Once the assumed, gradual relaxation of containment measures truly picks up pace in the second half of the year, the economy is expected to start recovering.

Yet, just as the pandemic's initial hit was very uneven across Europe, so will Member States' recovery paths be. More than half of Member States are forecast to close the distance to their pre-crisis output levels by the end of 2021. Others are expected to take longer. The economic structure — and the share of the tourism sector in particular — are among many factors contributing to such an outcome.

The longer the crisis lasts, the greater the risk of major cross-country divergences becoming entrenched, leading to a fragmentation that would disrupt the functioning of the internal market. A protracted crisis also risks inflicting deep scars on the fabric of the European economy and society, predominately through bankruptcies and higher unemployment.

Given the disproportionate impact of the crisis on economically more vulnerable people, including youth and women, a deepening of pre-existing inequalities is also a real risk.

The Member States and the EU have reacted swiftly to the enormous economic impact of the Covid-19 crisis. Swift and determined policy action at all levels has helped to shield firms and workers from losing earnings and jobs in the acute phase of the crisis. The European Commission's €750bn-Recovery Instrument, 'Next Generation EU' (NGEU), complements the various emergency measures by supporting a swift recovery and building a more resilient European economy in the wake of the crisis.

Next Generation EU and the RRF are Europe's attempt to 'build back better', combining future-facing investments with essential reforms.

Its centrepiece, the Recovery and Resilience Facility (RRF), will deliver financial support for investments and reforms in a fair manner. The allocation of financial support takes account of economic needs arising from the crisis while supporting the green and digital transitions of the European economy.

If implemented swiftly, with a strong focus on high-quality public investment and additionality, the level of real GDP in the EU could be roughly 1.5 to 2 per cent higher than without NGEU, according to stylised simulations with DG ECFIN's QUEST model.[1,2] This would help not only the sustainability of our economic model, but also that of public debt.

The common and coordinated European approach to tackling the pandemic's economic consequences is an expression of European solidarity, but it also makes good economic sense. Economic and financial spillovers spread fast through the Single Market and Monetary Union, supporting growth in all Member States. Moreover, high-quality investment and reforms address the challenges ahead – combatting climate change and supporting digitalisation. Our efforts are now fully geared towards the implementation of the RRF. Member States have been developing – in close cooperation with the Commission – Recovery and Resilience Plans that outline national reform and investment measures.

A lot of work lies ahead. However, there are good grounds to believe that Recovery and Resilience Plans can be finalised in months, allowing disbursements to commence around summer. Next Generation EU and the RRF should be seen as Europe's attempt to 'build back better', an endeavour that will require ambition to combine the investments in the right areas with the adoption of essential reforms.

1. European Commission (DG ECFIN) (2020), European Economic Forecast Autumn 2020, European Economy Institutional Paper 136, p.65-70.
2. QUEST is a structural macro-model in the New-Keynesian tradition with rigorous microeconomic foundations and frictions in goods, labour and financial markets. See Burgert et al. (2020), 'A Global Economy Version of QUEST: Simulation Properties', European Economy Discussion Paper 126.

BORIS VUJČIĆ
Governor,
Croatian National Bank

Thousand financial problems of a healthy society

While the magnitude of the initial shock brought by the COVID-19 pandemic may have run out of scale, European policymakers reacted with speed and decisiveness, in a way that may provide a temptation to congratulate themselves. With lockdown policies struggling to contain the virus and scarce vaccine supplies, the lifeline provided by the unprecedented fiscal, monetary and regulatory stimulus has kept our economies afloat.

Not only employment and incomes remained resilient, but also our financial sector, strengthened by the decade of continuous reforms, provided a lifeline to companies. However, if we look beyond the obvious, we may find the same old problems that warrant caution and vigilance.

The banking sector is indeed operating on a lower leverage, taking fewer risks, maintaining substantial liquidity reserves, and overall becoming much more robust and resilient than it was a decade ago. In contrast to the global financial crisis, when the financial system triggered the initial shock and continued to amplify it, this time round banks stood ready to cushion the blow and stabilize the economy.

Still, their first buffer for shocks, profitability, was subdued even before the crisis. This was slowly chipping away at the ability of banks to provide funding to the economy and act as a transmission mechanism for monetary policy.

The reasons for low bank profitability are multiple. European regulators have not always been vigorous to push inefficient banks with broken business models out of the market. Such decisions are not always easy – as we in the Croatian National Bank know very well. Over the past two and a half decades, since I got my first job at the Bank, the number of commercial banks operating in Croatia has shrunk by about two-thirds, coming from 60 down to 20. This has always been a sensitive job, full of legal and political landmines, but the alternative of overbanking is, as we can attest, even worse.

> As our societies overcome the disease, we will again have to deal with our thousand regular issues in the financial sector.

Further on, banks have been slow to reinvent themselves in the face of advances in information and in particular mobile technologies. After several decades of warnings that repeatedly turned out to be false alarms, the speed of technology diffusion in finance has been accelerating. In essence, banks need to become technology hubs in order to maintain their most cherished lines of business. Technological transformation may be painful for banks, and for bankers in particular, but it is the only way forward.

Finally, the long period of extremely accommodative monetary policy has driven interest margins down and compressed income from banks' core business. According to most market observers, this headwind is not likely to disappear any time soon.

On top of reinventing their operations, dealing with the aftermath of the crisis will be particularly challenging for banks. A sharp increase in corporate insolvencies has so far been avoided – to the contrary, exactly the opposite has happened as insolvency rates have fallen below even the levels observed in good years. However, insolvencies will gradually catch-up as broad-based support measures are gradually unwound, even if potentially destructive cliff-effects of a too-early withdrawal are avoided.

Banks will have to make complex decisions to restructure debts of viable companies and pull the plugs on non-viable businesses. The role of a neural vortex entails cleaning the economy of "zombie" firms, which have survived due to ample support, but lack the flexibility to adapt to changing circumstances. This should not be taken lightly.

An old Indian saying that a healthy person has a thousand wishes, a sick person only one, can be adeptly applied to policymaking. As our societies overcome the disease, we will again have to deal with our thousand regular issues in the financial sector, many of them exacerbated by the crisis. Our banks are even more intertwined with national governments than before the crisis, dynamism in the corporate sector has further dropped and banks may again have to deal with a pile of bad debts.

And the banking union still stands uncompleted. So, as we cheer the departure of the disease, we'll be moving to many old unresolved issues again.

MĀRTIŅŠ KAZĀKS

Governor,
Bank of Latvia

We have brought water to the horse, but we cannot make the horse drink

Since the global financial crisis and, in particular, during the Covid-19 pandemic major central banks have provided ample monetary policy accommodation. By several measures, the ECB has provided more support than the Fed. Since 2017 the balance sheet of the ECB in percent of GDP has substantially outgrown that of the Fed. The Fed never resorted to negative rates.

Euro area nominal and real interest rates are near their historical lows. Targeted long-term refinancing operations provide very favorable financing conditions to banks that pass this funding to their lending portfolio. Tiering shields bank profitability by reducing the cost of holding excess reserves when banks cannot pass this cost to their clients.

Unless policy rates go beyond their reversal rate levels, which they have not, zero or negative interest rates are supportive to investment. Ultra-low interest rates should encourage investment as they expand the universe of profitable projects, turning some of those that had negative net present value into profitable endeavors. Of course, some of the recent investment weakness is cyclical, but it is not the whole story. Structural factors must play a role there, too. Let me point to three such factors.

First, the EU common market is still in many ways fragmented, particularly in services. Take the digital domain. Different national requirements still act as virtual borders. Building scale quickly to harness network effects is crucial and the national markets of even the largest EU countries are too small for that. It is somewhat ironic that cross border retail transactions in the EU are mostly enabled by payment solutions developed outside the EU. We need to complete the single digital market and create a retail payment solution based in the EU. The latter should ideally be a private sector solution. A digital euro could support it.

Second, financial markets in the EU are dominated by banks. Underdeveloped capital markets, especially in smaller jurisdictions, mean fewer sources of financing for investment and innovation, less diverse risk taking and a limited set of business strategies, especially if the market is dominated by just a few big lenders. Moreover, the profitability of the European banks has been weak and that is only partly a cyclical issue.

> In addition to monetary policy, we need two more games in town - structural reforms and bolder fiscal policy.

Despite the efforts to strengthen the European banking union, banks largely remain domestically oriented, with a strong bank-sovereign nexus. As a result, they are not able to reap the full benefits of European integration. Extra efforts are needed to move towards a genuine European banking union. At the same time, banks cannot and should not intermediate all risks.

A more diverse financial market ecosystem is a must. Deep and well-functioning capital markets are not a luxury. Without a dynamic capital market, Europe risks more under-investment, a less vibrant economy and lost opportunities for its citizens.

Third, frontloaded and investment-geared fiscal support is needed both at the national and the EU level. The euro area non-financial investment has not yet fully recovered from the austerity of 2012-15. In view of worsening corporate balance sheets, low cost of sovereign financing makes it possible for the public sector to fill in the most critical private sector investment shortfalls.

True, national fiscal policies have been expansionary during the Covid-19 crisis, but little of it has supported investment. While the USD 1.9 trillion Biden package could risk being too concentrated in time and overheat segments of the US economy, it is projected to close the output gap already at the turn of the year.

The EUR 672.5 billion EU Resilience and Recovery Fund is a very welcome step in the right direction but is stretched over five years, only to visibly kick in towards the end of the year and will not close the negative output gap neither this year nor next. With single monetary policy, a larger common fiscal capacity would yield a more effective policy mix. If we let long-term investment dwindle, productivity and income growth will be anemic.

To summarize, in addition to monetary policy, we need two more games in town - structural reforms and bolder fiscal policy. Paraphrasing an old saying, central banks can make sure that there is plenty of water in the river, we can even bring water to the horse, but we cannot make the horse drink.

PIERRE HEILBRONN

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

Recovering sustainably from the Covid-19 crisis – focus on CEE

The word "sustainability" is in vogue now – it is used so often and in many different contexts that its original meaning can sometimes get lost. But when it comes to recovering sustainably from the economic crisis precipitated by the Covid-19 pandemic, we need to go back to first principles. It is important that we tackle this recovery in a manner that will endure beyond emergency interventions, so that we give true meaning to our promise to "Build Back Better."

Understandably, the emergency response of governments worldwide, including in the Central and European (CEE) region, has been focused on individual's incomes and corporate liquidity. Because of the severity of the crisis, there is always the risk that well-intentioned kneejerk reactions could lead to less sustainable outcomes. For example, increase in state ownership of companies to protect corporate balance sheets is likely viewed as systemically important. As a multilateral development bank with a distinct private sector mandate, the EBRD recognises that these types of solutions are likely during crisis, but we will be there to advise when such emergency measures need to be reversed to promote a private sector-led recovery that is both inclusive and sustainable.

When we interpret "sustainability" in its broader sense, meaning the ability to continue over a prolonged period of time, we need to look at the diverse tools at our disposal. At the EBRD, we are committing all of our activity in 2020-2021, worth €21 billion, to help our regions counter the economic impact of the pandemic.[1] Separately, all eleven CEE EU members will be net recipients of grants and will have access to new, cheap loans under the EU's EUR750 billion pandemic recovery plan. It is encouraging that the Rating Agency, Fitch, forecasts higher growth for all bar one of these countries in 2022 than 2021, making the CEE region stand out.[2]

However, no single source of finance will come to the rescue – they need to be manifold and diverse. That is why the EBRD has focused on introducing new products in the region, such as the Commercial Paper (CP) programs to mobilise emergency assistance for working capital as well as Banking sector capital Instruments to strengthen the capital base and promote new lending.

> We must tackle this recovery in a manner that endures beyond emergency interventions, so that we give true meaning to our promise to Build Back Better.

Interpreting "sustainability" in the more narrow sense, in terms of its impact on environmental matters, the EBRD recognises how important it is that there is a post-Covid green recovery. The emergency response in the CEE has so far not focused on green stimulus measures. However, if they are properly targeted, public policy interventions could spur economic growth in a more climate-friendly way. Policymakers should harness this unprecedented opportunity and use it as a springboard to a greener path. And a new vibrant group of investors is supportive of ESG goals and they are not shy in directing money to a sustainable future. Positives are already occurring in Poland and the Czech Republic, with both countries attempting to move to a future less dependent on coal.[3]

Separately, in Hungary, the Central Bank is working with the EBRD to develop a sustainable capital markets development strategy, which will complement its ongoing initiatives aiming to green the financial system and to mitigate the risks of climate change. A similar project is ongoing in Lithuania.

The genesis of many of these initiatives pre-date the Covid crisis, but are even more relevant now. And there are other reasons to be optimistic for the CEE region: the International Renewable Energy Agency has confirmed that there is huge potential for clean energy there. According to a recent study, the economies of Central and South-Eastern Europe could cover 34 per cent (from 16% in 2015) of their rising energy demand cost-effectively with renewables by 2030.[4]

At the EBRD, we stand ready to support them in their transition.

1. https://www.ebrd.com/what-we-do/coronavirus
2. https://www.fitchratings.com/research/sovereigns/next-generation-eu-fund-to-boost-cee-sovereigns-growth-in-2022-13-01-2021
3. https://think.ing.com/uploads/reports/CEE_Green_Opportunity_Master_3_Nov_-_FINAL_.pdf
4. https://www.irena.org/-/media/Files/IRENA/Agency/Publication/2020/Oct/IRENA_REmap_CESEC_2020.pdf

LAURENT ZYLBERBERG

Director of Public, International and European Affairs, Caisse des Dépôts (CDC)

Public finance is not the problem, it's part of the solution!

In this unprecedented crisis that our economies have gone through and from which we continue to suffer the consequences, one must think without blinders. We all see the new legitimacy of public intervention. We, NPBIs, have spared no efforts to contribute to the deployment of various and massive emergency measures. This is not enough! Our role is also to prepare the future by restoring today's economies and preparing tomorrow.

Figures speak by themselves, in France alone, in 2020, CDC via its subsidiary Bpifrance has supported 630,000 companies for an amount of loans guaranteed by the French State of €130 billion. Among many other initiatives, we also set up regional funds with local authorities (more than €300 million) for small businesses and social economy.

At European level, figures make dizzy (€ 750 billion of immediate measures in 2020 in 5 Member states). European NPBIs gathered in ELTI[1], were mobilized on all fronts (loans, equity, guarantee) to support their domestic economies and mitigate the severe effects of the pandemic.

Responding to the emergency by providing cash and short-term debt is only part of our job. Financing the recovery by providing long-term financing is another part. Following a sharp increase in indebtedness, strengthening companies' equity is another challenge. For that one, we, NPBIs, must take risks and leverage on other financial resources. This is why the success of European Program like InvestEU is so important with the direct access to European guarantee granted to NPBIs.

In a context of strong uncertainties and low interest rates (which pay poorly for risk taking and long-term commitment), it is quite difficult to find long, patient capital in capacity to bear risk. However, there is a paradox on which we could count on. Because of the current crisis betting on long term is probably less risky than on short term! Having said that, we shall not shoot ourselves in the foot.

All the actors should work for establishing a positive and incentive regulatory framework. Financial robustness and stability shall not be regarded as incompatible with risk taking in the long term. Of course, this is lacework, especially for prudential and accounting concerns, but it is worth to do it rather than having a holistic vision which could have so much collateral damages.

Together we shall do more!

In this context, because of our positive track-record, our knowledge of local needs and the constant support we received from public authorities, we, NPBIs, have a major role. We accompany our partners for taking risks and committing to long horizons, we help them into taking account of externalities in their investment decisions. Based on that, we can be considered as "enablers".

But for them to give their full potential, the NPBIs must benefit from support not only from their national governments (within the framework of domestic recovery plans) but also from European institutions as "implementing partners" of the EU financial instruments. In this respect, InvestEU as a cornerstone of the EU recovery plan illustrates this new decentralized approach of investment policies.

Besides, the regulatory environment applicable to long-term investment should not be discouraging so that long-term financial players can accomplish their role as a "catalyst": from this point of view, vigilance is required, for example, on the possible reinforcement of capital requirements on banking investment in equity with the Basel IV transposition.

As said above, recovery is only one part of the job. The most substantial part of it is to ensure resilient growth, sustainable development and digital transition and therefore adapt our economies. For this, we ought to build a diverse ecosystem of financial institutions with NPBIs playing a key part and appropriate incentives in terms of long-term sustainable finance. Taxonomy, reporting, incentive measures and many other elements shall be defined towards this goal.

Finance of all sorts, unite! Together we shall do more!

1. European Long Term Investors Association

SYLVAIN BROYER

Chief Economist EMEA,
Fixed Income Analytics,
S&P Global Ratings Europe Ltd.

The role of the Capital Markets Union in avoiding the liquidity trap

The liquidity trap occurs when consumers and businesses show an absolute preference for holding cash rather than investing because returns are too low. This leads to the central bank no longer being able to influence financing conditions. How can Europe avoid the liquidity trap?

European households and corporates have hoarded a large share of the liquidity that governments and central banks have injected into the economy to combat Covid-19 pandemic. However, that does not mean Europe has already fallen into the liquidity trap. After all, Europeans have had little opportunity to spend amid strict lockdowns. When restrictions to demand were lifted temporarily in summer 2020, households considerably scaled back their savings.

Moreover, productive investment has not decline further than GDP last year. In fact, it has increased continuously faster than GDP since the ECB introduced negative interest rates and QE in 2014. So, monetary policy does not seem to have lost all traction, and we will have to wait until well after the health situation normalizes to see whether Covid -19 has pushed Europe into the liquidity trap.

In the context of the EU's Capital Markets Union project, it is nevertheless unfortunate that the massive liquidity injected during the pandemic has not found a more effective use. Europe already had a huge pool of savings before Covid. The share of cash to financial assets held by companies has increased by two percentage points to an all-time high of 12.4% over the past three quarters.

More than two-thirds of households' financial transactions last year landed in bank accounts, while less than 2% were used to increase direct equity holdings. Cash and deposits replaced equities as the main class of financial assets held by European households in 2008.

Since then, the return on bank deposits has fallen to zero, while dividends on European equities offered a constant 3% per year. The unproductive use of EU savings is not only unfortunate for savers. It is also regrettable for SMEs in Europe which, as the IMF recently pointed out, suffer from a substantial equity gap of about 2%-3% of GDP (See IMF WP/21/56). This gap has widened due to Covid -19.

> The Capital Markets Union, spurring investment and return on savings, is vital to the economic recovery.

There are two ways to escape a liquidity trap, as Buiter and Panigirtzoglou described (See NBER WP 7245). The first is fiscal expansion. The second is for the central bank to lower the effective zero low bound on interest rates. Covid -19 has helped reduce the liquidity trap risk somewhat by triggering a bold policy response, both monetary and fiscal. The EU Green Deal would probably not have been endowed with €750 billion funding without the pandemic. EU budget rules would not have been relaxed.

The ECB would probably not have pushed long-term yields further into negative territory and further loosened refinancing conditions for banks. The latter might positively influence banks' ability to charge negative interest rates on customer deposits, but the process remains slow and uneven, and still tilted more towards corporate deposits than households' deposits (See Bundesbank Monthly Report February 2021 Box pp34-35).

While acting further on these two levers might alleviate the risk of falling into a liquidity trap, they would not make the allocation of savings in Europe more effective. This can only be achieved by completing the Capital Markets Union and, above all, by incentivizing retail investors to increase their direct or indirect holding in equities. Beyond the planned reviews of the regulatory framework for institutional investors (Solvency II, AIFMD, ELTIF, MiFID II/R, CRR2), access to independent financial advisers and improvements in savers' financial literacy are essential.

Positive tax incentives for retail investors would also help shift savings from bank deposits toward direct or indirect equity holdings if banks remain hesitant to pass negative interest rates to retail depositors. In a post-Covid world, the poor alternative to completing Capital Markets Union would be for EU states to fill the SME equity gap. This would necessitate direct participation financed by taxes. Europe can do better.

Capital Markets Union is vital to the economic recovery. It can help avoid the liquidity trap and spur investment by providing a better return on savings.

CYRIL ROUX

Deputy Chief Executive Officer, Groupama

Lighter capital requirements would allow European insurers to provide capital to the economy

European insurance regulation is not primarily designed to nurture the role these institutional investors can play in financing the European economy. The primary objective of regulation weighing on European insurers is to protect policyholders, from a twin prudential and consumer perspective. The detrimental effect of this regulation on investment capacity is recognized, but as a side-effect.

Furthermore, whenever a thought is given to the macroeconomic import of the insurance sector as a whole by EU institutions, it isn't primarily to address its investment capacity, thereby counterbalancing the aforementioned detrimental effects of microprudential regulation, but once again rather to address the risk the sector as a whole might pose to the economy by adding a further layer of so-called systemic regulation, thereby aggravating the investment disincentives already built in Solvency 2.

There wasn't anything foreordained in the unfavorable treatment of equity investments in microprudential regulation. When taking into account the time horizon of insurers as going concerns, the schedule of their cash flows and the structure of their liabilities, it is clear that a balanced portfolio comprising a sizable portion of well diversified equity investments is a better match than the current mix of their assets, which is massively overweight in fixed income. However, once the decision has been made instead to devise capital requirements on the basis of a mistaken one-year horizon, there is no escaping the fact that equity values can drop a lot in an accounting year, and thus to require a larger amount of capital for investing in equity rather than in debt instruments, notwithstanding their higher correlation and their lower rate of return.

It is unfortunately likely that the revision of Solvency 2 will go even further in turning insurers away from equity instruments. The sharpness of the drop of the interest curve in the recent years well below zero percent and the manifest flaws in the design of the standard formula has brought EIOPA to promote a large increase in the capital charge for fixed income instruments. A cursory view would welcome a reduction in the gap between regulatory capital requirements for equity and debt instruments; it would seem to reduce the disincentive to invest in equity.

> A set of capital charges reducing the overall solvency ratios of the insurance sector will bring insurers to reduce their investment in equities.

A plurality of governments sought for this reason to reduce the regulatory gap between instruments in the revision of the delegated Act by lowering the capital charge for some equities. However, this approach is mistaken and will not bring about the desired outcome. What counts, first and foremost, is the absolute level of solvency ratios. A set of capital charges reducing the overall solvency ratios of the insurance sector will bring insurers to reduce their investment in equities, even if the specific capital requirement in equity is lowered and the capital requirement for fixed income instruments is increased.

The French government has given much thought to the investment role of insurers for years and seeks to address it in part by creating a sizable pot of hybrid instruments. French insurers would invest in diversified funds of hybrid loans extended to French SMEs; these funds would benefit from a first loss guarantee from the French government, so as to apportion the risk between the issuer, the underwriter, the investor and the taxpayer. Depending on the quality of the underlying credits, the interest rate charged, the attachment point of the public guarantee and the diversification of the funds, these funds might help the national economy while providing a satisfactory risk-return profile to their institutional investors or to the life policyholders as ultimate beneficiaries.

However, the regulatory treatment is yet to be known, and the misalignment of interest between originators, which may own other exposures in the capital structure, and investors makes the structure a complex proposition. Although large in absolute terms, the overall pot of hybrid loans would be around 1 percent of life insurance policyholders funds. Hence, reducing overall capital solvency requirements remains key for unlocking the investment capacity of the European insurance sector.

2

FINANCIAL RISKS AND STABILITY CHALLENGES

ISSUES AT STAKE

The Covid-19 pandemic, and its impact on macroeconomic prospects as well as sovereign, corporate and household balance sheets, continue to dominate the outlook for EU financial stability. Near-term financial stability risks are contained by massive monetary, fiscal, regulatory and supervisory support. However, lasting very low interest rates and actions taken during the pandemic may generate further financial vulnerabilities related in particular to stretched valuations and levels of indebtedness never reached before in peacetime.

Liquidity issues experienced by some open-ended investment funds in March-April 2020 have moreover revived the debate about fund liquidity and more generally about the resilience of non-bank financial intermediation (NBFI), although the sector generally demonstrated resilience during this period in Europe. Further liquidity management rules and tools are being considered together with a reinforcement of the macro-prudential toolkit.

Alongside financial stability challenges, further reducing money laundering and better countering terrorism financing in the EU require completing the deep redesign of the related EU regulatory and supervisory framework that has been initiated.

KEY FINANCIAL SECTOR VULNERABILITIES

FRANCESCO MAZZAFERRO

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

Financial stability implications of Covid-19 support measures

During the first phase of the pandemic a liquidity crisis was avoided, and the financial system continued to function. Up to one-third of new bank lending to companies has been subject to crisis-related fiscal measures, and the prompt action taken by governments has been essential to mitigate the impact of the crisis on households and firms. The financial system has benefited from fiscal support programmes as well as from monetary policy. Moreover, a flexible approach within the existing regulatory frameworks has supported these measures, also by temporarily relaxing some bank balance sheets constraints. Overall, spillovers from the real economy to the financial system have so far been contained.

Differences in fiscal measures reflect, to a large extent, different exposures to the pandemic. Countries hit harder by the pandemic tend to have larger programmes with greater uptake, while countries with a higher share of employment in vulnerable sectors rely more on direct grants. The uptake of moratoria is positively correlated with the pre-crisis debt levels of non-financial corporations and households. Macroprudential authorities reported fiscal support packages related to the COVID-19 pandemic of around 14% of member countries' combined GDP (more than €2,400 billion) to the European Systemic Risk Board (ESRB).

The packages include public guarantees on loans, public loans, direct grants and tax measures. By September 2020, the reported uptake of these programmes was roughly 4% of member countries' combined GDP. In addition, around 5% of banks' total loans were subject to moratoria.

Authorities need to carefully manage the trade-offs related to the duration of the support measures.

The longer the crisis lasts and the weaker the economic recovery, the greater the risk that liquidity problems turn into solvency issues and losses in the non-financial sector spill over into the financial sector. During this phase of the pandemic, authorities should focus on (i) targeting fiscal measures to the most affected sectors, (ii) monitoring private debt sustainability, given that some of the measures increase the indebtedness of borrowers, (iii) preparing for a scenario of increased distress in the corporate sector by promptly addressing potential administrative constraints with regard to dealing with non-performing loans and restructuring and insolvency processes, (iv) enhancing financial institutions' balance sheet transparency and upgrading reporting, and (v) coordinating policies across policy areas and countries.

Authorities need to carefully manage the trade-offs related to the duration of the support measures. The scale of potential future solvency problems depends on the evolution of the pandemic, the performance of the different sectors and the appropriateness of policy responses. Withdrawing fiscal support too soon could exacerbate the effects of the economic crisis and put financial stability at risk. Maintaining fiscal support for too long would increase budgetary pressures and could delay structural change and subsequent recovery. Managing this trade-off effectively requires access to timely and reliable information on the state of the economy and the effects of policy measures.

To provide authorities with accurate information, the European Systemic Risk Board is continuously monitoring COVID-19 related fiscal measures and their financial stability implications.[1] It has a broad mandate, which includes the monitoring and prevention of all risks affecting all types of financial intermediaries, markets and infrastructure. It is in this context that the ESRB considers the overall implications – and in particular the cross-border and cross-sectoral implications – of the COVID-19 crisis.

The ESRB is monitoring the measures that are implemented directly through the financial system, such as moratoria, public guarantees on loans and credit insurance, as well as measures of a fiscal nature that could have an impact on the creditworthiness of borrowers, issuers and investors. These include loans by public entities, direct grants, tax measures and public equity participation.

1. See Financial stability implications of support measures to protect the real economy from the COVID-19 pandemic, ESRB, February 2021; and Recommendation of the ESRB on monitoring the financial stability implications of measures of a fiscal nature taken to protect the real economy in response to the COVID-19 pandemic (ESRB/2020/8).

BORIS VUJČIĆ
Governor, Croatian National Bank

Escaping the paradox of thrift in the liquidity trap

The Covid-19 pandemic induced an unpreceded shock to European economies at a time when Europe was already concerned about secular stagnation issues. When the pandemic hit, the conventional monetary policy transmission mechanism was out of order and the monetary policy framework focus was already shifted to unconventional policy measures which expanded the ECB's balance sheet.

While the efficacy of these measures is still being debated, many empirical studies found evidence that reliance on non-standard instruments helped to escape the liquidity trap in the past. It is therefore not surprising that the initial phase of the current crisis was characterized by a massive expansion of the ECB's balance sheet, which helped stabilize financial markets. This, in combination with a strong fiscal response, saved labour markets and businesses from crashing down.

Still, the ECB's success during the first wave of the pandemic confirmed the side effect of extensive reliance on QE and low interest rates during a prolonged period: much of the monetary policy space was spent without facilitating significant growth in productive investments.

As the Covid-19 pandemic continues to drag down European economies, growing hopes that the recovery is around the corner pose challenges to policymakers.

First, inflation has remained below the medium-term target despite the accommodative monetary policy. Since low inflation may signal lower growth in the future, the pandemic shock has amplified secular stagnation concerns as it pushed core inflation further below the target. Therefore, unresolved low inflation-related issues and QE-related asset price inflation will continue to occupy policymakers in the post-crisis's era.

Countercyclical policies going beyond the short run should not distract investment-enhancing reforms.

Second, lasting ultra-low interest rates have encouraged the growth of public and private indebtedness and the holding of cash without promoting productive investment. Long-run implications of mounting Covid-19 related public debt, which in some countries has accumulated on top of already high indebtedness, are still uncertain. On the one hand, low interest rates support and make high indebtedness less of a concern, while on the other, each in its own right, they pose a risk to financial stability and long-run growth. Sustainability of the QE-indebtedness nexus comes on top of these concerns.

Third, Covid-19 has triggered an unprecedented increase in the savings rate in the EU. This raises worries related to Keynes' paradox of thrift. In such a situation, monetary policy should focus on mitigating precautionary saving motives and fostering investment by reducing uncertainty. While trying to escape the paradox of thrift, it is important to ensure that investment activity is not constrained by banks' tight credit standards.

Not only that investments drive the demand side of the economy, but they also determine the supply side of the economy. The fact that we still cannot be sure about the extent of damage inflicted by Covid-19 on the potential output and growth amplifies the need to foster productive investment.

Finally, although it is hard to answer the old "appropriate policy mix" question which the current crisis has put in front of policymakers, post-crisis recovery calls for a clear commitment to countercyclical policies to mitigate uncertainty and adverse effects of precautionary savings. As some empirical evidence points out that there are limitations to what monetary policy can do on its own in promoting recovery, the fiscal expansion will become an indispensable tool to support demand and to reduce the costs of the pandemic.

Limitations of monetary policy and public indebtedness concerns, which will inevitably emerge when the crisis is over, will make targeted and efficient use of the NextGenerationEU's Recovery and Resilience Facility funds a key instrument to crowd-in investments.

While countercyclical policies may be needed beyond the very short term, they should not divert attention from regulatory and institutional factors which drag on private investments in some countries. In these countries, the priority is not to "let a good crisis go to waste" by implementing investment-enhancing reforms. Without them, the reach of macro policies will likely be very limited.

ROLF STRAUCH

Chief Economist and Member
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The corporate-sovereign-bank nexus and future policy space

While strong national and European policy responses have contained the economic impact of the pandemic, there are spill-over risks from corporates to banks and to sovereigns. Any exit strategy must consider both corporate revenues and debt dynamics.

The pandemic severely affected the corporate sector; many firms saw their revenues collapse while they still needed to pay their bills. This caused severe liquidity shortages with risks of corporate insolvencies, voluntary closures and defaults. While precise estimates are difficult, economic studies suggest a large increase of bankruptcies due to the economic restrictions that were imposed to contain the pandemic.

In response to these challenges, governments supported firms' liquidity through direct subsidies, tax deferrals, debt moratoria and state loan guarantees. Short-term work schemes enabled workers to keep their jobs while others were supported with unemployment benefits.

EU monetary and fiscal policies complemented these government actions. Together, they considerably reduced the depth of the recession: there has been a high uptake of credit lines by firms to continue operations, default rates have been limited so far and unemployment has been substantially contained.

However, these strong policy responses resulted in a growing corporate and bank dependence on public policy support. This interconnectedness will carry risks when the temporary policy support is phased out.

The pandemic has exhausted firms' own reserves and capital, and the necessary bank lending has resulted in higher levels of indebtedness - backed by explicit and implicit state support. We will likely see corporate defaults and non-performing loans (NPLs) increase with more firms facing solvency problems when the budgetary and regulatory support is phased out.

While a certain increase seems unavoidable, the question is how high it will be and whether viable firms, that would survive without the temporary impact of the pandemic, will also face these challenges.

Any exit strategy must consider both corporate revenues and debt dynamics.

So far, the impact on banks has been limited. Banks entered the pandemic crisis with larger capital buffers than during the financial crisis, and they have also been in a better position to absorb NPLs. Moreover, prudential and monetary policy as well as budgetary measures facilitate the extension of credit to firms during the pandemic crisis. But the expected increase in NPL rates will likely take a toll on banks' profitability and their ability to lend. The challenge is to sustain and phase out support measures in a manner that minimises the impact on viable firms, bank balance sheets and their ability to lend.

These developments in the corporate and banking sectors are occurring against a backdrop of a significant increase in sovereign debt due to the large fiscal expansion. While the government guarantee schemes have not significantly affected fiscal balances so far, the impact will become more sizeable in the coming years as guarantees are called. This will reduce fiscal space, particularly for hard-hit, highly indebted countries. Going forward, this government support, including the guarantee schemes, will therefore have to become more targeted.

Besides the fiscal implications, there is the crucial challenge of ensuring that viable firms as well as new firms have access to additional, new financing as we emerge from the crisis. A comprehensive, gradual and well-sequenced promotion of post-pandemic bank and capital market financing is critical for a strong and sustained recovery. This includes the narrowing of public support schemes to viable firms, restoring transparency, removing forbearance in bank operations and accounting, and remedying any capital shortfalls that may have emerged.

This will not only help protect public finances from further - potentially unsustainable - pressure but will also reinstate the right incentives in the corporate and financial sectors which are essential for private-sector-led growth. In this context, the progress being made towards banking and capital markets union is also very relevant, as this will encourage risk-sharing and financing flows throughout the euro area.

JORDI GUAL
Chairman, CaixaBank

Should the euro area worry about the US overheating?

One of the lessons of 2020 is that problems which many in the world had stopped worrying about can rear up with sudden force. There is a real risk that the overheating of the U.S. economy becomes one of them.

In pre-pandemic times, a low growth – low inflation scenario had led the mainstream circles of economic policymaking to focus on subdued demand problems, anchoring an environment of low interest rate expectations. The initial policy response to the economic crisis of the Covid-19 reinforced these expectations.

Against an unprecedented shock, there was a pressing need for central banks to anchor accommodative financial conditions with major liquidity injections and low interest rates. Economies steadied and most recently they have even managed to adapt to the restrictions that are still needed to contain the pandemic. A sustained recovery is now in sight as the vaccination campaign gathers speed.

China's case aside, the US is set to be one of the first countries to regain pre-pandemic levels of economic activity. Supported by a comparatively fast vaccination campaign, the Fed's accommodative monetary stance, a major fiscal push and a boost from pent-up demand (real disposable personal income managed to grow by an astonishing 6% in 2020), this could happen as soon as mid-2021.

In this context, the fiscal packages approved at end-2020 and in March 2021 (which together amount to ca. 15% of GDP) have led many to warn about a significant risk of overheating in the US. This alarm has been raised before and proved wrong. The scars of a balance sheet recession and a low money multiplier hampered the inflationary pressures on goods and services of the massive monetary expansion in the Great Recession – while price pressures were more visible among real estate and financial assets.

But this time really could be different: the huge fiscal stimulus has shifted much of the potential impact from the private sector balance sheet onto the public sector and a lot of the cash that the Fed has injected has gone directly into people's pockets through fiscal transfers. While there was no doubt that a locked-down economy needed income support, many voices across the political spectrum are warning that doubling down on a stimulus that will be implemented with a recovery well underway poses significant overheating risks in the US.

If a US overheating materializes, global and European financial conditions could be set for a bumpy ride.

A few steps behind, Europe's recovery could benefit from a booming US economy thanks to the positive spillovers on external demand – raising euro area growth and, possibly, nudging up Europe's inflation. The euro depreciation against the dollar would also provide support to European exporters.

At the same time, an overheating US economy could also imply higher interest rates not only in the US but also abroad. Changes in US rates tend to spill over to other economies in a highly synchronous manner. As a matter of fact, Europe has recently imported a bit of the increase in US yields. Overall, positive spillovers from stronger US demand and a weaker euro may outweigh the drag from higher interest rates – more so because the ECB has the firepower and the commitment to keep financial conditions anchored in an accommodative region.

But there are also risks. If a US overheating materializes and inflationary pressures become more persistent, US monetary policy could face an uncomfortable dilemma: stick to the 'low interest rates for long' narrative that has supported markets in the past decade – risking higher inflation and future financial instability – or tighten the policy stance and risk an abrupt readjustment of expectations in financial markets. In any event, no matter the response, global and European financial conditions could be set for a bumpy ride.

ALASTAIR WILSON

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

Enormous policy challenges, but the financial sector is holding firm – for now

Even at the darkest times, there are silver linings. As Europe weathers a humanitarian and economic crisis unprecedented in recent times, policymakers can reflect with relief on the absence – for now at least – of signs of financial instability. And take some credit for that.

The financial system sat at the heart of the global financial crisis – in some cases the proximate source of instability, in others the channel by which it propagated, in all cases an impediment to recovery. The financial system's woes drove and magnified the impact across multiple sectors.

So far, this crisis has been a different story. The European banking sector entered it from a position of relative strength. Capital has been built to levels, and is generally of a quality, well exceeding that prevailing ahead of the last crisis. Liquidity is similarly strong. More broadly, the sound banking system has been accompanied by (and its resilience to some extent reflects) a prompt, proportionate, concerted response from policymakers acting individually and (reasonably) collectively.

Central banks' actions have ensured that banking sectors and sovereigns have retained access to affordable funding. Regulators have taken steps to encourage the flow of credit. National policymakers have launched unprecedented fiscal support. EU agreement on initiatives such as the NGEU will support the recovery and help sustain investor confidence in Europe.

Taken together, the first order impact on the financial sector should be in stark contrast to the global financial crisis. In Moody's view, corporate defaults will remain high through 2021, but the European spec grade default rate is projected to have already peaked at around 5%, well under half that in the prior crisis. And while nonperforming loans will continue to rise through 2022, we do not expect material pressure on bank balance sheets.

> The future is unusuallyuncertain, and risks are to the downside.

The intuition behind this view is strong. Unlike prior crises, this crisis was not the result of longstanding imbalances; it was not at all 'cyclical'. It resulted from an exogenous 'black swan' event. Policymakers have spared little expense to try to contain the resultant economic scarring and to allow economies to return to something approaching normality as quickly as possible.

The inevitable consequence of those actions – higher debt – has fallen largely on the public sector. While household and corporate debt has risen somewhat over the crisis, the largest increase has been in public-sector debt. But with interest rates very low, governments can carry higher debt for longer.

But the future is unusually uncertain and risks are to the downside. The return of growth is dependent on successful rollout of vaccines and avoiding new strains which lead to further lockdowns. A return to pre-pandemic growth levels assumes minimal scarring (e.g., rises in long-term unemployment) and the smooth reallocation of resources from damaged to more productive sectors. Neither is assured.

Europe remains overbanked and the low-rate environment – so essential to managing public debt loads – exacerbates structurally weak profitability. Weak profits and fear of losses may once again hamper banks' ability to support the economic recovery.

Relatively low default forecasts are predicated on a rapid return to health of parts of the economy – for example the SME sector – currently on life support. Even a relatively small increase in defaults in those sectors could undermine weaker banking systems.

And most fundamentally, so much rests on confidence. Confidence that vaccines will work – and be rolled out effectively. That policymakers will (individually and collectively) calibrate the removal of extraordinary monetary and fiscal policy measures without either stoking inflation or choking off recovery. That economies will respond. And, looking ahead, that the crisis will revitalise the fiscal and economic reform effort that had been fast running out of steam as the last decade neared its close.

Because a less rosy narrative is easy to construct, in which lack of confidence impedes the flow of credit to vulnerable sectors, and the flow of capital to more vulnerable sovereigns. That way lies a credit crunch and a debt crisis. And we've been there before.

XAVIER LARNAUDIE-EIFFEL

Deputy General Manager,
CNP Assurances

The combined risk of ultra-low interest rates and too restrictive (future) regulation for life insurers: the economy needs a balanced Solvency 2 review

Life insurers manage their balance sheet over the long term with savings and retirement products representing several trillions of commitments in euros on a European scale. Consumers have shown interest in these offers, especially with the growing aging of the population in Europe. Insurers are therefore committed and continue this management to meet the needs of European citizens over several decades. Based on this time horizon, very low rates are still recent for insurers.

This paradigm shift occurred with the Quantitative Easing of the ECB in 2015 and now the Covid19 crisis reinforces the scenario of low interest rates for long. It seems likely that an accommodative monetary policy will be necessary to overcome this unprecedented crisis further while at the same time it is a challenge for the insurance industry. Ultra low or even negative rates weaken insurers and medium-term profitability as of now solvency is undermined. The 2020 results showed substantial declines in solvency for life insurers, until several dozen points lost over the year due to the decrease in interest rates.

Insurers must adapt and transform their business models to survive. They can no longer offer long-term products combining security, liquidity and yield. It would take time to adapt the offers and its success with customers. In the meantime and under pressure from low interest rates, insurers have already implemented measures in order to seek yield, such as adjusting asset allocation by focusing on riskier and sometimes less liquid assets.

In the medium term, the risk of low interest rates could increase with the 2020 review of Solvency 2. Initially, the calibration of capital requirement in the standard formula did not foresee a risk of negative rates. There is no doubt about the reality of negative rates and the formula has to be adjusted in particular in the computation of the interest rate SCR submodule within the standard formula. However, other items in the calculation should be adapted in order to achieve a balanced review that does not result in a substantial increase in capital requirements. Maintaining the very accommodating monetary policy helps reorient insurers' investments towards equities, unlisted investments or real estate.

The risk of low interest rates could increase with the 2020 review of Solvency 2.

This movement is favorable to the economic recovery at the end of the pandemic crisis. In these conditions, it is necessary that the Solvency 2 review does not penalize this movement. In current EIOPA advice on 2020 Solvency 2 review, there are positive adjustments such as slight reduction of risk margin or simplification of criteria for long-term equities investment qualification. However, these propositions are not sufficient to compensate other very penalizing propositions as interest rate SCR recalibration and the change of methodology for the extrapolation the interest rate used for technical provisions valuations. A balanced review of the prudential framework is essential so that insurers can continue to offer long-term products and be actors in the economic recovery, by promoting the investment of amounts entrusted by policyholders in the economy.

A sudden and disorderly rise in rates after a long period of low rates would also constitute a risk. Large capital losses would expose insurers who may then be unable to meet demand for redemptions, especially since the differential in return to market assets would induce policyholders to invest outside of life insurance. However, there is an opportunity in case of a controlled rise to slight positive levels, stimulating for savings and investment and not dissuasive for its financing.

ANDREAS DOMBRET
Global Senior Advisor,
Oliver Wyman

Monetary policy's powerful role in the wake of the pandemic

2020 is now firmly behind us and the annual financial statements are being finalized. While the balance sheets of most companies have weakened the real consequences of Corona will only appear fully once the fiscal aid measures will have been withdrawn, and only then will a potential zombification become apparent.

The effects of the pandemic are already visible. Several banks have profited in their capital markets business from the increased volatility. Central bank purchase programs and low to negative interest rates have further reduced profitability of banks. The real surprise of the last 12 months, however, was that loan provisions increased much less than most observers had predicted.

The key question is how long this state of limbo can last. At the fundamental level, the evolution of the pandemic and the speed and shape of the economic recovery are the key drivers, both of which cannot be predicted with any certainty. Secondly, the ability of sovereigns to maintain their far-reaching support and the real economies' ability to restart will determine how much of the economic pain can actually be buffered away.

That said, the 2020 financial statements will lead to a widespread deterioration in credit ratings, particularly as almost all businesses will have less equity. This is likely to put considerable pressure on the capital situation of banks. An increase in non-performing loans can be assumed certain, even while estimates vary widely with regard to the extent of such increase. Banks themselves must be quick in providing both the necessary staff and the tools required to deal with a higher number of company failures. A certain standardization of restructuring approaches is helpful. Banks should also make full use of preventive restructuring.

Fiscal policy needs to carry most of the burden, while monetary policy needs to be targeted more to aid recovery and growth.

In addition, market-based mechanisms should be established to handle NPLs. This includes functioning secondary markets and a uniform framework for securitization rules - very much in the spirit of the European Capital Markets Union. Mutualising credit risk across national borders, on the other hand, is still associated with far too high political and economic side effects.

Regulators play a key role. Warnings of supervisors recommending banks to build sufficient buffers and adequate provisions have been plentiful. Regulators will need to carefully consider when and how to expire the regulatory relief granted on the assumption of a short-term liquidity crisis, which is rather difficult to withdraw once balance sheets have deteriorated.

The big open issue, however, is the role of monetary policy. The low interest environment has without any doubt been a significant factor keeping economies afloat. But together with the strong fiscal stimulus, which monetary policy has made possible considering the significant debt burden of many countries, it carries two important risks:

- First, the funding glut may mask a deterioration in asset quality at the level of the individual borrower as well as on the systemic level. This smoke screen may persuade investors and banks to maintain, or even expand, their exposures for too long, thereby preventing a more proactive and timely management of their position with deteriorated credit quality.

- Second, the risk of a sharp and sudden correction in interest rates has risen as evidenced by the recent turbulences in US treasuries. In the worst of cases, a reversal of the current environment could lead to a strongly correlated market environment in which the prices of equities, bonds and real estate assets all experience downward pressures simultaneously. In such a scenario NPLs would jump considerably, adding to the already existing problems. The risk of such a dynamic might become a constraint for monetary policy, severely limiting policy space in case inflation were to pick up markedly. Fiscal policy therefore needs to carry most of the burden, and monetary policy needs to be targeted more to aid recovery and growth.

Progress on vaccination shows a light at the end of the unexpectedly long tunnel. But to avoid negative consequences of the pandemic and to enable the system to work properly through the inevitable rising amount of bad debt all parts of the financial system will need to prepare, need to remain vigilant and proactive.

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LESSONS FROM COVID ON NON-BANK FINANCIAL INSTITUTION (NBFI) RISKS

ROBERT OPHÈLE

Chair, Autorité des Marchés Financiers (AMF)

NBFI put to the test by March/April 2020 events: the issue of money market funds

Open ended funds were buffeted by the financial consequences of the Covid-19 pandemic, both on the asset side (drop in valuations, high volatility, derivatives positions undergoing significant margin calls...) and on the liability side (waves of redemptions). All of which constituted a live test of their ability to weather problems of valuation and of liquidity. Amid these trials and tribulations, money market funds (MMF) came under a specific pressure: they recorded the largest redemptions and in some cases subscriptions while short-end debt markets, in which they invest, were themselves severely unsettled.

Bank sponsors (Europe aside) and above all central banks intervened to steady the short-term debt sector, which, although no accident was recorded, stood out as a major source of risk to global financial stability. Indeed, MMF are one of the main investors in these instruments and thus participate directly in funding the real economy, absorbing a major part of short-term funding of financial, non-financial and public-sector institutions, whilst enabling corporate treasurers, institutional investors and investment funds to place their excess treasury or cash.

This episode was striking: the MMF sector was one of the epicentres of the 2008 financial crisis and, in order to reduce the risks to financial stability that are associated with their functioning, deep reforms were undertaken in all countries. Actually, the quality of assets held in their portfolio, notably their credit quality, did not raise any concerns in March or April.

The 2020 crisis was a liquidity crisis caused by exogenous factors and it leads us to raise the question of the need for further reform of this ecosystem and, ultimately, the legitimacy of bank disintermediation for funds that are meant to be highly liquid and risk free, that are considered as a substitute for cash and besides, fall within the scope of money supply in many countries when held by resident non-financial agents.

The framework within which money market funds operate must be reviewed and clarified.

Analysis of this episode however highlights the broad diversity of situations, notably when it comes to types of MMF. In the US, said Prime MMF invested in corporate paper recorded large redemptions while inflows into MMFs invested in public paper (Government & Treasury MMF) were nearly eight-fold higher. In Europe, USD & GBP-denominated low volatility MMF (LVNAV), registered in Ireland and Luxembourg and mainly held by non-Eurozone residents, underwent large outflows, in these same countries offset by inflows into USD-denominated constant price public debt MMF (CNAV). And EUR-denominated MMF valued at their market price (VNAV), the greater part of which are registered in France, underwent severe outflows which were more sustained than with other types of MMF overall while bank deposits of their historical holders tended to grow.

In fact, amid a particularly uncertain economic environment with the closure of certain market segments, MMF holders reacted according to a given fund's characteristics its asset profile and associated regulatory constraints. Somewhat unexpectedly some of these regulatory constraints could have spurred withdrawals and, in the case of EUR-denominated MMF, measures taken by the European Central Bank, targeting first the bond market, managed only belatedly to steady the situation.

This should lead, at least in Europe, to a review of the regulation and supervision of MMF and to find ways of enhancing the liquidity of the underlying money market, as well as to a clarification of the central bank's role with regard to these funds that are considered as monetary financial institutions.

At the same time, we must maintain the needs MMF fulfil: for an investor, holding a better yielding and safer liquid asset (more diversified than a straight bank deposit); for a financed entity, finding cheaper and more flexible funding via the short-term market as opposed to bank credit; for the bond market, smoothing its functioning by offering counterparties for long-end securities nearing to maturity.

Policy options currently considered are diverse and some of them very extreme; we should find the right balance in our regulatory stance in order to increase the robustness of MMFs without losing sight of their beneficial purpose.

FRANCESCO MAZZAFERRO

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

Liquidity mismatches in the NBFI sector should be addressed

The spread of the pandemic and the lockdown measures imposed to contain Covid-19 triggered an adverse shock to the global economy and large falls in asset prices. Markets reacted by substantially repricing risk, as investors fled towards safe and highly liquid assets. Assets in the non-bank sectors fell by EUR 1.2 trillion (3.3%) in the first quarter of 2020, mainly due to large valuation losses resulting from asset price falls.

Outflows rose and contributed to the fall in assets under management across a wide range of fund types. Redemption flows appeared to largely reflect the increased risk associated with the underlying assets and/or the demand for cash to meet short-term liquidity needs. Liquidity mismatches in certain types of open-ended investment funds amplified market volatility in late February and early March.[1]

The sudden rise in volatility led to a large increase in variation margin calls, putting additional pressure on some investment funds' liquidity positions. Derivatives data reported under the European Market Infrastructure Regulation (EMIR) show that daily variation margin calls on euro area investment funds rose fivefold, from around EUR 2 billion in the first half of February to over EUR 10 billion in the second half of March.

For 27% of the funds for which EMIR data are available, daily variation margins exceeded their pre-pandemic cash buffers on at least one day during the period of market turmoil.[2]

A number of EU investment funds, particularly high-yield corporate bond funds and real estate funds, used liquidity management tools to help address outflows and valuation uncertainties. Some funds used quantity-based measures, such as suspensions of redemptions or redemption gates, while other funds used price-based tools, such as swing pricing or redemption fees, which impose the liquidity cost on the redeeming investors.

In response to these developments, the European Systemic Risk Board (ESRB) adopted a Recommendation to ESMA to coordinate a supervisory engagement with funds that have significant exposures to corporate debt and real estate assets.[3] In its response to the ESRB, ESMA noted that only a few funds have adjusted their liquidity set-up according to the pursued investment strategy and in light of liquidity strains they encountered.[4]

Liquidity management tools help address outflows and valuation uncertainties.

The vulnerabilities highlighted by the Covid-19 pandemic are not new and need to be addressed. In 2017, the ESRB issued a recommendation to ESMA and the European Commission on liquidity and leverage risks in investment funds.[5]

The most important messages were: (i) the development of a common set of liquidity management tools for investment funds across EU jurisdictions, (ii) further setting out the role of ESMA when authorities use their power to suspend redemptions, (iii) measures to limit the extent to which the use of liquidity transformation in open-ended alternative investment funds could contribute to systemic risks, and (iv) enhancements of data reporting requirements for all type of funds.

Another market that came under stress during March 2020 amid substantial outflows from money market funds (MMFs) is the short-term debt funding market. In case of market stress, MMFs may be reliant on banks, corporates or central banks to purchase their commercial paper back in order to raise cash and accommodate heightened redemption flows. This materialised during March 2020.

It is not the first time that MMFs contributed to the propagation and amplification of liquidity strains. In 2013, shortly after its creation, the ESRB had sent a recommendation to the European Commission on MMFs, requesting that Union legislation would require MMF to have a fluctuating net asset value and that stricter liquidity requirements be introduced. Despite the introduction of the Money Market Fund Regulation in 2017, which enhanced the regulatory regime for MMFs, vulnerabilities remain within MMFs and need to be addressed.

1. See EU Non-bank Financial Intermediation Risk Monitor 2020, ESRB, Oct 2020.
2. See Liquidity risks arising from margin calls, ESRB, Jun 2020.
3. See Recommendation of the ESRB on liquidity risks in investment funds (ESRB/2020/4).
4. See Report on the Recommendation of the ESRB on liquidity risk in investment funds, ESMA, Nov 2020.
5. See Recommendation of the ESRB on liquidity and leverage risks in investment funds (ESRB/2017/6).

NAUSICAA DELFAS

Executive Director of International, Financial Conduct Authority (FCA)

How regulators can address financial stability concerns in non-bank financial intermediation (NBFI)

Despite the scale of the Covid-19 pandemic and the depth of the economic shock it has triggered, financial markets have proved largely resilient to significant volatility and unprecedented operational strains. Market participants were able to switch on business continuity plans and transition to remote working, while critical financial market infrastructures were able to withstand all-time highs in trading activity. Nonetheless, the period of extreme market volatility in the Spring of last year did see dislocations in some parts of the market, and these need to be addressed.

The response to the Covid market stress has been a global effort, spearheaded by the Financial Stability Board (FSB) and coordinated across other bodies including IOSCO and the IAIS. Working with our counterparts in the UK, the EU and globally, it became quickly apparent that the risks we had seen were complex and intertwined, and that developing an adequate policy response would not be straightforward. The FSB's 'holistic review of the March market turmoil', presented to the G20 in October 2020 is the outcome of these initial deliberations. It sets out an ambitious roadmap for analysis and assessment, both of specific markets or actors, as well as the links that connect them. Considering global regulatory issues in a joined-up manner such as this is precisely what the FSB was established to do after the last financial crisis.

A key lesson learned from this crisis must therefore be to reaffirm the value of a global regulatory architecture that reflects the globally interconnected nature of financial markets. While a holistic approach is more complex -and can appear slow from the outside- the consensus remains that a piecemeal approach simply won't work.

This is particularly the case when considering vulnerabilities in non-bank financial intermediation (NBFI). This has grown markedly over recent years and now shoulders much of the risk previously held by banks, prior to global banking reforms in the wake of the 2008 crisis.

> The financial system has proved to be a reliable and resilient source of funding [..] and we must ensure it remains able to be so in the future.

To consider the resilience of NBFI as a whole, therefore, some of the key areas we are working on at the FSB and other bodies are:

- We are looking closely at Money market funds (MMFs). Some funds experienced significant liquidity pressures over the Spring, in particular prime MMFs in the United States. Given the key role MMFs play in funding and managing the cash of corporates across the real economy, our priority is to ensure that liquidity risk borne by these funds is both well managed and adequately understood by investors.
- We are working to shed light on the behaviour of the broker-dealers active in short term funding markets, what factors may have constrained their ability or willingness to intermediate, and the knock-on effects of this for MMFs.
- We want to further deepen our understanding of the redemption pressures and liquidity risk management practices in open-ended funds. Discussions about liquidity mismatch, and the tools to manage this, pre-date the COVID crisis, but have found a new urgency in its wake. In the UK, we have already begun work on potential rule changes for property funds, which represent the largest portion of funds (by Assets under Management) that suspended trading during March 2020.
- Liquidity in corporate bond markets over the course of the market stress, and in the wake of central bank interventions, is an important consideration. We want to understand trends in the liquidity, structure, and resilience of these markets as a core part of well-functioning capital markets.
- Finally, in a joint effort across relevant global standard setting bodies, we are analysing margining practices and the extent to which elevated margin calls in cleared and Over-the-Counter markets may in turn have transmitted liquidity pressures to the rest of the system.

All of this work will allow us to address the fundamental questions of systemic resilience, and if we see possible vulnerabilities, undertake reforms where needed. We neither can, nor should, seek to eliminate risk entirely from the financial system. Neither should we take steps which shift risk from one part of the system to another without due consideration of the consequences, in particular on investors and the critical role that non-bank financial actors play in funding the real economy and the recovery from this crisis.

The financial system has proved to be a reliable and resilient channel for funding throughout the Covid-19 pandemic to date, and we must ensure it remains able to be so in the future.

LUIGI FEDERICO SIGNORINI

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

Towards a more resilient NBFI sector

The resilience of European investment funds, including money market funds (MMFs), was tested by the large and widespread imbalances in the demand and supply of liquidity and the repricing of risk caused by the economic impact of the Covid-19 pandemic. Between 20 February and 20 March 2020, several funds investing in illiquid assets experienced severe outflows, sometimes in excess of liquidity buffers; cumulative redemptions from euro-area high-yield corporate bond funds reached 10 per cent of their assets under management (AUM). Outflows from MMFs in the central week of March reached 5 per cent of their AUM. Redemptions stabilised only after unprecedented central bank interventions that alleviated market stress.

Outflows from open-ended funds and MMFs were driven primarily by institutional investors. Insurance corporations and pension funds invest largely in MMFs primarily for liquidity management purposes. Distress in other parts of the non-bank financial intermediation (NBFI) sector spilled over to the investment funds' sector, amplifying liquidity strains. Recent research shows that institutional funds tend to act procyclically, by actively investing in higher yielding, longer-duration and lower-rated assets as spreads compress, ultimately affecting asset price volatility. In some cases, redemptions from institutional investors occurred due to the need to cover exceptionally high margin calls resulting from heightened market volatility.

In other cases, liquidity pressures on institutional investors were associated with a significant mismatch between assets and liabilities; this is the case, for instance, of some unit-linked policies, where insurance companies hold assets whose liquidity profile does not necessarily match with the daily redemptions frequency offered to policyholders.

An increased need for cash amplified both intermediaries' demand for highly liquid assets and the potential for forced asset sales by investment funds. Interconnections among non-bank financial intermediaries' balance sheets also contributed to propagating and amplifying the stress.

Non-bank financial institutions experienced broadly similar episodes of stress. In general, liquidity risks in the NBFI sector contributed to the international transmission of the financial shock induced by the pandemic. The "dash for cash" episode in March 2020, for instance, led to severe strains in the dollar funding market, thus affecting entities that borrow in US dollars worldwide.

The G20 Italian Presidency will lay out the stepping stones of a macroprudential approach to NBFI regulation.

The increasing role of the NBFI sector in financing the economy and the vulnerabilities seen last year renewed a policy debate on the adequacy of the regulatory and supervisory framework for these intermediaries. Given the global dimension of the issues, the multilateral setting provided by the Financial Stability Board (FSB) and the global Standard Setting Bodies is most suited to adopt a common approach aimed at increasing the effectiveness of the framework and preventing fragmentation.

Last December, Italy assumed the Presidency of the G20, with a commitment to the full implementation of the FSB workplan on NBFI. Building upon the FSB "holistic review", the work program includes a number of key deliverables to be submitted to the G20 later this year, including a report on policy options to enhance MMFs' resilience, as well as analytical work on vulnerabilities in open-ended funds that invest in illiquid assets and on potential procyclicality issues on margin calls.

The G20 Italian Presidency will lay out the stepping stones of a macroprudential approach to NBFI regulation, with the aim of contrasting the build-up of risk in periods of market exuberance and reducing the probability of central bank interventions.

GERRY CROSS

Director Financial Regulation – Policy and Risk, Central Bank of Ireland

Well calibrated policy responses required to mitigate potential vulnerabilities

At the onset of the Covid-19 shock, as financial markets turbulence, a 'flight to safety' and heightened demand for cash generally swept through a range of markets, investment funds experienced a sharp increase in redemptions and challenges in liquidity management. At an individual level, the vast majority of funds managed to meet investor redemption requests. However, this needs to be seen in the context of unprecedented central bank interventions that played a key role in restoring market functioning.

Of particular concern to regulatory authorities were sector-wide dynamics evident during the period of stress. The potential for collective behaviour of funds to add to market-wide pressures in periods of stress requires regulatory change.

As an integrated central bank, prudential, conduct and AML/CFT regulator, macroprudential and resolution authority, the Central Bank of Ireland approaches regulation of the funds sector in the light of our statutory mandates of safeguarding monetary and financial stability, securing the proper and effective regulation of financial service providers and markets, and ensuring that the best interests of investors are protected. Following the COVID shock, three areas require particular scrutiny in our view.

As the Covid crisis began to unfold, Money Market Funds (MMFs) saw a substantial increase in redemptions and a deterioration in the liquidity of their assets. Redemptions were concentrated in MMFs with investments in private sector debt and this led to liquidity management challenges for those MMFs. While all MMFs managed to meet redemption requests, had any been forced to suspend redemptions or fail to meet key expectations, liquidity stresses could have spilled over to other parts of the financial system.

The interconnectedness of MMFs with other parts of the financial system – including banks and other non-banks – means their resilience in periods of stress can be systemically important. Regulatory authorities are currently examining ways to strengthen MMF resilience in light of the lessons learned.

Effective liquidity management in open-ended investment funds, particularly those which invest in less liquid assets, is also an area of particular focus at present.

Funds dynamics contribute to market-wide pressures in times of stress and requires regulatory change.

Such funds, as evidenced during the Covid-19 shock, are particularly susceptible to the risk of large redemption requests during periods of market stress and may have to sell assets quickly in order to meet such redemption requests. The redemption patterns observed during March and April 2020 in such parts of the funds sector are consistent with the operation of first-mover advantage dynamics.

There is a need to develop additional measures to address this issue. This could include measures to ensure that the costs associated with such redemptions, including increased liquidity premia in times of stress, are fully borne by the redeeming investors.

Finally, there is a need to enhance the macro-prudential framework for investment funds. The lack of a complete and operational macro-prudential framework for funds in Europe and internationally remains a key gap which is correctly gaining more attention following the recent market events.

Market-based finance, and the funds sector in particular, provides a valuable alternative to bank financing, supporting economic activity. However, like all forms of financial intermediation, they may also contribute to the build-up of financial vulnerabilities. It is important following the lessons learned from Covid shock that well calibrated policy responses are introduced in order to mitigate such vulnerabilities.

JOANNA COUND

Managing Director,
Global Public Policy,
BlackRock

A lesson from Covid-19: liquidity risk management is central to open-ended funds

March 2020 saw market liquidity deteriorate significantly – as many companies, banks, and investors looked to cut their risk and raise cash – and an extreme stress test of the previous decade's reforms. While UCITS and AIF outflows rose sharply to relative levels last seen during the Great Financial Crisis, they remained manageable, and the overwhelming majority of funds met all redemptions.

Strong fund liquidity management was instrumental in achieving this, and managers deployed tools ranging from swing pricing to suspending redemptions to protect their investors. Their availability was thanks to efforts post-2008 by IOSCO, ESMA, regional and national regulators to raise the bar for liquidity risk management. By 2020 best practises had been incorporated into many fund rulebooks, building on existing EU rules – for example in the UCITS Directive – to manage liquidity risk.

Funds suspensions were rare in March 2020, and mainly a response to idiosyncratic price uncertainty in regional real estate and bond markets: Fitch estimate that 0.11% of global fund assets were subject to suspensions during the turbulence; ESMA estimate 0.8% of EU-domiciled corporate bond UCITS were. Use of swing pricing – a mechanism for allocating a variable premium or discount to transactions in or out of funds – was more prevalent, and meant redeeming investors paid the higher cost of accessing liquidity. And while the primary purpose of swing pricing is to protect fund investors, from a systemic perspective it incentivised shareholders to remain invested; or spread redemptions over time.

To fully realise these benefits going forwards, use of swing pricing or similar 'anti-dilution' measures must be comprehensive. ESMA data on last year's turbulence shows swing pricing was used by many but not all EU funds. We strongly support extending implementation of the full liquidity risk management toolkit in all EU member states. This should also be accompanied by efforts to encourage the practical adoption of the tools by all fund managers.

> We strongly support extending implementation of the full liquidity risk management toolkit in all EU member states.

An alternative suggestion – requiring funds to hold more 'High Quality Liquid Assets' – misunderstands fund liquidity. The notion that funds went into March 2020 with depleted 'liquidity buffers' incorrectly applies a bank regulation concept – HQLA – to asset management. Funds aim to meet redemptions while maintaining a risk-constant position over time, not by tapping cash buffers. In challenging market conditions, even high yield bonds could be sold to meet redemptions.

Asset liquidity, and fund liquidity in turn, vary with market conditions and position size. Assumptions around both are continuously and rigorously tested by fund managers as a matter of course and in line with regulation (indeed in March 2020 EU fund managers were mid-way through implementing ESMA's new liquidity stress test standards for UCITS and AIFs).

Macroprudential policy measures would be at best ineffective, and at worst pro-cyclical. Open-ended funds only hold a portion of assets: McKinsey data shows asset managers accounted for 27% of global financial assets by end-2019, of which funds are only a sub-section. Attempts to manage system-wide conditions via macroprudential controls on funds would therefore be ineffective, missing most assets.

And their effects may instead be counter-productive: some recommend mandatory cash or liquid asset buffers for funds, to be drawn down during stresses. Notwithstanding the performance drag, a buffer insufficient to meet redemptions will likely leave a portfolio more concentrated in risk assets to meet any subsequent outflows.

Achieving system-wide resilience should follow a three-pronged approach.

First: make individual products and activities as robust as possible, for example by giving all funds the full liquidity management toolkit.

Second: ensure banks can play their role as market intermediaries, setting prudential limits that strike a balance between safety and smooth market operations.

Third: evolve market structure to reflect bank balance sheet constraints: many fixed income markets would benefit from modernisation – with more use of central clearing and electronic all-to-all trading venues – while securing quality, comprehensive, real-time data for all asset classes through a European consolidated tape would improve transparency and liquidity.

DENIS GEPP

Senior Vice President,
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The Global Health Crisis – A real-life stress test of MMF reform

The market stresses experienced in March/April of 2020 were the result of an unprecedented Global Health Crisis the likes of which has not been seen since the Spanish flu over a hundred years earlier. It was not a financial crisis. The stresses experienced were the predictable and obvious result of chaotic and uncoordinated responses of governments around the world and their affirmative decisions to shut-down global economies.

The disruptions were not caused by structural vulnerabilities in money market funds (MMFs). Conditions in the real world affected the markets, not the other way around. And the market impacts were felt first in equities and commodities, later in bond markets, then in money markets and finally in MMFs.

The only appropriate comparison of the Health Crisis with the 2007/09 Financial Crisis is the perpetuation of a false narrative that MMFs caused or exacerbated each crisis. Accepting this false narrative blindly allows policy makers to ignore the more complicated issues that need to be addressed to ensure that financial markets operate in a crisis. In a crisis, the implementation of emergency liquidity assistance to financial institutions is a core responsibility of central banks. They are the lenders of last resort. They serve this role, not to preserve MMFs, but to preserve liquidity and stability across markets. Whether central banks serve in this capacity once in 12 years, twice in 12 years, or 3 times in 100 is of no consequence – it is the role they are intended to serve when markets are placed under extreme pressure.

The real problem to be addressed is not MMFs, but the systemic illiquidity and seizing up of markets that are essential to financial stability. Many regulators fail to distinguish between systemic liquidity events and systemic credit events. This distinction is essential for understanding today's reform debate.

Global regulators are currently focused on potential MMF reforms included in the President's Working Group (PWG) Report. Most of the policy measures discussed in this report have been previously considered and rejected because they would negatively impact the viability of MMFs to the detriment of investors, issuers and the capital markets generally.

The real problem to be addressed is not MMFs, but the systemic illiquidity and seizing up of markets...

However, one of the proposals does address the key issue which impacted MMFs in the Health Crisis – and that is the decoupling of the weekly liquid asset requirement from a necessity to consider the imposition of a fee or gate. This bright line trigger was adopted by global regulators, despite industry warnings, and served as a catalyst for investor redemptions. It should be removed.

We do, however, believe that a MMF's board should be permitted to impose liquidity fees or redemption gates when doing so is in the best interest of the fund and its investors to prevent unfair dilution, without reference to any specific level of liquidity. Additionally, we believe requirements to maintain minimum levels of liquidity and knowledge of one's investor base should remain, as they are appropriate and necessary safeguards for investors. The benefits of such requirements were evident throughout the Health Crisis.

The experience of MMFs throughout the Health Crisis should be applauded, as despite frozen markets and delayed central bank action, all MMFs were able to fully meet investor redemption requests. The Health Crisis was a real-life stress test of the global MMF reforms adopted after the Financial Crisis and demonstrated that MMFs were not only resilient, but that are instrumental to investors and markets and should be protected – not eliminated.

MMFs have been one of the most successful market innovations over the past 50 years. They improve market efficiency and stimulate competition by providing lower cost borrowing for issuers and higher returns for shareholders.

Since 1985, MMFs alone have provided over Eur 500 billion more in incremental returns to investors than bank deposit accounts and over this whole period only two prime MMFs have "broken the buck" at no cost to taxpayers. Meanwhile thousands of banks have failed, costing depositors and taxpayers Eur billions.

TIMOTHY CUDDIHY

Managing Director,
Financial Risk Management,
The Depository Trust & Clearing Corporation (DTCC)

Balancing act: maximizing potential, minimizing risk of NBFIs

Non-bank financial institutions (NBFIs) exist somewhat outside the traditional banking system, but they can play an important market intermediation role. NBFIs support markets, as they can broaden the availability of investment options, enabling risk diversification and financial innovation. These types of firms are often more nimble than traditional avenues and can provide a faster source of credit and liquidity capacity.

Because of these key benefits, there has been significant growth in this sector over the past decade as firms navigate environmental factors including changes in bank regulation; capital and liquidity constraints in traditional financing; strong capital flows into alternative venues that seek higher returns; technology advancements including digital assets; and better addressing areas of the financial system that are under-served.

In fact, two market events - the global financial crisis and the volatility spurred by the COVID-19 pandemic in 2020 - reinforced just how systemically important NBFIs have become. After all, NBFIs form an important part of the bank credit intermediation chain, connecting with counterparties around the world. But with these connections and the increasingly prominent role of NBFIs can also elevate risk.

Managing risks in a growing egment

One area of growing risk is around the connections that exist between NBFIs and other firms. Interconnectedness risk has become a growing area of focus within the industry, as firms look more closely at the NBFI activity, connections and potential contagion risks that exist between organizations.

Policymakers are also exploring this important area as they work to identify how to maximize the benefits of NBFIs while minimizing systemic risks. At the same time, NBFIs have different requirements for liquidity and capital buffers than banks. In the U.S., NBFIs may build up leverage outside the regulated banking system, which can amplify shocks during market or firm-specific dislocations. The key question becomes: how can we further protect this growing segment of the market, as they deliver increasingly critical services to the industry? We believe the answer lies in the increased resiliency and transparency.

> How can we further protect this growing segment of the market - the answer lies in the increased resiliency and transparency.

The value of CCPs

Introducing central counterparties (CCPs) and trade repositories – proven, best practice utilities – to the NBFI sector could deliver the same major benefits that they bring to traditional financial sectors, including transparency, risk mitigation, and standardization. Both central counterparties and trade repositories play a role in aggregating trade and counterparty information.

While central counterparties are focused on protecting market stability and maximizing value for the industry through standardization and efforts to reduce risk, trade reporting enables regulators to assess traditional banking broadly, including concentration exposures, for example in the OTC derivatives space.

Most recently, CCPs played key roles in helping the industry navigate the volumes and volatility as a result of the pandemic, with many key stakeholders across the industry stating that market stability was enhanced by central clearing. Given the increasingly systemic importance of CCPs, future international policy will likely focus on the evolving role of central clearing in order to address risks that fall squarely in the NBFI sector, including risks to financial stability, the interactions between banks and non-banks, and the resilience of NBFIs.

The way forward

While NBFIs offer major benefits to the industry, including their ability to provide liquidity, they also come with their own set of unique challenges and risks that could have far-reaching impacts. The use of an intermediary such as a central clearing counterparty and services like trade reporting utilities could provide the standardization, transparency and risk-reduction benefits that are greatly needed in the NBFI sector, while better supporting the industry's growth and enabling it to continue reaping the benefits of all it has to offer.

EU ANTI MONEY LAUNDERING (AML) POLICY REDESIGN

ALEXANDRA JOUR-SCHROEDER

Deputy Director-General,
DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Anti-money laundering and countering financing of terrorism – the way forward at EU level

Money laundering and terrorism financing (ML/TF) continue to pose a serious threat to the integrity of the EU economy and financial system and the security of our citizens. According to Europol around 1% of the EU's annual Gross Domestic Product is 'detected as being involved in suspect financial activity'. Despite progress made in recent years, further reforms at EU level are needed to address remaining shortcomings; these were identified in a package of Commission reports in July 2019 based around a Communication on better implementation of EU AML/CFT rules.

The EU Action Plan on Anti-money laundering and countering financing of terrorism (AML/CFT) of May 2020 sets an ambitious agenda for a comprehensive AML/CFT policy at Union level with six pillars for future action:

1. Ensuring effective implementation of the existing AML/CFT framework in the EU;
2. Establishing an EU single rulebook on AML/CFT;
3. Bringing about EU-level AML/CFT supervision;
4. Establishing a support and cooperation mechanism for FIUs;
5. Enforcing EU-level criminal law provisions and improving information exchange;
6. Strengthening the international dimension of the EU AML/CFT framework.

The European Commission will shortly issue legislative proposals related to some of these pillars - the single rulebook, a support and cooperation mechanism for FIUs, and EU-level supervision, which will then be negotiated with the European Parliament and the Council. There is strong political support in all EU institutions for a more stringent EU framework that should allow moving forward quickly.

The single rulebook´s objective is to achieve more harmonisation in key areas of the AML/CFT legal framework (obliged entities, customer due diligence, beneficial ownership and sanctions), and be directly applicable, in the form of a regulation. Other provisions, for example concerning national supervisors and FIUs, will remain in a Directive. A proposal to create an EU supervisor with direct supervisory competence over a limited number of the riskiest financial sector entities and a support and cooperation mechanism for FIUs, possibly under "one roof" is supposed to address the current deficiencies of the current decentralised supervision.

On the international front, the Commission will continue engaging actively in the Financial Action Task Force, as well as in bilateral dialogues with a number of third countries. The Commission will give its views on the way forward on pillar 5 of the Action Plan, including Public-Private Partnerships for information exchange, in a publication in the autumn of 2020, along with an updated Supranational Risk Assessment report.

At the same time, enforcement remains our key focus. Enforcement monitoring includes how effectively the EU rules are applied in the Member States, including the capacities and resources of the relevant authorities; full population of registers of beneficial ownership of legal entities and trusts is also a priority.

PEDRO MARQUES

MEP, Committee on Economic and Monetary Affairs, European Parliament

Upgrading the EU's anti-money laundering framework

In the past few months, more scandals, such as Open Lux, FinCEN files or Cyprus papers, exposed how complex schemes are still used for illicit financial transactions, including money laundering. These revelations are particularly dramatic given the social and economic impact of the Covid-19 pandemic. While honest people, families and companies still struggle to recover, others enjoy the profits of criminal activity. This is not admissible; EU must act now and deliver on an effective anti-money laundering framework.

The scale of this challenge should not be underestimated. According to the United Nations Office on Drugs and Crime, up to EUR 1.87 trillion are laundered each year, at the global level. Currently, in the EU, despite several AML directives, effectiveness in tackling money laundering remains suboptimal. For instance, according to a recent report by Europol, relevant authorities confiscated just 1% of criminal profits in the EU. To this background, the European Commission has taken a first step by adopting an action plan that aims to provide solid ground for progress. To be successful, the upcoming AML legislative package must

address the main shortcomings of our current framework.

Firstly, the loopholes created by diverging national implementation of the directives. By turning some content of AML directives into a Regulation, we can set common record keeping, internal controls, customer due diligence requirements and define a single way to identify beneficial owners. We should also seize the opportunity to harmonise sanctions and establish penalties proportional to the turnover of companies.

Secondly, the lack of a central supervisory body. Given the single market's cross-border economic activity, it is clearer that an effective AML supervision cannot be restricted to the national level. We need an EU supervisor and a common approach that fills in the gaps of national supervision, thus contributing to better compliance and enforcement.

If we want the citizens' trust, our fight against money laundering must be relentless.

Thirdly, the limited integration of financial intelligence units. Introducing a mechanism for coordination and support at the EU level would lead to better execution by Member States. It would improve data collection and exchange of information, as well as upgrade the financial analysis of cross-border suspicious transactions.

Furthermore, other resources should also be considered for the upgrade of our AML framework. For instance, leveraging digital technologies, such as artificial intelligence and machine learning, can deliver smarter checks and improve not only the outcomes, but also the cost-effectiveness of the whole process, which must also be taken into account.

The upcoming AML legislative package is our best chance to prevent the EU's economy recovery from being undermined by illicit financial flows. If we want the citizens' trust, our fight against money laundering must be relentless.

MARCUS PLEYER

Deputy Director General,
International Financial Markets,
Digitization, Anti-Money Laundering
& Counter Terrorist Financing,
Federal Ministry of Finance, Germany

Cooperation and information exchange as the key to fighting money laundering

The prevention of money laundering and terrorist financing has become a top priority on the EU's agenda in recent years, also against the backdrop of money laundering scandals. It is important that we continue to step up our efforts in the fight against money laundering. But how?

The Commission's legislative proposal announced for May 2021 looks likely to be a key building block. In particular, it will establish more harmonised rules and a more uniform application of these rules throughout the Union.

However, it should be borne in mind that the fight against money laundering can only be successful if:

- all parties involved in prevention work together effectively, and
- links to law enforcement authorities are further developed.

A key aspect of such cooperation with added value is the exchange of data within the prevention system. Money launderers are neither restricted by national borders nor are they limited to laundering their dirty money through only one institution. Therefore, illicit activity often becomes visible only when obliged entities and authorities monitor suspicious activities across jurisdictions and different institutions. Data sharing currently takes place only to a very limited extent between obliged entities.

We must overcome any silo mentality and focus on a more intensive cooperation and possibilities to share data in the fight against money laundering.

More extensive forms of data exchange – e.g. pooling transaction data – could help prevent the exploitation of information gaps that enable arbitrage by criminals who e.g. may attempt to engage with multiple financial institutions, each having a limited and partial view of transactions. This would result in more accurate and valuable STRs that could significantly improve the effectiveness of AML prevention and simplify the work of law enforcement authorities.

This potential cannot be fully exploited at present due to the lack of unambiguous rules on how data can be exchanged effectively and in compliance with data protection requirements, while fulfilling both interests. Because of the untapped potential in this area, the FATF is also addressing these issues within the framework of the "Digital Transformation" project initiated under the current presidency.

Due to the enormous amount of data involved in such exchanges, the use of RegTech must also be further developed and promoted to analyse these data volumes accurately, quickly and automatically. RegTech solutions also enable complex processes to be designed more cost-effectively.

However, accurate STRs are not an end in themselves; they are only the starting point for law enforcement if suspicious cases arise. Therefore, once these STRs have been forwarded to law enforcement authorities, it is vital to ensure that they fall on fertile ground. For the analysis and prosecution of suspicious cases, too, the exchange of information between all responsible parties must become a daily routine.

Public-private partnerships offer potential to better link prevention and law enforcement in the fight against AML. Through such partnerships, knowledge and experience can be exchanged between private entities and competent authorities with the aim to provide necessary information, but also valuable feedback to obliged entities. Thereby obliged entities can minimize risks for their own institutions and simultaneously improve prevention by the private sector.

HANNES MÖSENBACHER

Chief Risk Officer,
Raiffeisen Bank International AG

Are AML regulations the world's least effective policy?

30 years after the first steps in fighting money laundering in Europe, results are still negligible. The ratio between banks' efforts in collecting data and complying with subsequent tracking obligations is disproportionate to the actual prosecution and conviction of criminals. Of the 80% – 90% SARs[1] that are filed, an alarming number bring no immediate value and only 10% are investigated further (Kaiser, 2021). It should therefore not come as a surprise that AML regulations have been described as the world's least effective policy (Pol, 2018). Add to this a reluctance to embrace digital opportunities by regulators and unwieldy formulaic requirements for customers, it is easy to conclude that AML regulations need to become smarter.

According to the Compliance Week (2021) European banks annually spend 115 billion Euro on AML Compliance, three to four times more than their counterparts in North America. Yet all too often, we have the impression that European supervisory authorities focus on sanctioning formal inaccuracies made by banks, instead of managing AML risks in partnership with banks.

The EU Commission has recognised this disparity. With the Action Plan for the Prevention of Money Laundering and Terrorist Financing presented in May 2020, we see a window of opportunity to step up our collective ambition by establishing a standardised anti-money laundering framework throughout the Union. When implementing this Action Plan, we expect that the legislative proposal in May 2021 will consider two strands:

The time has come for a more effective AML approach and equilibrium between effort and benefit.

Firstly, the harmonisation of legal frameworks and supervisory competences. We would welcome the introduction of a supervisory authority at EU level, exclusively and directly responsible for all institutions, banks, payment services, crypto-asset providers or brokers. Parallel supervisory structures incl. different regulatory approaches, loss of information and thus duplications of costs must be avoided. EBA's and ECB's AML competences, which recently have been strengthened, must be redefined, and national supervisory authorities should be integrated into the new EU authority. We do not need more; we need a more focused regulatory regime.

While it is very much appreciated that the existing legal instrument of a "Directive" will be changed into a "Regulation", we believe it is important to have a unified approach towards regulatory examination. This is the only way to ensure we have an aligned understanding and interpretation of the supervisory regime within the EU, preventing regulatory arbitrage. Also, cross-border exchange of information within a group like RBI, being active in 13 CEE countries, and also between banks and banking groups, should be made possible and strengthened. A starting point could be a central European Beneficial Ownership Register, with complete and qualified data, that market participants can rely on.

The second strand relates to cooperation between the banking industry and public authorities. We need a stronger and more cohesive partnership between the private and public sectors, as it is successfully practised in Great Britain with the "Joint Money Laundering Intelligence Force" or in the Netherlands in the area of transaction monitoring.

European banks are committed to fight money laundering. Enhanced collaboration between banks and authorities based on harmonised rules will help Europe not only to follow the money trail but to also become more effective in preventing crime. The time has come for a more effective AML approach and equilibrium between effort and benefit. First steps have been made by the European Commission in the right direction, but there is still a long way until it becomes an effective framework against money laundering.

1. Suspicious Activity Report

MATTHEW ELDERFIELD

Chief Risk Officer, Head of Group Risk and Compliance, Nordea Bank Abp

A paradigm-shift is needed to efficiently combat financial crime in Europe

The European defence against financial crime has not been working effectively in the past. Banks have been found to have been ineffective compared to the size and complexity of the problem. But the public authorities have also been found to be ineffective, as has the European regulatory framework.

The fact that European firms spend over a hundred billion euros on AML compliance every year but that only about 1% of the proceeds of crime are confiscated illustrates that the current system is not working. This is a complex area, where there is a lot to consider but at its heart, I would suggest that the reforms need to have three key elements.

First, that the public authorities in this area need to be better resourced and better coordinated. This argues in favour of the Commission proposals for an EU AML Authority and for taking action to strengthen and support the FIUs. This is needed for a number of reasons: to help the smaller member states that are out-gunned by the criminals, to recognise that this is an international problem, to create a more consistent framework that is less burdensome to comply with for businesses and consumers

- and many other factors. Until a credible EU-level authority is in place it is de facto the US that is the financial crime regulator for European banks.

Secondly, there needs to be better use of technology and data in the fight against financial crime.

Thirdly, there needs to be more public-private collaboration between banks and authorities.

The facts around transaction monitoring illustrate these last two points. Research notes that only 10% of suspicious activity reports are investigated. I am skeptical it is actually that high. This makes the point for better resources, for better use of data and technology and for better collaboration. The UK model, the Joint Money Laundering Intelligence Task Force, is a forerunner in this. This allows sharing of information between the banks and the public authorities and allows for targeted and intelligence-led activities. In the Nordics, we have been part of a pilot to establish a similar approach in Sweden, called SAMLIT, which is showing great promise.

Banks want to be partners in a better system that catches the real criminals.

Imagine an EU-level approach, where the new AML Authority and well-resourced and data-driven FIUs worked in partnership with the banks to have targeted transaction monitoring on the typologies of organised crime, where specific criminal names were provided to allow sophisticated network analysis using AI to find associates, seize more of the proceeds of crime and make arrests.

I am humble about the historic track record of the banking sector. And I know the sheer size and complexity of the problem and indeed the complexity of the compliance requirements means we will make mistakes and criminal money will get through. But banks want to be partners in a better system that catches the real criminals. Given how much money is being spent throwing hundreds of thousands of SARs at under resourced FIUs each struggling in their own country, we can collectively do much better.

JOSÉ MANUEL CAMPA

Chairperson, European Banking Authority (EBA)

The EBA moves forward in the fight against financial crime

Europe is at a crossroads. The approach to stemming the tide of dirty money into the single market has until now focused on a succession of minimum harmonisation directives, specific provisions in sectoral laws and a strong reliance on national governments, supervisors and financial institutions to take the steps necessary to fight money laundering and terrorist financing (ML/TF).

Not surprisingly, we ended up with a fragmented approach. An approach where financial sector anti-money laundering and countering the financing of terrorism (AML/CFT) supervisors in different EU Member States do not have the same powers; where prudential supervisors consider financial crime risks differently across countries and sectors; and where the common EU rules that determine what financial institutions do to prevent and detect ML/TF are interpreted differently in each Member State.

One year ago, the EBA was given a new legal mandate to lead, coordinate and monitor the entire EU financial sector's fight against money laundering and terrorist financing. We have been working hard to make the best use of the new duties and powers to tackle ML/TF. For example, we have published regulatory products, strengthened cooperation between AML/CFT and prudential supervisors, created AML/CFT colleges and assessed competent authorities' approaches to AML/CFT supervision. We are also creating a central AML/CFT database.

Greater harmonisation of rules with cooperation and direct EU supervision is needed to embrace a bold, integrated approach to tackle financial crime.

But while our new powers are an important step in the EU's journey towards a more effective and comprehensive AML/CFT regime, they are not sufficient to ensure financial crime in Europe is contained once and for all. For this, a much more ambitious approach is needed. We have set out what this should entail in our response to the Commission's call for advice on the future AML/CFT legal framework.

First, we need rules that are homogeneous and apply directly to all financial institutions wherever they operate in the single market. Greater harmonisation should be conducive to an approach that is proportionate and risk-based and guarantees that the same risks are managed consistently.

Secondly, we need a more integrated and sufficiently intrusive approach to supervision where prudential and AML/CFT competent authorities work together to ensure that ML/TF risks are addressed effectively across all Member States, across all sectors and throughout an institution's life cycle. Active cooperation and information exchange among supervisory authorities and stakeholders in the public and private sector is a prerequisite for this and has to be enhanced.

Third, we need direct supervision at EU level of the highest ML/TF risk institutions as part of a harmonised, proportionate approach to the AML/CFT supervision of all obliged entities throughout the Union.

Embracing a bold, new and integrated approach to tackling financial crime, and emphasising the roles and responsibilities of each of us in government, supervision, law enforcement and the financial services industry in stamping out financial crime is the right way forward. The EBA's ongoing work harnessing the synergies between AML/CFT policy and other policy areas such as prudential, resolution, deposit guarantee schemes and consumer protection will be crucial to this.

Together, we can make a difference.

3

GLOBAL OUTLOOK

ISSUES AT STAKE

Financial fragmentation is a significant challenge for regulatory authorities and policymakers. It can have detrimental effects such as less competition, higher costs of capital, and reduced availability of services. The Covid-19 crisis has put the global economy under extraordinary stress. But rapid and coordinated public policy responses have largely averted fragmentation in the global financial system. It will be equally important to coordinate exit strategies from public support measures in order to maintain a level playing field for healthy competition among the major jurisdictions. Multilateralism remains the most efficient way to finding solutions to common issues affecting our global economy, provided there is a common will.

Brexit is a further potential source of fragmentation and continues to raise many questions 4 months after the end of the transition period. At this stage no equivalence agreements have been agreed in the financial sector and risks of regulatory divergence are appearing. The recently agreed MOU is a step forward but it is unlikely that the future EU-UK financial services relations can be built solely on the Joint UK-EU Financial Regulatory Forum that is due to be established.

GLOBAL FRAGMENTATION

JOHN BERRIGAN

Director-General,
DG for Financial Stability,
Financial Services and Capital Markets Union,
European Commission

Global financial fragmentation: can progress be made?

Financial market fragmentation is a significant challenge for regulatory authorities and policy-makers. The challenge is between ensuring and promoting financial integration on the one hand and preventing contagion and maintaining financial stability on the other. Fragmentation in financial markets can have detrimental effects such as less competition, higher costs of capital, and reduced availability of services. However, as noted for example by the FSB in its Report on Market Fragmentation, some types of market fragmentation are justified and legitimate, and are inevitable consequences of measures taken to safeguard financial stability[1].

Indeed, fragmentation can be an inevitable result of the fact that jurisdictions across the world must retain an appropriate degree of control over risks to their financial stability, even if they also wish to exploit the opportunities deriving from international integration.

The Covid-19 crisis has put the global economy under extraordinary stress. However, a remarkable feature of the crisis has been how rapid and coordinated public policy responses to support the economy, including the financial sector, have largely averted fragmentation in the global financial system. This has confirmed the economic rationale for policy coordination at the international level.

Regulators and supervisors have coordinated their response via the various fora and bodies that had been set up in the aftermath of the global financial crisis. They have also learned from one another in designing and implementing their respective measures. Going forward, it will be equally important to coordinate exit strategies from public support measures so as to avoid possible fragmentation from this source and maintain a level playing field for healthy competition among the major jurisdictions.

Multilateralism, when there is a common will, remains the most efficient way to finding solutions to common issues affecting our global economy.

The EU takes concerns about market fragmentation seriously. The EU financial sector entered the Covid-19 crisis from a position of strength, due to the regulatory reforms introduced after the global financial crisis and to the sector's own efforts to overhaul business models and build resilience. The financial sector is "part of the solution" to this crisis. Nevertheless, the EU has responded to the crisis with a set of measures to support the financial sector, notably actions taken by the European Central Bank to facilitate bank lending and ease pressure on financial markets and a series of legislative and regulatory measures brought forward by the Commission and supervisory authorities.

These measures complement the wider policy response reflected in the €750 bn recovery effort, Next Generation EU (NGEU), and major fiscal support measures in the Member States. The EU has also intensified its efforts to complete the Banking Union and the new CMU Action Plan will result in deeper and more integrated capital markets. On the other hand, while the EU is committed to a more resilient and open global economy, it must also reinforce its open strategic autonomy in financial services as well as its capacity to protect the EU's financial stability.

While there is no "one-size-fits-all" approach to finding the appropriate balance between financial integration and financial stability, equivalence is a key tool in this regard. Equivalence decisions in financial services are mutually beneficial for the EU and for third-countries, and serve the EU's objective to promote the international integration of financial markets while preserving financial stability. By narrowing cross-border divergences and incompatibilities, equivalence reduces global market fragmentation and enhances the EU's regulatory and supervisory cooperation with third-country authorities in a sustainable way.

Multilateralism, when there is a common will, remains the most efficient way to finding common solutions to common issues affecting our global economy. In the financial sector, convergence towards international standards helps all jurisdictions to ensure that similar risks can be addressed in a similar way and that races to the bottom - prone to creating financial instability and contagion risks in global markets - are avoided.

1. https://www.fsb.org/wp-content/uploads/P040619-2.pdf

BERNARD MENSAH

President of International, Bank of America

Why non-financial reporting matters

Europe needs sustainable, environmentally-friendly growth, and the EU's Green Deal promises to deliver the green transformation that society needs – while at the same time supporting an inclusive economic growth.

The UN Sustainable Development Goals provide the target society is aiming for. A key component of reaching this target will be measuring companies' sustainability practices. Environmental, social and governance factors relevant to sustainable value creation are increasingly material to business performance. Investors, regulators and other stakeholders all want to know how companies perform in these areas.

However, for an accurate measurement of long-term sustainable value creation, there needs to be a single framework integrating all ESG reporting metrics. Today, companies face challenges in measuring and reporting on their long-term value creation in a consistent manner at international level – the various ESG metrics and frameworks hinder companies from demonstrating value creation in a comparable and meaningful way.

Bank of America fully supports the work of the World Economic Forum's International Business Council (IBC) on a common core set of metrics to standardise ESG reporting. The IBC, chaired by our CEO Brian Moynihan, along with the Big Four and in collaboration with all stakeholders, built on the wide range of existing standards – such as TCFD, GRI, and SASB – and identified those ESG factors material to business performance. The IBC's "Stakeholder Capitalism Metrics" provides a core and expanded set of metrics that will lead to greater consistency, comparability and compatibility with the existing sector-specific approach and will serve as one of the building blocks for a global standard.

These metrics are NOT a new ESG standard in themselves, but rather a foundational set of existing metrics and disclosures deemed most critical for sustainable value creation – distilled together to help deliver a new kind of corporate leadership.

The EU is also reviewing its own rules for non-financial reporting, as part of its Green Agenda to progress towards the disclosure of more meaningful and comparable data to support financial decisions. We would suggest that such work at EU level should be informed by and build on already existing and verified standards.

The time has come to establish a single sustainability standard-setter.

Looking more widely, we recommend that standards on non-financial reporting should be established at international level, as achieving the UN SDG goals must be a global ambition. Moreover, any standards should converge towards the development of a systemic global solution – similar, for example, to international accounting standards.

Ideally in our view, a reporting standard should cover the entire range of ESG reporting, including the broader range of environmental factors. The metrics will need some uniform characteristics. They will need to be industry and business model agnostic, while remaining relevant and material to each; they will need to be measurable, verifiable and comparable across firms; and they will need to describe the connection between sustainability and longer-term financial results. For this purpose, we propose that any new standard follows the IBC's four pillars that are aligned with the SDGs and principal ESG domains: Principles of Governance, Planet, People and Prosperity. Metrics like Sustainability reporting should be developed with the same level of governance and controls that support financial reporting and hence be auditable. It is not an easy task and will require some imagination and creativity.

The time has therefore come for all parties, including companies, investors, regulators, and governments to work together to achieve these ends and establish a single sustainability standard-setter. This should be independent and properly funded, with broad stakeholder composition and the requisite expertise at both the board and staff levels, to address the full suite of ESG reporting. We support the IFRS Foundation in leading the discussions on developing a global sustainability reporting standard.

To address the challenge of climate change, ambitious international solutions are called for. An internationally-accepted common reporting framework embedding non-financial and financial considerations will lead to a better allocation of capital – and in turn will help address one of humanity's most pressing challenges.

MARKUS RONNER

Group Chief Compliance and Governance Officer, UBS

More international coordination today to improve financial system resilience tomorrow

Following decades of global financial integration, we have begun to see some retrenchment, as evidenced by declining euro area portfolio investment flows since their peak in 2016. With global flows being reshaped as a result of geopolitical tensions, we have also seen continued financial fragmentation within Europe – not just as a result of Brexit but also due to continuing frictions between home and host countries.

The trend towards financial fragmentation has been aggravated further by COVID-19. While the banking industry appreciates the bold and swift policy reactions to the pandemic, the supervisory response to common issues brought about by the crisis appeared somewhat disjointed, with capital and liquidity relief measures diverging significantly across major jurisdictions.

An inward-looking focus may unfortunately undermine the encouraging progress in financial integration made since the 2008/09 financial crisis. Over time, this could negatively impact the pricing and availability of financial services within the EU.

The lack of consensus around the finalisation of the Too-Big-To-Fail (TBTF) reforms illustrates the scale of the challenge we now face. The industry has made great progress in terms of self-sufficiency (financial, processes and governance) within individual entities – around USD 300bn of TLAC built up globally in the first half of 2020 alone. Yet the global implementation of agreed reforms – highlighted by the FSB itself – remains uneven in important areas. These include cross-border coordination and allocation of internal TLAC, while open issues remain to be addressed consistently through closer regulatory cooperation, avoiding uncoordinated measures across host jurisdictions.

To direct capital towards facilitating the transition to net zero carbon emissions, internationally harmonised definitions and rules are essential.

Open issues include 'funding in resolution' and ensuring a robust framework for the increasingly significant activity related to non-bank financial intermediation, where lessons need to be drawn from the market liquidity issues experienced in March 2020. A reliable, internationally consistent approach to central banks' Lender of Last Resort role will be crucial as a key enabler of an effective and credible bail-in tool.

Together with other measures outlined below, this should encourage in particular host authorities to limit excessive pre-positioning requirements, as intended by the FSB in designing the TLAC framework. As a consequence, the increase in costs for banks, which would over time feed through to the economy, would be limited. Clearly this is important to support the recovery.

Moreover, there are several actions which could be taken to foster further international integration to the benefit of each individual country, given the global financial system remains highly interconnected, reflecting both supply and demand needs across jurisdictions.

First, authorities need to follow through consistently on the reforms already started, such as completion of the Banking Union, the TBTF reforms and consistent implementation of Basel 3. It's also key to step up efforts to remove existing impediments to cross-border consolidation, which is the best route to attain financial integration.

Furthermore, regulatory cooperation will continue to be critical to address the global challenges posed by climate-related financial risks, cyber risk and operational resilience, the digitalisation of finance and financial crime / AML, to name just a few. Ideally this should be moderated by global fora such as the BCBS, the FSB and IOSCO and potentially broadened even further to a wide range of public authorities and stakeholders due to the cross-sectoral nature of many of these issues. We will otherwise risk ending up with a scattered landscape of rules across major jurisdictions for an additional range of highly critical topics which are, by their nature, global.

Taking sustainable finance as an example, global principles would fill a key gap, enabling regulation focused on disclosure, climate risk measurement and taxonomy to become clear, actionable and truly purposeful. The inflow rate for sustainable investing funds by the third quarter of 2020 amounted to 36% year-on-year in an otherwise fairly static fund market.

If we want to unleash the full potential of private investors to direct the flow of capital towards facilitating the transition to net zero carbon emissions, internationally harmonised definitions and rules are essential.

SHINSUKE TODA

Chief Executive Officer for Europe, Middle East and Africa
Mizuho Financial Group, Inc. / Mizuho Bank, Ltd.

Drive globally balanced sustainability through regulatory coordination

In response to the Covid-19 pandemic, fiscal relief policies have been introduced to a greater extent in developed economies, notably in the EU and the US, than emerging markets. Consequently, revenues in these markets are more at risk of any economic downturn in the aftermath of the pandemic. The divergence in national responses has exacerbated existing regulatory fragmentation and its impact will remain even when Covid-19 subsides, but conversely the Covid recovery presents a real opportunity to re-orient capital flows towards sustainable investment.

Europe is the world leader in the burgeoning frontier of ESG reform and we fully support the EU's Renewed Sustainable Finance Strategy. Regulation aims to bring certainty to an arena where there is rapid change, considerable financial and legal risk, and a keen focus on organisational governance. These regulations should be harmonised globally as far as possible, to attract investors from around the world and, to this end, the EU's International Platform for Sustainable Finance (of which Japan is a member) will have an important coordination role. Regulatory harmonisation is critical for a common understanding of the rules and how various activities are categorised from an ESG perspective.

However, regulatory harmonisation should be balanced against ensuring that the rules appropriately consider the varying economic circumstances, energy needs, infrastructure constraints and cultures of different jurisdictions and industry sectors. This means focusing on high level global standards, rather than detailed prescriptive rules, particularly early on when there will be material disagreement amongst market participants on the minutiae.

We note that sustainability-linked bonds have been eligible for the ECB's Asset Purchase Programme since January and further initiatives are under consideration to achieve the objectives of the European Green Deal. We appreciate the need to gather momentum towards a carbon neutral economy and support the Commission's drive for a long-term attitude towards transition, noting the risks of "greenwashing" amongst market participants in order to meet certain targets or take advantage of applicable funding schemes.

The mission for banks and policy makers is to support clients' sustainable finance transition pathways with appropriate liquidity provision...

Policies that reward short-term actions may result in a pricing gap based on an entity's transition status, harming its access to funding and consequentially its ability to transition, and ultimately the economy as a whole. This is vital for enterprises with high climate change risks globally, where transition requires a huge amount of investment. The mission for banks and policy makers is to support clients' sustainable finance transition pathways with appropriate liquidity provision, recognising that there should be a proportionate application of regulations dependent on the client's circumstances.

In respect of Brexit, the envisaged memorandum of understanding covering financial services should provide a platform for EU-UK cooperation on regulatory standards to mitigate the effect of overlapping and inconsistent rules. An immediate concern for firms is how to find and interpret the law post-Brexit, due to the complexities introduced by the tangled web of statutory instruments promulgated as a result of the onshoring regime and the piecemeal temporary waivers set up to delay the anticipated "cliff-edge" effects.

Further regulatory divergence may also affect the competitiveness of the European financial market, with the average cost-to-income ratio of European banks being higher than that of US or Asian banks. This crucially affects third country banks operating in Europe, who may look to allocate capital elsewhere if their EMEA business is not sufficient to maintain sustainable growth. In addition to the increased cost that regulatory fragmentation brings for financial institutions, a key point that is often overlooked is the consequent impact for clients through direct cost increases, poorer service quality and more limited choice.

We urge policy makers to move towards global regulatory harmonisation and to enhance mechanisms for continuous and systematic cross-border cooperation, with appropriate deference for national and industry idiosyncrasies, so that all enterprises can thrive without being burdened unnecessarily with the cost of incremental compliance.

POST-BREXIT PROSPECTS

KATHARINE BRADDICK

Director General,
Financial Services,
HM Treasury

The future of financial services in the UK

The global financial sector is experiencing a period of rapid change. The Covid-19 pandemic has transformed the behaviour of individuals, organisations and economies. The balance between protectionism and free trade is being tested in many major economies, and the European banking sector is under increasing pressure while the US and Asian markets grow. There are also unprecedented challenges and opportunities on the horizon, as the urgency of the climate crisis increases and technology diversifies our financial markets, pushing the boundaries of how our financial institutions operate.

This direction of travel will have unknown consequences on the shape of Europe's future financial landscape. In the face of this uncertainty, the UK continues to advocate for a global financial system that is built on open and competitive markets, which preserves financial stability and market integrity and protects both citizens and investors. In November, the Chancellor outlined the Government's plans to ensure that the UK moves forward as an open, attractive and well-regulated market, that continues to lead the world in pioneering new technologies and shifting finance towards a net zero future.

Central to our strategy is maintaining a predictable and transparent environment for business, backed by high-quality, proportionate regulation. Our key aim of the Future Regulatory Framework Review is to achieve an agile, coherent, and democratically accountable approach to financial services regulation. In parallel, we are undertaking a series of policy reviews to ensure regulation effectively addresses the risks arising in the UK's financial system and enhances its competitiveness.

To take just one example, we have announced that we are going to consult on wider capital markets reforms to build on the UK's reputation as a hub for high quality capital markets underpinned by high standards of regulation and market efficiency. We do not plan to significantly overhaul the current regime but rather enhance the effectiveness of our regulation.

> The UK continues to advocate for a global financial system that is built on open and competitive markets.

Innovation-friendly regulation is also a key component of the UK's sector, to promote the adoption of safe, cutting-edge technologies in financial services, and the growth of the fintech sector itself. We are considering the recommendations of Ron Khalifa's FinTech Review and have announced the introduction of a new unsponsored points-based route and visa process for UK 'scale ups', that will allow us to attract talent from overseas.

We're pursuing an ambitious agenda in Green Finance, committing to make Task-Force for Climate Related Financial Disclosures fully mandatory across the economy by 2025; implement a green taxonomy; launch our first green gilt; and offer a green retail savings product. Our G7 and COP26 presidencies come at a critical time for us to champion sustainable financial flows and work collaboratively with partners. This is a key area where the UK and EU share ambitions to drive global change.

Maintaining openness is also integral to strengthening our international relationships and has always been a cornerstone of our financial services policy. To foster further collaboration with partners, we are developing ambitious trade and regulatory relationships with several jurisdictions. The proposed UK-Switzerland Mutual Recognition Agreement is a truly exciting opportunity to develop our tool kit for appropriately managing cross-border financial services business between advanced financial centres. I would like to think that a successful agreement might set a new international standard for openness and the benefits that brings when underpinned by global standards and close cooperation.

At the time of writing, we're working towards a Memorandum of Understanding on regulatory cooperation with the EU. Providing certainty and stability for the industry remains at the forefront of our minds, and I'd like to thank the sector and the regulators for their extensive preparation for the end of the Transition Period.

Constructive engagement between industry and the authorities will be essential for the UK/ European financial sector to thrive, pioneering solutions to global challenges and tackling novel challenges as they arise. The UK will continue to build on its vision for financial services in the coming months, to strengthen the role it plays in global financial markets – now and in the future.

JOHN BERRIGAN

Director-General,
DG for Financial Stability,
Financial Services and Capital
Markets Union,
European Commission

Nearly 4 months after Brexit: where do we stand and what way forward for the EU and UK?

The Trade and Cooperation Agreement (TCA) between the EU and the UK covers financial services in the same way that financial services are generally covered in the EU's other free trade agreements with third (non-EU) countries. The TCA provides for limited market access commitments for cross-border provision of financial services and preserves the sovereignty and regulatory autonomy of the EU (and the UK), in line with the Commission's mandate.

A regime change took place in financial services on 1 January 2021. UK firms have lost their passporting rights and are now treated as third-country firms for the provision of financial services in the EU. Market fragmentation is an unfortunate, but inevitable consequence of the UK decision to leave the EU and the Single Market. Nevertheless, the transition in financial services has gone smoothly. Market participants were prepared. While there have been some necessary adaptions, there has been no volatility or disruption.

The Agreement last December brought to an end a four-year period of preparations and negotiations. However, for financial services, 2021 is the start of a new, complex period. The EU-UK relationship in financial services will have to be developed over time. While Brexit is unfortunately a fragmenting event, we will strive for close cooperation with the UK. As set out in the Joint Declaration on Financial Services Regulatory Cooperation, annexed to the TCA, our aim is to establish a durable and stable relationship between the EU and the UK. Our bilateral relationship with the UK will be based on voluntary regulatory cooperation outside of the TCA structures.

The purpose of a regulatory cooperation framework will not be to restore market access rights that the UK has lost, nor to constrain the EU's unilateral equivalence or regulatory process. Equivalence is an area which we will discuss with the UK – progressively, taking into account the UK's regulatory intentions, on a case-by-case basis. The EU is an open financial jurisdiction. We use equivalence as a tool to manage interactions with third countries, including the UK. Our third-country regimes allow EU consumers and investors to benefit from the services provided by third-country firms, whilst ensuring adequate risk management.

I remain hopeful that, over time, through cooperation and trust, we will manage to build a stable and balanced relationship.

When it comes to UK equivalence decisions, the EU, just as we do with all third countries, must consider our own interests. Given the close links between the EU and UK financial systems, our risk-based and proportional approach needs to be particularly thorough in order to capture, across all sectors, all potential risks for financial stability, market integrity risk, investor protection and the level playing field. It is clear that there cannot be equivalence and wide divergence.

Over time, there is scope for a broad and deep relationship with the UK in financial services. There are many areas of common interest in regulatory developments, such as risks to financial stability, digital finance, or new issues like green finance where the UK will play an important role with its presidency of the COP26. I would also anticipate close cooperation with the UK at international level in the FSB and other standard setting bodies.

The past four months has marked the beginning of a new phase in the trade of financial services between the EU and the UK. Given the level of interconnectedness between the two jurisdictions, it is essential that we get the basis for our new relationship right from the outset. I remain hopeful that, over time, through cooperation and trust, we will manage to build a stable and balanced relationship with the UK in the area of financial services.

Let's not forget that London will remain a very important global financial centre on our doorstep, and although a third country, the UK will remain one of our main partners in the area of financial services. It will be important for the EU to strategically manage the significant level of interconnectedness between the two jurisdictions so as to maximise the benefits of our new relationship while, at the same time, avoiding any element of dependency that would translate into reduced autonomy for the EU.

VERENA ROSS

Executive Director,
European Securities and
Markets Authority (ESMA)

EU-UK regulatory and supervisory relations in a post-Brexit world

The end of the UK's transition from the EU on 1 January 2021 marked the beginning of a new era in the relations between the EU and UK financial sectors, both for firms and for the authorities overseeing those sectors. The good news was that the transition period ended without any notable disruption. Since then, the EU and UK have turned their attention to establishing a framework for structured regulatory cooperation, which will be the foundation for a strong, balanced and fruitful future relationship.

Separate to this, the EU and UK begun the process of assessing the equivalence of each other's rules and supervisory arrangements in early 2020. On the EU's side, the Commission (with the technical assistance of ESMA and other EU bodies) undertook a comprehensive assessment of 28 areas of EU law where the most relevant equivalence provisions exist. With the end of the transition period approaching in late 2020, in the interest of mitigating potential risks to financial stability, time-limited equivalence was granted by the Commission for UK Central Counterparties (CCPs) and UK Central Securities Depositories. For all other areas, the assessment remains ongoing. Any future equivalence decisions will be unilateral and in the interest of the EU, just like the equivalence decisions adopted by the UK towards the EU in November 2020.

The EU is an open financial jurisdiction and ESMA is a strong proponent of the use of deference in financial services, as a means to reduce market fragmentation and limit cross-border divergences. Unfortunately, Brexit is by its nature a market fragmenting event and with the UK signaling its intention to diverge from EU rules, the task for the Commission on equivalence becomes more complicated. Equivalence normally works by fostering coherence between EU rules and the corresponding framework in a third country. In this case, with one jurisdiction likely to increasingly diverge from the other, it makes sense for the EU to also be forward-looking in its assessments.

> ...the most important thing from ESMA's perspective is that cooperation and information sharing between EU and UK regulators remains open and constructive.

The EU's equivalence model, which focuses on achieving the same outcomes, remains the tool which the Commission will use to determine equivalence for the UK. It should be noted however that there are heightened level-playing field concerns and increased systemic risks due to natural and historic interconnectedness of the UK and EU economies and financial markets. The European Supervisory Authorities, with their new equivalence monitoring powers, will assist the Commission through technical advice and monitoring of ongoing compliance by third countries with the conditions of equivalence decisions.

In addition, the EU's third-country supervision model has been enhanced in recent years. The most notable enhancement, which was first used in the context of the 2020 time-limited equivalence decision for the UK, was to the EMIR regime for third country CCPs. ESMA must now tier and recognise applicant CCPs and, depending on the tiering decisions, they may be subject to additional requirements and to ESMA's direct supervision. These additional safeguards ensure that any risk which is imported into the EU via third-country entities can be appropriately managed, in particular when it comes to third-country entities that may be systemically important in the EU.

Aside from the ongoing question of equivalence, the most important thing from ESMA's perspective is that cooperation and information sharing between EU and UK regulators remains open and constructive. In 2019 ESMA concluded two cooperation agreements with the UK Financial Conduct Authority (FCA), which have ensured that ESMA, the FCA and EU securities markets authorities can cooperate effectively on supervisory and enforcement matters, and exchange information to allow all authorities to discharge their duties regarding investor protection, orderly markets and financial stability.

Similarly, we intend to continue our cooperation with the UK at international level in the work of standard setting bodies like IOSCO.

STÉPHANE BOUJNAH

Chief Executive Officer and Chairman of the Managing Board, Euronext Paris

Following Brexit, a strong and multipolar capital market is rising in the EU

In the first weeks of 2021, there has been a massive shift of trading in European shares from London to Amsterdam. This trend is likely to continue in other areas because of the quality of European financial centres and increased uncertainty stemming from Brexit. It is my strongly held conviction that the EU must now act as a strong and competitive finance maker, not merely as an open territory of finance takers. Brexit has been a clarification moment and a wake-up call for the EU.

But the EU will not strengthen its capital market without strong European financial institutions and market infrastructures. We must stop the unilateral disarmament of the European financial system to the sole benefit of non-European players. Building a fertile and innovative ecosystem in the EU will be critical. In this context, the work on delivering Capital Markets Union to build a powerful integrated European financial system and ensure the financing of the recovery from the Covid-19 crisis assumes its full importance and significance.

Euronext believes a competitiveness test should be introduced within the new CMU to assess the impact of any new proposals on EU competitiveness as compared to major third country jurisdictions. This is obviously important in respect of the UK, but also the US. The EU must remain attentive to significant policy and regulatory changes in those countries and adjust when necessary. Alongside impacting on any consideration of possible equivalence measures, the EU must also ensure that its rule-making processes are agile enough to be able to adjust the European rulebook to respond promptly where necessary.

The recent evolution of Euronext into a stronger pan-European financial markets infrastructure is a key enabler to build the backbone of the CMU. With the Italian capital market expected to join Euronext, investors and issuers will be able to benefit from the largest capital and liquidity pool of the internal market, across eight countries in Europe. This transformational project for Euronext will also contribute to the objective of better funding the recovery of the EU economy, with a positive impact in terms of efficiency as well as market and product availability. At the same time, this evolution strengthens Euronext's federal model, closing the gaps between the different financing needs and ecosystems at European, national and local levels.

> It is my strongly held conviction that the EU must act as a strong and competitive finance maker, not merely as an open territory of finance takers.

This capability is very much needed to build an effective CMU to deliver integrated capital markets across the EU to the benefit of European companies, investors and the real economy, whilst nurturing and developing the often diverse ecosystems on which these markets depend. The Euronext markets reflect this reality. On the one hand, our markets benefit from a significant presence of global investors in European listed companies, boosting access to growth for European companies, thanks to our single order book and our single liquidity pool. On the other hand, retail investor participation is increasing, often with a local outlook. Both these dynamics should be enhanced by CMU. Ultimately, an efficient combination of the global, European, national and local market participants is required.

An effective CMU will be essential for the recovery of the EU economies because the economic transition initiated by massive injection of debt programs must be coupled with an efficient injection of equity to fund risky projects and innovation.

Beyond factoring in the consequences of Brexit, the CMU will also have to enable green finance, contribute to the strengthening of the role of the euro and adapt to the lasting impacts on markets of the recent massive central bank interventions and fiscal stimulus measures.

It is now time for European financial market infrastructures to meet the challenges of building strong integrated financial centres distributed across Europe. Through the expected inclusion of the Borsa Italiana Group into its successful federal model, Euronext will continue to prove that building European capital markets is the core of its project.

PATRICK THOMSON

Chief Executive Officer, EMEA, J.P. Morgan Asset Management

Putting customers first means cooperation over competition

The UK's departure from the EU remains a source of political tension. It also comes with an economic price for business large and small. On a personal note, I have a French mother and a British father. I served for five years in the British armed forces and my first J.P. Morgan project was based in Paris, so I have been lucky to work in both the UK and EU and understand the myriad opportunities for growth. But political or personal, we cannot afford to dwell on what has come to pass. COVID-19 and other challenges facing the EU and UK collectively – the region of Europe – are too significant and too urgent. Equally, there are huge opportunities to be gained by working together, especially when it comes to supporting a thriving investment culture in Europe and promoting the sustainability agenda. Intense and constructive cooperation must be our North Star moving forward.

Debating about financial market access has been constant over the past few years. The reason is obvious: the UK hosts a large amount of our region's capital markets. And the EU has a strategic interest in housing financial markets more in line with its geopolitical weight. This view is understandable and rational, but, importantly, this is not a zero-sum game.

In the political heat, it has, at times, seemed like the impact on clients has been secondary to which jurisdiction will 'win' more business. This is regrettable. Ultimately the success or failure of the EU and the UK should be judged on the impact on clients and the economy, rather than the relative size of financial sectors. We need to continue putting customers and the economy at the heart of everything we do.

Recent years have seen increased geopolitical tensions. Logically, the EU wants to look after its strategic interests in a more uncertain geopolitical landscape. However, as a global firm with an almost-200-year history in Europe, we are concerned when we hear concepts like 'strategic autonomy' and 'financial sovereignty' voiced as tenets for policy. The openness of financial markets has long been a source of their strength. Due to its nature as a supranational organisation, the EU has a natural knack for cross-border financial services. My sector, investment management, is a perfect example of this.

Ultimately the success or failure of the EU and the UK should be judged on the impact on clients and the economy, rather than the relative size of financial sectors.

EU lawmakers' vision to create a pan-EU fund product, UCITS, in the early 1980s, remains commendable. Forty years later, UCITS have become an international gold standard, marketed in Europe, Asia and Latin America. J.P. Morgan Asset Management Europe, established in Luxembourg in 1988, was an early adopter of UCITS. Today we have branches in Austria, France, Germany, Italy, Netherlands, Spain, Sweden, and a subsidiary in Switzerland, 330 staff and nearly €390 billion in AUM. We distribute across thirty-six countries worldwide. Our European funds are sold in, for example, Croatia, Korea, Poland and Peru. We are just one of many firms enthusiastically embracing the global success story that is UCITS, and increasingly AIFs. The European funds market is almost €19 trillion.

And yet recently, we have faced a debate about the global supply chains of European funds. Third country delegation, a key pillar of the global success of UCITS has come under constant supervisory and regulatory scrutiny since 2016. Delegation allows global investors in UCITS funds access to the benefits of talent and expertise across the globe with robust investor protection.

Some policymakers have asserted that third country delegation presents supervisory risk. We have not seen evidence of any inefficiencies or risks in this model, nor have these policymakers raised any concrete or specific issues. Customers recognise the delegation model as a good one; a model that has enhanced the attractiveness and competitiveness of Europe. Why tamper with this model now or, needlessly, put investors' trust in UCITS into question?

Investors will be better served by investing time and energy into the many positive areas that will, collectively, drive our economies forward. The UK has left the EU, but it has not turned its back on the sustainability agenda. The UK has doubled down on helping make finance flows consistent with a pathway to net-zero. Whether we are promoting corporate governance toward a carbon-free future, or fine-tuning climate-related financial reporting, getting the balance between consistency and flexibility is key. So is striving for global consistency.

The EU is charting new courses and leading the way with the ESG agenda. The US, with a new administration, is starting to engage. The UK has a leadership role to play, alongside the EU, in fostering global partnerships especially with the US. In my view, the UK is showing genuine eagerness to be a world leader, not least with its ambitious net zero targets and its role in co-hosting COP26.

But the sustainability agenda is just one of many examples where the UK and EU can thrive together, putting differences aside. Together, we can support financial technology and lead policy on cyber resilience. Together, we can tackle issues related to gender, sexual orientation and ethnic diversity and promote a more diverse and inclusive financial services sector. Last but not least, together, we can support the development of the Capital Markets Union, especially through increasing the level of retail participation in Europe's capital

markets, supporting greater financial literacy, pension initiatives and helping more Europeans make the jump from saver to investor. In other words, how can we better help European individuals and families achieve their life goals through investing, while channelling more money into companies, transport networks, hospitals, schools and housing?

We need concerted cooperation to achieve the best outcomes for investors and our economies. The agreed Memorandum of Understanding between the EU and the UK gives us hope. It formalises a technical dialogue, helps to park the politics and fosters trust. But this is just a starting point and frankly, the minimum we would expect between partners. There is an opportunity here to make the next chapter a positive and constructive one. As we write this next chapter, let us never lose sight of the end-users of financial services – businesses, investors, savers. They must be prioritised. The notion that 'cooperation is a higher moral principle than competition' feels particularly pertinent here. Constructive cooperation must be our North Star moving forward.

KEIICHIRO NAKAMURA

Chief Executive Officer,
SMBC Bank International /
Managing Executive Officer,
Head of EMEA Division,
Sumitomo Mitsui Banking Corporation
& Sumitomo Mitsui Financial Group

After Brexit - Looking towards closer regulatory cooperation

Now that the UK has left the EU, the financial services sector is looking ahead at what the future might hold. The UK is now a "third country" under the EU financial services regime, and UK banks have lost important access rights to the EU markets, in particular, the ability to freely "passport" financial services across EU member states. As a result, UK banks must now carefully navigate the regulatory framework in each EU member state in which they look to do business.

Looking ahead, it is possible to see that, notwithstanding Brexit, there may in the future be a return to close EU and UK regulatory alignment. It seems possible that the benefits of free market access which have been enjoyed by both the EU and the UK – making both the EU and the UK attractive international centres of business – may continue through bilateral "equivalence" arrangements.

Close regulatory cooperation will ensure the continued attractiveness of UK and EU financial markets.

"Equivalence", however, depends on regulation achieving outcomes which are comparable between the EU and the UK, and it is up to the EU and the UK to agree equivalence in key areas. Although developments towards equivalence have so far taken place at a measured pace, it is hoped that an agreement on financial services will be reached between the EU and the UK in due course. In many areas, in particular, derivatives and securities business, there is otherwise the risk of fragmented markets which are inefficient and costly to navigate. Equivalence would not only benefit UK businesses, who would be able to easily access EU markets, but also European consumers and corporates needing liquidity.

Equivalence – although very important for financial services – is clearly only part of the picture. Regulatory cooperation in the purest sense means countries working together to determine the appropriate direction of regulatory policy, all the while being able to react appropriately to real-world events. This will create a positive environment for international business.

As a basic matter, it is hoped that the EU and the UK will continue to be "open" rather than "protective" financial services markets. Being "open to business" has made London, Frankfurt, and other European financial services hubs global centres of financial excellence. It is hoped that even outside of areas of regulation which are deemed "equivalent", the EU and the UK will be able to work closely together to formulate regulatory objectives which ensure broadly similar standards. Close co-operation going forward on the green agenda, for example, is a high priority.

While there are clear benefits to equivalence in being able to enjoy free market access across borders, this will always be subject to the possibility of equivalence being withdrawn by either the EU or the UK at short notice. Businesses, of course, need time to react effectively. Where equivalence is taken away, there may not be an easy solution to ensuring that businesses are protected from the adverse impacts of sudden regulatory change; in particular, where they have structured their business based on equivalence decisions.

Regulatory cooperation should therefore not just be an area-by-area assessment, but should be an exercise at the highest level of regulatory policy in financial services; closer cooperation will, hopefully, reduce the risk of the EU and the UK taking a radically different path from each other. Equivalence should, therefore, be easier to maintain. Where rules are broadly aligned, they are easier to understand, and they provide a more comprehensible basis for structuring international business.

The ultimate aim in close regulatory cooperation – across the full spectrum of financial services – is to create an environment which ensures the continued attractiveness of the UK and EU financial markets for international business.

4

BANKING AND INSURANCE REGULATION

ISSUES AT STAKE

European banks entered the Covid-19 pandemic with stronger capital positions, higher liquidity buffers and better asset quality than the 2008 financial crisis. So, this time European banks have been part of the solution. The EU banking crisis management framework however needs reviewing to ensure that the banking system can face future episodes of stress. In addition European banks suffer from a persistent low level of profitability caused by excess capacity, low interest rates and insufficient efficiency that need tackling for preserving their capacity to support the post-Covid recovery going forward. Further challenges include the competition from non-banks and tech companies, digitalisation costs and Basel III standards.

Policy changes are also needed for supporting the role that insurers play in the long-term financing of the economy. The European Commission has launched a review of Solvency II in this perspective that also aims to preserve the soundness of the insurance sector and adapt the framework to new risks and opportunities - such as climate and environment-related risks, digitalization and cyber risks - and the unprecedented monetary conditions. These new risks and opportunities for the insurance sector also need further assessing at the global level. In parallel the monitoring of the ongoing reforms of the International Capital Standards (ICS) and the Holistic Framework for assessing and mitigate systemic risk in the insurance sector are underway.

CHALLENGES FACED BY THE EU BANKING SECTOR

EDOUARD FERNANDEZ-BOLLO

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

How healthy is the European banking sector in the pandemic?

On 11 March 2020, the World Health Organization declared Covid-19 a pandemic.[1] The very next day, ECB Banking Supervision announced its first supervisory relief measures with a view to giving banks the breathing space they needed to continue supporting viable households, small businesses and corporations. That policy, which was fully consistent with the decisive action taken by other public authorities in the EU, has been a success. At the end of 2020, the ECB was generally satisfied with the prudential situation in Europe's banking sector. Nevertheless, many uncertainties remain, with European banks facing four clearly identifiable challenges as regards their financial health.

The first issue relates to credit risk, which is one of the most immediate challenges facing the European banking sector. When loan moratoria and other policy measures (such as government guarantees) that have been used to support the real economy are phased out, solvency risk may rise at the most affected firms, potentially resulting in an increase in non-performing loans. Consequently, banks should proactively manage credit risk, reclassifying loans on a case-by-case basis and ensuring prudent provisioning.

While it is true that banks went into this crisis with improved asset quality, they may find, when support measures expire, that their asset quality and capital adequacy deteriorate again. Banks need, therefore, to have a comprehensive and forward-looking credit risk strategy that allows for adequate provisioning and efficient management of asset quality.

What challenges are European banks facing as regards their financial health and how can they be addressed?

Second, banks' interest income and profitability levels have fallen further in the course of the pandemic as a result of increased impairment, loan moratoria and declines in lending rates. At the same time, commission and fee income has also declined amid strong competition.

Third, pre-existing vulnerabilities (such as banking overcapacity, lingering cost inefficiencies and increased competition from non-banks, particularly fintech and big tech firms) are putting additional pressure on banks to adjust their business models and make them more sustainable. Banks should, for example, increase their use of digitalisation in response to the pandemic.

Fourth, the COVID-related protection schemes that have been established by European governments have resulted in surging public debt ratios. Consequently, a significant increase in banks' exposure to domestic government debt could potentially give rise to a sovereign-bank nexus, which could, in turn, trigger the return of adverse feedback loops between weak fiscal positions and weak banks in some countries if concerns regarding the sustainability of public debt were to re-emerge.

All of these challenges have been addressed in our supervisory priorities for 2021, with credit risk being our key area of focus this year. However, this is not something that we can deal with on our own. It is essential to have a harmonised European crisis management framework to make Europe's banking sector healthier and more resilient.

For example, it is important to avoid "limbo" situations after banks are declared failing or likely to fail (FOLTF), thus ensuring that a bank which is declared FOLTF and is not subject to resolution is wound up and exits the market within a reasonable time frame. It seems that national implementation of the revised version of the Bank Recovery and Resolution Directive (BRRD2) will not be sufficient to achieve this objective in all Member States, so further legislative amendments should be considered in order to harmonise the definition of "orderly winding-up".

Furthermore, in order to foster such orderly winding-up, it is important to expand the available toolbox across the EU with a view to properly managing exits from the banking system for all types of unsustainable bank (including those not eligible for resolution as defined by BRRD2) in full consistency with the aims and mechanisms provided for in that directive.

1. https://www.who.int/director-general/speeches/detail/who-director-general-s-opening-remarks-at-the-media-briefing-on-covid-19---11-march-2020

JEAN LEMIERRE
Chairman, BNP Paribas

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

Since the beginning of the Covid-19 crisis, banks have provided support to their clients, through moratoria, credit lines drawn, and loans, with or without public guarantees. The economy was also supported by massive measures at European and national levels, considerable fiscal support, prompt resumption of the ECB asset purchase programs and TLTROs, as well as targeted measures to operationalize the flexibility embedded in the accounting and regulatory framework.

From a policy standpoint, this response to the crisis has been a success, with corporate bankruptcies still at a low level, job losses contained, and financial stability maintained, despite the unprecedented drop in EU GDP.

While we can see positive signals of recovery in 2021, notably given progress in vaccination, uncertainty remains high, and the crisis will have profound impacts in some sectors, while others will show robust recovery potential. Banks will again be at the core of the new phase, unavoidably affected by some rise in NPLs, and at the same time actively involved in financing liquidity needs, consolidating debt, and providing equity or quasi-equity to enable viable corporates to absorb the shock and invest into the future recovery.

While regulatory and fiscal support is likely to be progressively phased-out, monetary policy is expected to remain accommodative to support the economy but will continue to weigh on bank's earning generation. EU and national recovery plans must be deployed urgently to boost growth and job creation.

The experience of the last year has shown the resilience of diversified and integrated bank business models, which have benefitted from a more robust earnings generation capacity and have been able to gain market share by supporting their clients across a broader range of financial needs, from cash to capital markets. Diversification as a factor of resilience is not embedded in the regulatory framework, which rather penalizes size, and should be taken into account by supervisors.

For banks to continue to efficiently support the European economy, they should not be handicapped by unnecessary regulatory pressure that would have recessive effects...

EU banks' earnings generation capacity is already affected by the combination of structural (competition by unregulated entities such as non-banks and BigTechs) and conjunctural (low/negative rates, decreasing credit quality and NPLs) factors. Such earning streams should be mobilized by the banks to the benefit of their clients, to restore a productive, innovative, job-creating, and greener economy.

For banks to continue to efficiently support the European economy, they should not be handicapped by unnecessary regulatory pressure that would have recessive effects:

- Contributions to the Single Resolution Fund should not be inflated by the significant increase in deposits resulting from the abundant liquidity creation by the ECB, and the flexibility embedded in the regulation to increase the IPC from 15% to 30% should be used.
- The Basel finalization package needs to be implemented in Europe in the respect of the "no significant capital increase" mandate, respecting the European specificities and the level playing field with other key jurisdictions, notably as regards to FRTB.

In the current environment, this is also crucial to ensure Europe's financial sovereignty, preserving the capacity of European banks to serve sovereigns and corporates, in the highly competitive capital markets activities.

LUÍS MÁXIMO DOS SANTOS

Vice-Governor, Banco de Portugal

Unusual crisis, unusual measures, big challenges

In November 2020 at the ECB Forum, in the recent past ordinarily held in Sintra, Portugal, the President of the ECB, Christine Lagarde classified the economic crisis caused by the Covid-19 pandemic as being a "highly unusual recession".

This is undoubtedly a deeply uncommon crisis for having originated in a pandemic (something we knew could be a real risk, but in fact only admitted in the abstract), due to its global and strongly synchronised nature, for a supply and demand shock materialising simultaneously and, of course, for the dimension of the damage caused to the economic and social environment.

But the response of the political, economic and supervisory policymakers has also been uncommon due to its speed, the high degree of convergence and coordination at Portuguese and European level, and to the fact that different instruments were used in hitherto unseen dimensions: monetary policy and budgetary policy, as well as employment policy, social policy, regulatory and supervisory policy.

In regulatory and supervisory terms, macro and microprudential instruments were used, and similar action was taken in terms of conduct supervision.

Acting in this way produced results that were very positive inasmuch as they avoided greater ills: financing capacity to enterprises and households was maintained and liquidity was ensured, productive capacity was preserved, more drastic falls in employment were avoided and drops in income were mitigated. On the other hand, the approval of an unprecedented volume of European funds to support the recovery of the European Union's economies, a large part in the form of straight grants, gives credence to forecasts for growth in the near future.

We should learn a lesson from this fact: the instruments at the disposal of public authorities are quite powerful if managed in a timely, coordinated and convincing way.

The near future will be very demanding for the European banking sector. The pressure on profitability and asset quality, for example, will be high.

We are still at a stage of the crisis where we are hostages to the health situation and developments in the pandemic. This means therefore that we are in a situation of high and atypical uncertainty. The vaccination process, notwithstanding its difficulties and setbacks, has changed expectations for the better, giving a feeling of hope even to those sectors most affected by the pandemic, that is, those that depend more directly on people's mobility.

We know that a recovery path is forecast for 2021 and 2022, but its real dimension is still quite uncertain.

The European banking sector is currently much more capitalised and robust than during the financial crisis and therefore much better prepared to take on the pandemic-induced crisis. For example, Portugal has seen a significant reinforcement of capital ratios in recent years, a very considerable improvement in the quality of credit portfolios, a structural adjustment in liquidity that reduced the system's vulnerability to changes in international investors' risk perceptions, a significant reduction in operational costs and even a gradual recovery in profitability.

We do not know yet the depth of the structural changes that will be caused by the present crisis. How will consumers behave? How will investment be encouraged, especially in the private sector?

With the data already known, it seems clear that the asymmetries and inequalities tend to intensify within each country and across the European Union. If it is true that the effects of the pandemic crisis are cross-cutting, they are, however, quite far from being symmetrical, given for example the different composition of the economies of each Member State, clearly penalising those economies most dependent on tourism. In this context, it will be difficult to understand why the banking union is not completed sooner.

The global geopolitical framework is also at a stage of notable tension and readjustment, which in itself is a factor of instability. Even if the most optimistic scenarios come to fruition, the near future will be very demanding for the European banking sector. The pressure on profitability and asset quality, for example, will be high.

The time we live in requires banking management much more focused on each customer, their problems and potential. In turn, Portuguese and European authorities must remember that to be successful in their policies, notably in defining a moratorium exit strategy, they will once again have to be timely, coordinated and convincing.

DENIS BEAU

First Deputy Governor,
Banque de France

Challenges for the EU banking sector in the Covid context: no time for complacency

The Covid-19 pandemic has strongly hit the economic tissue worldwide. Nonetheless, the absence of major impacts on the banking sector vindicates the Basel III framework put in place over the last decade. The quick action taken by European supervisory institutions, like the dividend ban, the CRR "quick fix" or the release of the P2G, and macroprudential buffers by national macroprudential authorities also brought additional support. As a consequence, banks have been able to keep strong solvency and liquidity positions, while continuing to finance the real economy.

Indeed, credit has remained dynamic across Europe: for instance, in 2020, France has recorded a 13.1% growth of loans to resident Non-Financial Corporations (NFCs, including SMEs). Here again, the policy response to the crisis is to be credited, as governments have implemented ambitious measures to support the economy and lending, such as moratoria and state guaranteed loans (SGL). Banks have also been strongly committed: in France, they have distributed widely and swiftly the scheme enforced by French authorities (SGL have accounted for 130 bn euros in 2020, out of 436 bn euros of new loans to French NFCs).

The way these supporting measures will be removed is flagged as a risk for financial stability in Europe. While the exit strategy is to be carefully tailored, the cliff effect scenario remains a low probability event, given that the consequences of sudden exit from supportive measures are on the governments' screen. But the alternative risk, meaning the risk of overindebtness and "zombification", in particular of the corporate sector and the associated build-up of financial vulnerabilities must be also taken care of and not underestimated.

For banks, this means that, while for the time being the pandemic economic impact has not resulted in an increase of non-performing loans, globally for SSM banks, an increase in corporate defaults is not to be overlooked. Credit risks must be therefore proactively managed, and provisioning must remain prudent. In addition, uncertainty remains high and strong structural challenges still afflict the European banking landscape. The profitability of European banking institutions remains a source of concern: while they displayed returns on equity close to their main US competitors before the great financial crisis, they now lag far behind.

> The profitability of European banking institutions remains a source of concern.

The causes of this discrepancy are manifold and so are ways of improvements. Among them is the shift to digital banking, which could ultimately lead to a reduction of operating costs and increase the ability of banks to compete with non-banking actors. Moreover, the European banking system remains too fragmented, and consolidation would provide significant improvements. The institutional setup being completed with and effective Single supervisory mechanism and European resolution framework, the conditions are now favourable for the emergence of cross-border banking and insurance groups.

Lastly, the pandemic is a reminder of the need to anticipate emerging financial risks, especially those related to climate change. As stated by the Network for greening the financial system (NGFS) last June, the sweeping disruption of the economy following the onset of the pandemic could illustrate to a certain extent what we could potentially experience in an increasingly unstable climate or following a disorderly transition shock.

These risks must be proactively tackled. Significant work initiated by the NGFS in recent years are finally finding their route towards regulatory developments, with Europe and France being front-runners: the European Banking Authority is mandated to propose venues to integrate ESG risks in the three pillars of the prudential frameworks while the European Central Bank will implement a climatic stress-test exercise in 2022, following the path of the Banque de France.

Initial reflections by the Basel Committee and the Financial Stability Board at a global level respectively on the adequacy of the current prudential framework to allow the inclusion of climate change-related risks and the way to close data-gaps are essential developments which needs to be forcefully pursued.

JONÁS FERNÁNDEZ ÁLVAREZ

MEP, Committee on Economic and Monetary Affairs, European Parliament

Time to complete the Banking Union for a strong recovery

The EU institutions have thus far responded adequately and in a timely fashion to the economic and financial challenges stemming from the impact of the Covid-19 health crisis and the resulting social distancing measures. The Commission quickly adopted a flexible interpretation of the Stability and Growth Pact in order to allow for the use of more expansionary fiscal policies by member states. In addition, it spearheaded the process of building support for national unemployment insurance (through SURE) and presented a revision of the Multiannual Financial Framework (MFF), supplemented by the Next Generation EU (NGEU).

Furthermore, the European Stability Mechanism established a Pandemic Crisis Support instrument, based on its Enhanced Conditions Credit Line, available to all euro area countries, by which to cover direct or indirect expenses derived from the pandemic, but still unused until now. In addition, the EIB has broadened its program of guarantees to support the efforts of the national development banks. All of these fiscal efforts have been backed by the ECB, particularly through the Pandemic Emergency Purchase Program (PEPP), which, together with previous asset purchasing programs, has allowed for the financing, at the end of the day, of public deficits through the secondary market.

In one way or another, the short-term response to survive the confinement economic impact have included direct financing by member states, with European coverage, as well as, starting in 2021, additional efforts to stimulate the economic activity financed directly and more thoroughly by the EU (MFF + NGEU). That said, the health crisis is lasting longer than expected and has been deepened by the subsistence of structural problems that already existed in the pre-pandemic world, thus likely leading to structural changes in our economy. This prolongation of the crisis is making difficult the functioning of previously planned support policies, which, in turn, is pushing member states to create new solvency support instruments.

> It is now in our hands to avoid this and to finally complete the Banking Union.

However, the longer the health crisis endures, the bigger the public intervention needs to be in order to avoid an economic collapse. At the same time, underlying structural changes will happen more rapidly and will lead to necessary reforms in some sectors. Thus, the stretching of the health crisis makes it more difficult to implement micro programs that are more adjusted to the medium-term. This environment would therefore impede the so-called Schumpeterian concept of 'creative destruction'.

This being true, the current situation is also hampering a sufficiently 'micro' approach to the deployment of support measures. As such, we will observe an increase in the amount of Non-Performing Loans in the upcoming months that, at this moment, is difficult to measure. This will impact on bank's balance sheets and, for that matter, the stability of the entire financial system.
The EU has proposed certain measures to slow this impact through the Capital Requirements Regulation (CRR) 'quick fix' revision. Predictably, the revision of the CRR/CRD (Capital Requirements Directive), which stems from the implementation of the Basel Framework, should become more flexible to allow banking entities to absorb the increase of bad loans. This adaptation should also affect the management framework for banking crises, the BRRD, whose reform proposal is foreseen for late 2021.

At this time, the final impact of this recession upon the banking system remains unclear, with medium-term return rates currently unsustainable. For all of these reasons, the EU must swiftly prepare itself and invigorate the debate for the construction of the European Deposit Insurance Scheme, facilitating the implementation of a European crisis management framework. The Union must, among other things, revise the definition of "public interest" in order to facilitate access to European funds in case of a bank resolution or liquidation. Priority must be given to a strategy of "business for sale", thus reducing national discretions within the Banking Union.

Until now, the banking sector has been key in supporting the European economy, making part of the European solution. However, the prolongation of this health crisis will heighten the risk of a spillover into the financial sector. It is now in our hands to avoid this and to finally complete the Banking Union.

BOŠTJAN VASLE
Governor, Bank of Slovenia

New and old challenges for European banks

In less than a decade, banks in the EU have gone through post-crisis cleaning up of balance sheets, recapitalisations, and strengthening of regulatory and supervisory frameworks. The banks entered the COVID-19 crisis better capitalized and more liquid than in 2008, but many still had pre-existing fragilities such as subdued profitability, while others also had elevated NPEs. The current economic crisis reverses some of the favourable trends in the banking system and exacerbates pre-pandemic challenges.

The imposition of pandemic-related lockdowns led to a faster GDP decline than the 2008-2009 financial crisis. Due to a sharp decline in revenues, enterprises in many countries were urgently seeking liquidity relief, deferrals and new financing. Banks responded well to such demands. The flow of liquidity from banks to households and businesses has remained smooth also thanks to swift and wide-ranging policy measures.

These have: (i) provided banks with cheap access to abundant liquidity (ECB's TLTROs and PEEP), (ii) transferred some of the credit risk to governments (public guarantee schemes for deferred loans and new financing), (iii) provided favourable prudential and accounting treatment of EBA-compliant debt service moratoria, and (iv) increased banks' credit potential with the relaxation of capital and liquidity buffer requirements.

In the face of extensive support measures, the effects of the crisis on banks' balance sheets have so far been limited, though visible. The early signs of asset quality deterioration can be seen in the form of an increase in the volume of forborne loans and a rising share of stage 2 loans (in line with the IFRS 9), and some countries have reported moderate increases in the NPE ratio. Banks have started increasing loan-loss provisions, which together with further net interest margin compression has dampened their profits.

The negative impact of the crisis on banks is likely to become more visible this year and fully over the coming years, as various relief measures phase out or narrow. Banks have more insight and knowledge about their clients than the government, so it should soon be up to them to evaluate the eligibility of their clients for loan restructuring. Banks should recognise troubled loans in a timely manner, form adequate loan-loss provisions, identify viable firms and embark on case-by-case treatment of struggling clients.

For smaller banks, addressing structural changes and rising NPEs might be more challenging.

They should not hesitate to recognize incurred losses and dip into capital buffers, and some might have to consider raising fresh capital. It is important to support the timely resolution of NPEs, so that they do not accumulate on banks' balance sheets, where clear supervisor expectations regarding the recovery of capital buffers and development of a secondary market for distressed assets play an important role.

Damage to the banks' balance sheets will depend crucially on the duration of the crisis and thus the consequences it will have on the economy, unwinding of crisis intervention measures and the composition of bank assets. Smaller banks are in a less favourable position due to higher exposure to SMEs. Even before the current crisis, they had on average relatively high forbearance and NPE ratios, and in the last year they have notably reduced the coverage ratio of NPEs. While they have less staff and expertise to address increasing NPEs, they now have some experience from the previous crisis and detailed guidelines for monitoring of clients and management of NPEs.

The pandemic crisis has exacerbated the chronically low profitability of European banks, reflecting ultra-low interest rates and depressed margins, legacy assets from the previous crisis and competition from non-banks. This further increases challenges to banks' business models, even more so for smaller ones. Searching for higher returns by focusing on riskier loan segments, as observed in the last few years, is not a viable path. In this crisis, banks have taken a step forward in digitalisation.

While this can help to streamline operations and offer new digital services, it poses a disproportionate cost burden on smaller banks. Partnerships with FinTech firms might help to overcome such challenges. Overall, the way forward is also further consolidation, which accelerated last year and is likely to continue in the coming years.

PER CALLESEN

Governor, Danmarks Nationalbank

Back to markets

The outbreak of the Covid-19 pandemic has caused significant declines in economic activity. As opposed to the financial crisis, banks have not been part of the cause of the crisis, and have so far not been substantially affected. Suspension of dividend payments and release of capital buffers have increased capital levels, and banks have made provisions expecting a large deterioration in asset quality with lower profitability as a result. Large losses are, however, yet to materialize.

This is not least due to extraordinary support measures from governments and the EU. Crisis-related discretionary fiscal support measures in 2020 amounted to close to 4 per cent of GDP, automatic stabilizers added a lot to this and liquidity support is close to 20 per cent of GDP. The support measures have helped prevent a wave of bankruptcies. Bankruptcy levels in 2020 were in fact below the previous year. Administrative delays, temporary relaxations of bankruptcy regulations and loan repayment moratoria in some instances have contributed to this. Bankruptcies can be expected to increase once the support measures are lifted, with higher NPLs in the banking sector as a result. This raises the question of how to best phase out support measures.

Support measures have been warranted for firms which have been prevented from doing business as a result of the lockdowns. Once restrictions are lifted, direct support measures towards firms should be phased out as well, and firms should go back to doing business on market terms. Business dynamics have been hampered by the lockdowns, and some unviable firms have been kept alive by support measures. Large reductions in revenue are not an unusual event for firms. A Danish study shows that, even in the best of times, 6 percent of firms experience a year-to-year drop in turnover of 30 percent or more. That has been the national threshold to qualify for government compensation for fixed costs.

Furthermore, the pandemic may lead to structural changes and a shift in consumer preferences. Some firms may experience decreased demand and ultimately default, and banks will experience losses. This is a natural part of the workings of a market economy. Firms default and new firms enter. We must not hamper this dynamic. Once restrictions are lifted, firms should do business on market terms – without government aid. As always, existing labour market policies etc. can assist transition.

A financial sector which is part of the solution and which can adjust dynamically to changing environments.

Once bankruptcy levels start to increase, banks will inevitably experience increasing NPL levels. The strong fiscal and monetary measures, temporary macroprudential and supervisory relief, dividend restraint and prudent bank behavior imply that this is manageable by viable banks and should not act as a squeeze on lending capacities.

In the long period in between the GFC and the pandemic, we have improved the financial sector a lot. Risk levels in the EU banking sector have been reduced, capital levels have increased and we have the system and institutions to resolve non-viable banks. The BRRD made great strides to ensure that orderly resolution can be applied without costly government funds, which would distort competition, break the link between facing risk and earning risk premia, invoke moral hazard and revoke the bank-sovereign nexus. Some cases might test the resolve of governments to apply the BRRD. Yet, the role of the financial sector during and post COVID-19 should be seen as an opportunity to demonstrate how we have built a financial sector which is part of the solution and which can adjust dynamically to changing environments, on market conditions. Harvesting this opportunity will be important for years to come.

KLAUS WIEDNER

Director, Financial systems and Crisis Management, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Addressing the fall-out of the Covid-19 pandemic on the financial system

The Covid-19 pandemic has led to a sharp economic downturn. Governments reacted promptly by taking measures to compensate income losses of households and, to a lesser extent, of businesses, which were mostly supported through liquidity measures such as moratoria, loan guarantees and public loans. EU regulators and supervisors took measures to bolster banks' lending capacity. This includes the Commission Covid-19 banking package, which addressed issues in the Union's accounting and prudential frameworks, aimed at ensuring that banks were able to continue lending during the most acute phase of the crisis.

These measures, combined with suspensions of the obligation to file for bankruptcy and the impact of lockdowns on courts, reduced corporate insolvencies to record lows – in the midst of a deep recession. This shielded banks from the impact of Covid-19 and kept many firms alive that would otherwise have quickly gone under. Some of these firms should perhaps have exited the market and there is a risk that the extensive public support might lead to a certain degree of zombification in the corporate landscape. However, this has been a risk well worth taking, which was mitigated by the condition that only firms in good financial health at the start of the pandemic were elegible for support. Furthermore, it may still be too early to tell which companies will be viable post-Covid and which might only survive as 'zombies'.

A key determinant of post-Covid business viability is the amount of corporate debt that was also driven by the extensive use of liquidity support measures. Higher debt levels may be affordable thanks to lower interest costs, but many companies with viable business models may need a restructuring of their debt. This is what banks and policy makers have to prepare for as crisis support measures are being phased out. Redesigned fiscal support measures focusing on debt restructuring for fundamentally viable firms will be key to avert a wave of insolvencies, which would transmit the Covid-19 shock to the banking system.

Banks and governments must continue to support viable firms. Banks' lending capacity will be preserved by keeping them sound and by addressing possibly rising non-performing loans.

The temporary suppression of economic activities, through lockdowns and social distancing measures, could then still morph into a crisis with the vicious cycle of business failures, bank retrenchment and public finance crises.

The EU finds itself in the comfortable position that the financial health of its banking sector remains strong, and private and government debt affordable thanks to low interest rates. Yet risks are tilted to the downside, with large disparities across Member States. As we know from the experience of the sovereign debt crisis, the euro area can be destabilised by problems in a small number of Member States.

It is therefore vital to to ensure that banks can continue to play a constructive role in the recovery following the economic downturn and to closely monitor possible risks to financial stability. Banks and fiscal authorities need to work together to identify debtor distress early and engage in timely and appropriate restructuring to prevent insolvencies of fundametally viable firms. If this objective would not be attained, banks' asset quality – and in turn their lending capacity – could deteriorate sharply as a result of the Covid-19 crisis.

Public authorities need to be mindful that banks may be capital-constrained and may need the right incentives to engage in restructuring. This requires an adjustment of support measures, and in many Member States also improvements to national insolvency frameworks, notably to facilitate preventive restructuring, in line with the 2019 Directive that Member States have to transpose.

However, a rise in non-performing loans (NPLs) will not be avoided entirely. Early and decisive action, as outlined in the Commission's Action Plan on NPLs adopted in December, should be taken now to:

(i) develop further secondary markets for NPLs;
(ii) improve the efficiency of insolvency frameworks across the EU;
(iii) support the voluntary establishment of national asset management companies;
(iv) allow possible precautionary public support measures, where needed, to ensure the continued funding of the real economy.

The end of the pandemic will not be the end of the crisis, but there are good ways of dealing with its legacy and to create the conditions for a swift recovery.

DIONY LEBOT

Deputy Chief Executive Officer, Société Générale

Only strong European banks can limit future sudden stops

The moment that turns a downturn into a deep recession is, in peace time, most often tied to a sudden-stop in cross-border financial flows; any dry up in liquidity translates rapidly into insolvency. With the Covid19 crisis, however, the sudden stop was triggered by measures imposed to protect public health. Vaccine rollout offers the prospect of reopening economies yet concerns linger that as temporary support measures are lifted, a large number of firms could still fail, triggering a wave of non-performing loans (NPLs).

Adaptability and well-adjusted policies suggest such fears are likely overdone. Ensuring a full recovery of the euro area, however, requires a much more determined effort to complete Europe's architecture.

When Covid-19 first struck the global economy back in early 2020, financial markets were gripped by fear, but large-scale and fast-track action by central banks and governments quickly dispelled it. Equally important, European banks entered the present crisis with capital levels twice as high as in 2008 and soon became a primary channel of support, rolling out government guaranteed loans and providing moratoria. With liquidity assured, many firms found the financial space required not just to stay afloat but also to invest in adaptations and others yet have sprung up. Just taking France as an example, new start-ups surprised with record numbers. Encouragingly, experience from last summer also shows that once social distancing measures are eased, economic restart can be swift, aided by pent-up savings.

Back in June, the ECB warned that a severe scenario could leave the euro area with a cumulated real GDP loss of 27.7% over 2020-2022 compared to 2019 levels, with NPLs near tripling from just under €500bn to €1,400bn. The ECB's latest projections see a loss of 14.9% in the severe scenario, 9.3% in the baseline scenario and 4.3% in the mild scenario. While still marked, these new scenarios nonetheless ease fears of the most adverse NPL outcomes. Banks, moreover, have built important provisions and cost of risk remains contained.

European banks entered the present crisis with capital levels twice as high as in 2008 and soon became a primary channel of support.

Once the health crisis allows economies to reopen, policymakers must calibrate the lifting of temporary measures while still rolling out sufficient support for the real economy to recover. This observation holds true also for banking measures. Last spring, the Commission's Banking Package offered temporary flexibility to accounting and prudential rules. This, combined with the decision to defer the transposition of the final Basel III package by one year to 1 January 2023, increased the capacity of both banks and supervisors to respond to the Covid-19 crisis.

The appropriate timing of when to roll back policy support is well known from previous crises, but the extraordinary nature of the current one, with its unprecedented sector heterogeneity and likely permanent changes to consumer and business behaviours, adds to the uncertainty that policymakers must take into account to prevent error.

Avoiding a replay of another partial recovery, that the euro area suffered in the wake of the previous crisis, furthermore, requires that European policymakers deliver on long overdue promises; a robust framework to tackle NPLs, completion of Banking Union and Capital Markets Union.

The EU Action Plan of December 2020 to prevent a future build-up of NPLs is welcome but far from sufficient to complete Banking Union, which most importantly requires single jurisdiction. The Capital Markets Action Plan of September 2020 is likewise encouraging yet also falls short in recognising the parallel need for public risk sharing, and notably a single safe asset, absent which the euro area financial architecture will continue to bear the high cost of fragmentation.

As warned by the ECB, reform policies are particularly important in addressing long-standing structural and institutional weakness and in accelerating a fair, green, and digital transitions. Europe today, moreover, has a unique opportunity to become a global green leader, lowering the risk of future sudden stops triggered by the natural world.

Strong European banks in a complete Banking Union are a prerequisite, not just to pave the way for the necessary private investment and jobs, but also to ensure that Europe is sovereign in its choice of economic growth model and to limit the risk of future sudden stops in cross-border financial flows.

SANTIAGO FERNÁNDEZ DE LIS

Head of Regulation,
Banco Bilbao Vizcaya Argentaria (BBVA)

Public aid, level playing field and the role of banks

Corporates and SMEs all over the world have suffered from the lockdown and the drop in demand. Bold support measures have been adopted by many governments, which postponed payment difficulties, but a wave of bankruptcies and non-performing loans seems difficult to avoid. It is crucial in this context to ensure the viability of solvent firms that face temporary problems and/or an increase in debt as a result of the pandemic.

In Europe there were significant differences in the degree and modality of support of national governments, some of which relied more on credits with partial public guarantee whereas others used direct aid to a greater extent. Indeed, different problems require different solutions, but variation in national approaches across Europe seem to reflect more the willingness to use the fiscal space of each country than the size and nature of the problems. Viable firms with temporary liquidity problems and/or debt or capital constraints may need a combination of public aid, fiscal incentives for the injection of fresh money and debt restructuring.

Non-viable firms require an efficient and quick resolution framework that facilitates a fresh start. The latter requires in many European countries improvements in the insolvency framework, making it swifter and more efficient.

In Spain several measures have been adopted in this regard in February 2021:

(i) a new direct aid line of €7bn will facilitate the repayment of fixed costs and debts of the most affected sectors;
(ii) a €1bn fund will be used to recapitalize SMEs, on top of another €10 bn line approved a few months earlier for bigger firms and
(iii) €3bn will be destined to restructuring financial debts with public guarantees (via term extension, conversion into equity loans and, as a last resort, direct grants to reduce loan principal). Regarding the latter a voluntary code of good practices will be agreed by financial entities. These measures are welcome, although perhaps they are late and too timid compared to other EU countries.

Banks have a key role to play in distinguishing solvent from insolvent firms.

Banks have a key role to play in distinguishing solvent from insolvent firms, in particular in countries where the average size of firms is small and previous knowledge of the firm becomes crucial. But direct support measures should come from the government. Banks will always have skin in the game as a result of the previous lending relationship with the affected companies. Incentives should be designed carefully for all the parties involved to play their role. In this process it is particularly important to avoid that a potential corporate crisis is compounded by a banking crisis that would exacerbate the exit problems.

Financial regulation has been relaxed to a certain extent to facilitate an anti-cyclical role of bank lending. The degree of effectiveness of the different measures adopted has been uneven, but in any case, this relaxation is by definition temporary, which reinforces the case for direct public support measures to compensate for the eventual return to normality of financial regulation, which should in any case be calibrated carefully by regulators and supervisors.

European institutions acted decisively and boldly in the early stages of the crisis, especially with the Next Generation EU funds. Now that the funds are beginning to flow to the recipient countries, we need to make sure that the additional measures adopted by national governments are harmonized to the extent necessary to ensure a preservation of the level playing field in the single market. And governments, banks, corporates and SMEs need to cooperate in a constructive way to create the conditions for a robust recovery.

BASEL BANKING STANDARDS EVOLUTION

ANA PAULA SERRA

Member of the Board of Directors, Banco de Portugal

Building resilience of the EU banking system through regulation

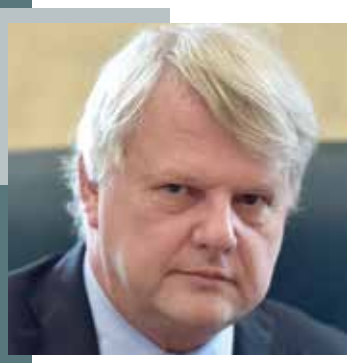
The Global Financial Crisis evidenced clear shortcomings in the regulatory framework that the BCBS aimed to address with the Basel III reforms, notably by improving the quantity and quality of regulatory capital, setting up a new global liquidity framework and introducing macroprudential elements. Included in the wide-range set of support measures taken during the current crisis to support the economy and preserve financial stability, additional relevant initiatives have been adopted at the regulatory level, some of them on a temporary basis. In this context, (i) the amendments of the EU regulation anticipating some of the flexibility embedded in CRR2 and implementing transitional provisions to defer impacts in a context of higher uncertainty, (ii) the EBA clarification on the flexibility embedded in regulation regarding default and forbearance, and (iii) the flexibility provided on the use of capital buffers should be particularly highlighted.

The Covid-19 crisis has stressed the importance of having prudent standards. Thanks to the progress in building capital and liquidity buffers, most banks continue, as of today, to meet the minimum capital requirements. Moreover, most of the regulatory relief measures taken since the outbreak of the crisis made use of the flexibility available in forthcoming Basel standards or were granted using transitional arrangements.

But the pandemic crisis is not over yet. As the situation evolves, more information on the impact of the pandemic becomes available but the level of uncertainty is still high. While assuring that banks rigorously reflect credit risk in their balance sheets, both regulatory and supervisory authorities need to continue following a consistent approach. In a context where temporary relief regulatory measures set to incentivize banks to finance our economies and absorb losses are still in place, flexibility should not be offset by conflicting requirements that could lead to a sudden halt of credit supply and magnify bank losses.

The adequacy of the international banking regulatory framework is also being tested for the first time in crisis times. While some debates emerged over the last year, for example on whether existing releasable capital buffers were adequate and sufficient in crisis times, it is too early to evaluate the effectiveness and resilience of the Basel III framework. Only in a few years, it will be time to take stock of the lessons learned.

The adoption of the latest Basel III reforms has been delayed and it raises some challenges in the current juncture. However, even if some additional transitional arrangements, beyond those already envisaged for the output floor, may be needed, the adoption of those standards in the EU should not be jeopardized or weakened. Notwithstanding short-term priorities, it is important to ensure the return to normality in regulation, implementing the reforms in a gradual manner. Basel III standards are a structural piece of the prudential framework to continue strengthening EU banks and make them better prepared to face future crises. Failing to fully and consistently implement the standards may have a detrimental impact on the resilience of the EU banking system in the long run.



LUIGI FEDERICO SIGNORINI

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

How should Basel banking standards evolve now?

Banks faced the pandemic crisis in a significantly stronger capital and liquidity position than they had at the onset of the Great Financial Crisis (GFC), also thanks to the Basel III standards adopted in response to it. For this reason, the international banking system acted as a shock absorber rather than amplifier and kept lending to the real economy.

The positive role of banks in dealing with the crisis has also been facilitated by far ranging measures taken by the supervisory community under the aegis of the Basel Committee. The Committee encouraged banks to fully exploit the flexibility embedded in the prudential standards on capital and liquidity buffers making clear that a measured draw-down of such buffers in time of stress was appropriate. The same encouragement was made with regard to the use of the flexibility in the accounting framework. Further, the Final Basel III standards was deferred by one year, to 2023. The overall effect of such measures will be subject to a continuous monitoring by the Committee.

The dramatic events of last year underlined the importance of having a

resilient banking system supported by a comprehensive and effective regulatory framework. The latter needs to evolve to keep up with the challenges that the financial sector will face in the future. Looking ahead, the regulatory agenda should focus on the implementation and evaluation of the reforms adopted in response to the GFC as well as on how to deal with emerging issues.

Notwithstanding the flexibility granted by the Basel Committee, the latter called the supervisory community to a full and timely adoption of the Basel standards at a national level. Furthermore, having in place the revised prudential framework will also facilitate the Committee in evaluating whether the new prudential framework has achieved its policy goals or whether there is still room for a fine tuning or simplification. The evaluation process will also shed light on whether the new regulatory framework is ready to address also the structural changes that will emerge in the 'post-Covid 19' environment.

...global standard setters should be ready to look beyond the crisis and start a comprehensive discussion on future trends...

The more forward-looking line of evolution refers to how the regulatory agenda should deal with emerging risks such as those posed by the ESG framework and the FinTech evolution.

On the former aspect, works should continue to assess how to adequately incorporate ESG factors in the prudential framework.

On the latter, the pandemic has shown the large potential benefits of the increased digitalization of the economic environment. The banking business and the financial sector in general made no exception to this trend. The regulatory framework should evolve to keep up with the spread of technology-enabled innovation in financial services in order to develop appropriate safeguards to deal with such new risks, such as cyber risks. An additional challenge for supervisors and regulators is also posed by the potential impact of the Fintech environment on banks' business models, as the competition in the provision of certain financial services is rapidly increasing. While still tackling the emergency, global standard setters such as the Basel Committee should be ready to look beyond the crisis and start a comprehensive discussion on future trends and challenges in banking and finance.

OTHMAR KARAS

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

Making financial markets work for the future of Europe

It has been over a year that we have been gripped by the Covid-19 pandemic and its profound impact on our lives, economy and financial markets. The European legislator has continued to function through all these difficulties. While many important measures have been adopted, we need to learn the lessons to be much better prepared for future shocks. At the same time, we need to complete our common projects to realize a genuine EMU.

Clearly, the financial markets are part of the solution in dealing with this crisis. We must continue to create suitable frameworks so that the financial sector can effectively contribute to optimal financing conditions for citizens and companies. On the road to recovery, we have already made important steps. On the one hand, we have adopted in record speed targeted banking rules to mobilize 450 billion Euros in fresh loans. On the other hand, we have realized a comprehensive recovery package for the capital markets.

However, key building blocks still need to be put together. Our effort to complete the EMU yields a high return: The EPRS estimates the added value of a complete Banking Union, a stronger CMU and closer fiscal policy coordination to be up to 275 billion Euros per year. At the same time, we need to make the financial rules future-fit. Let's just think about digitization, sustainable finance and the expected rise of NPLs and bankruptcies. Also, "Next Generation EU" can be more than a recovery fund: It is a forerunner to new shared fiscal tools to complement our monetary policy.

Our Banking Union is only as strong as its foundation. We must continue to implement global standards while taking account of European specificities.

Our Banking Union is only as strong as its foundation. I strongly welcome that the BCBS has postponed the implementation of the finalisation of Basel-III to increase the capacity of banks and supervisors to support our economy. Even though Basel-III is postponed, it is not off the table. We must continue to implement global standards while taking due account of European specificities. Both, in terms of a primarily bank-financed economy and in terms of the different business models. Because in Europe, the diversity of our banking landscape is a strength.

What the European Parliament has adopted in November 2016 still applies today: "no significant increase in overall capital requirements". In this context, some elements must remain undisputed in my view: the stronger SME Supporting

Factor and the CVA exemption. At the same time, concerning the Output Floor – our "elephant in the room" – all options remain on the table as long as we achieve a Basel-compliant solution that implements our common goals. European solutions are also needed in the areas of equity investments, un-rated corporates and specialized lending. And we need to move forward on capital and liquidity waivers to improve the integration of cross-border banking groups.

2021 also marks the start of the debate about the Future of Europe. This is much more than an answer to crisis. It is about the vision to actively shape our common future. And it is about realizing what we have already planned to do – such as deepening the EMU. Let us be ambitious and bold. And let us always be aware that Europe is all of us – citizens, politicians, stakeholders, regions, nations. We all share the responsibility in further developing a strong, efficient and credible EU in the world.

GOTTFRIED HABER

Vice Governor, Financial Stability, Banking Supervision and Statistics, Oesterreichische Nationalbank

Lessons from the Covid-19 pandemic and how regulatory banking standards should evolve

In response to the Covid-19 pandemic European authorities acted swiftly to help mitigate the impact on the economy, secure lending and ensure a smooth functioning of the financial sector. Coordinated policy measures comprise fiscal public support measures, public loan guarantees and moratoria, monetary policy interventions as well as capital, liquidity and operational relief measures enacted by banking supervisors. In addition, compared to previous crisis European banks entered the pandemic with significantly higher capital levels and more stable liquidity and funding positions. As a result, banks so far could cope well with the current economic deterioration. However, the impact of the pandemic on banks' balance sheets is not yet fully evident as several support measures will phase-out during 2021 and credit impairments materialize with a time lag.

Banks have responded to the pandemic by pursuing strategic overhauls, implemented restructuring programs, and in some European countries the pandemic has started a long overdue consolidation in the banking sector. In addition, the pandemic has accelerated innovation projects and digitalization. However, banks are expected to strengthen their reporting framework as with the increasing use of technologies timely and accurate data will become even more important in the future.

The future regulatory agenda needs to focus on a comprehensive and risk adequate inclusion of future risks like digitalization, data issues and ESG.

How will the post COVID-regulation look like?

First of all, regulators will have to phase out the temporary COVID-19 relief measures and restore pre-COVID-19 regulation standards. While some simplifications might be warranted in this respect, regulatory and supervisory standards should remain on high level. Second, the remaining Basel III reforms need to be implemented in a timely and consistent manner in the EU. Moreover, considering the lessons from the pandemic, an evidence-based evaluation of the effectiveness of the already implemented Basel III framework, especially the usability of capital buffers, should be conducted.

Third, future developments in the financial sector need to be tackled. New risks from the ongoing digitalization in finance should be reflected in the regulatory framework. ESG (Environmental, Social and Governance) risks are another topic, which must be incorporated into banking supervision in the coming years. However, isolated regulatory initiatives regarding ESG risks in the financial sector will not be sufficient to address climate change. These initiatives must be embedded within a holistic, cross-sectoral approach based on the comprehensive European Green Deal. It is important to focus on a true and accurate inclusion of such risks on a risk-by-risk basis and within the context of existing risk models.

In addition, supervisors themselves need to make better use of digitalization as regulatory and supervisory technology has tremendous potential to improve analytic capacity and quickly scan for unusual developments.

Banks and regulators are in this together: Like the banking sector, regulators must adapt to a changing environment. Regulation must evolve constantly to ensure a framework which addresses new developments and changing risks appropriately. But, changes in the regulatory framework have to be decided upon sufficiently in advance in order to ensure stable expectations and smooth adoption.

PHILIPPE BORDENAVE

Chief Operating Officer, BNP Paribas

What are the policy mistakes to be avoided, to foster a stronger economic rebound in Europe?

One year after the unprecedented Covid-19 lock-down, a lot of lessons should be learnt from the policy responses that have been implemented by political and regulatory bodies in Europe. They should help Europe to choose the right way to foster a strong economic rebound.

In parallel with unprecedented fiscal and monetary stimulus, regulators, at international and European levels, decided targeted and temporary revisions to the accounting and prudential frameworks, to allow banks to channel fiscal and monetary support programs to the economy.

Those measures have indeed alleviated the consequences of the pandemic on banks' balance-sheets, but, at the same time, they are the testimony that regulatory requirements were too high, and too pro-cyclical, as banks had argued for years. The EU had also over-transposed international standards: solo application of capital and liquidity rules, EU specific buffers, MREL requirements above TLAC levels, contribution

to deposit guarantee scheme AND resolution fund, ...

Setting excessive, non-flexible levels of capital in good times, to discretionarily relieve pressure in crisis times is not a healthy nor sustainable regulatory regime. Indeed, stability and predictability of regulation are crucial for economic agents like banks to set dynamic strategies and invest over the longer term. Contra-cyclical flexibility has to be built-in and transparent.

Excessive levels of capital and liquidity requirements during good times are counterproductive. They constrain banks to curb lending to the economy, which affects investments and competitiveness. Banks' balance sheets may be extremely robust, but growth is subdued, and economy is more vulnerable. This in turn leads monetary authorities to lower rates, which deteriorates further banks' profitability, and investors' appetite to invest in bank equity and debt securities.

Now should be the time to relaunch the economy.

There are currently no signs that the EU has recognized the risks of this approach. Instead, the EU is considering a costly transposition of the "final Basel III" rules, which, as per the Basel Committee itself, only hits European banks, with a +18.5% increase in capital requirements. Such combination of continued downward pressure by low rates on banks' capital generation capabilities, and of upward pressure on regulatory capital requirement will dampen the EU economic recovery, aggravating the EU growth deficit compared with the US and China.

In this context, it should not be a surprise that European banks have become unattractive as compared with US banks or with other EU sectors. Such perception by investors has been further anchored by the decisions on dividend distributions, where the supervisors solemnly "recommended" not to apply the Minimum Distributable Amount (MDA) rules that had been carefully designed at international level and voted by European co-legislators in the CRR!

Now should be the time to relaunch the economy. With banks balance sheets having been reinforced for more than 10 years, regulators should allow banks to fully deploy their lending capacity rather than devoting their efforts to comply with additional and ever-changing regulatory constraints.

JAMES VON MOLTKE

Member of the Management Board, Chief Financial Officer, Deutsche Bank AG

European banks after Covid – Challenges and opportunities for the years ahead

The Covid crisis saw a remarkable turnaround for Europe's banks. In 2008-9 they were part of the problem; through Covid, they were part of the solution, deploying much-strengthened balance sheets to maintain the flow of financing to the EU economy. Loans to companies are expanding at the strongest pace since the financial crisis (+5.5% yoy in December 2020), while retail lending also maintained its solid momentum (+3.2%).

A year into the crisis, Europe's banking sector has proven its resilience, with a total capital ratio above 16% and liquidity well above 100%. Banks are well placed to continue to play a vital role in Europe's recovery. Two priorities stand out. First, dealing effectively with insolvencies and other impacts of withdrawing government support; second, seizing and supporting opportunities to boost growth.

Regarding the first: the impacts so far have been contained. Non-performing loans have not risen appreciably as government measures are still in place. They are expected to rise in 2021-2022, although with important local differences as the economic impact and scope of government support both vary across different nations.

As we re-build after Covid, Banks can play a vital role in setting Europe on the path to growth.

So far, flexibility on all sides has been key – for example, through moratoria or other forbearance measures. Going forward, this is vital; entire sectors will need restructuring to become viable. Working with clients to identify workout solutions has proven successful, and regulation needs to enable this to continue. Excessively onerous capital requirements on non-performing loans would have the opposite effect: forced asset sales, collateral enforcement and insolvencies, and thereby choke off the post-Covid recovery.

Regarding the second: a clear path to competitiveness, innovation and growth is vital for Europe. Digitalization and the transition to a low-carbon economy both offer significant opportunities; however, both require financing on a scale which goes beyond conventional balance sheet lending – still the dominant source of financing for most European companies. Here, too, Europe's banks can play a central role, but two factors will be decisive.

First: further progress on banking union and capital market union. This will spur consolidation in the banking sector and help Europe's leading banks close the 'scale gap' to their US and Asian peers. Enabling Europe to develop deeper capital markets helps finance economic growth and creates opportunities to boost returns for savers and investors.

Second: a regulatory level playing field. This is all-important as Europe completes implementation of Basel III. If we raise capital requirements for lending, Europe's businesses, particularly smaller companies, may find financing more expensive or less available at a critical time in our recovery. The high impact on large banks may translate into higher cost across all types of financing.

Europe's path ahead is clear. We will only make progress on that path by working together. Governments, regulators and banks came together and worked in partnership to steer Europe through the Covid crisis. Let's keep that partnership spirit as we set the course for recovery, competitiveness and growth.

ALBAN AUCOIN

Head of Public Affairs,
Crédit Agricole Group

We need to breathe

During the covid crisis, banks have been part of the solution, together with the support of monetary and fiscal policies. They provided liquidity to the European businesses and households, to bridge their cash needs when the economy stopped due to the pandemic. This has been crucial, because the European financial market is too small to substitute banks' ongoing external financing. Banks have enough liquidity and capital to weather this "live" stress test, as recognised by supervisors (SSM vulnerability analysis, July 2020).

So far, the impact of the economic crisis on banks' balance sheets has been limited. It is no wonder, since public institutions absorbed most of the shock. They were indeed the only ones able to do so, due to the nature and magnitude of the crisis. Bankruptcies and NPL have not soared. For the time being, most of the impact on banks comes from the ex-ante provisioning of possible risks.

In any case, banks will absorb part of the shock. However, the materialisation of these risks depends on public policies. The pandemic crisis is not over. We still need strong support from public authorities to back the economy and the most affected businesses. If this occurs, casualties will be limited. In the meantime, pessimistic forecasts feed old habits: self-protection, mistrust and the comeback of the usual bureaucracy. The implementation of Basel IV is especially worrying. Indeed, the Commission plans to release its draft legislation next July, in the middle of the economic crisis.

All we need is appropriate implementation, respecting the political mandate.

First, legislators should not transpose the Basel agreement until the EBA has completed a deep analysis to provide the full picture of the Covid impact on banks. An estimated impact by supervisors of between 200 to 800 bp on solvency ratios confirms that additional capital requirements may destabilise the financial sector by seriously narrowing capital buffers European banks now have over regulatory minima. The trick of a long phasing-in has already proved its inefficiency in in the past, since markets always priced a fully loaded approach of regulations such as Basel III.

Second, at the very time when Europe needs financing to continue supporting businesses and to support the green and digital recovery, this reform would freeze hundreds of billion euros representing a financing capacity of thousands of billion euros, with no possible compensation by the financial market.

As supervisors have repeatedly said that the capital level of European banks is adequate, the urgency is not to increase it further. Rather than finalising the answer to the previous and different crisis, we should try to solve the present one, with timely solutions. Americans are pragmatic. They are faithful to the political mandate of no significant increase in capital requirements. They said they would stick to it, noticeably for FRTB. This will not hamper their recovery.

Third, Europeans are not lagging behind as regards prudential regulations! They have gold-plated

Basel III with pillar 2 and MREL. Another layer of gold plating is not necessary. All we need is appropriate implementation, respecting the political mandate of not significantly increasing overall capital requirements, and not resulting in significant differences for specific regions of the world.

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POLICY PRIORITIES FOR THE EU BANKING SECTOR

SEBASTIEN RASPILLER

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

The completion of the Banking Union should aim at improving the profitability and the competitiveness of EU banks

So far, the Banking Union (BU) agenda has been focused on building a more resilient banking sector, through stronger prudential requirements, addressing legacy risks, active supervision and preparation of resolution. The ability of the banking sector to continue funding the economy throughout the Covid crisis, supported by pragmatic regulatory and supervisory measures, proves that we have successfully built a resilient banking system. Some progress remains to be seen at individual level, notably on less significant institutions, but overall risk reduction has largely been achieved. However, risk reduction is not the only challenge facing the EU banking sector. It is not the only criteria to measure the strength and success of our BU. Today, EU banks are facing increased competition, at a time when Europe loses pace both globally and within the Single Market. Their market share has fallen over the last 15 years. Even within the Euro area, cross-border banking activity is on a continuous downward trend.

At the same time, although banking groups have to answer the immense funding needs of the twin green and digital transitions, they should be able to invest in their own digitization where there are many potential levers for growth: the EU payments initiative should strengthen the independence of banks and allow them to start (re) conquering important markets. The ongoing development of the regulation on crypto assets should allow EU banks to invest more in the market opportunities offered by this new segment.

We should move beyond the "risk reduction-risk sharing" slogan, to gather on a vision of a diversified and profitable EU banking sector.

Moving forward, we need to address the lack of competitiveness and structural under-profitability of our banking system, which drives a persistent reliance on extraordinary public interventions. In 2019, return on assets was three times lower for EU banks compared to US banks, putting a drag on their ability to rebuild lending capacities to finance the recovery. From a financial stability standpoint, the weak profitability of the EU banking sector is a serious hurdle endangering public finances and market discipline.

Our focus must therefore shift from resilience to competitiveness and strategic autonomy. We should move beyond the "risk reduction-risk sharing" paradigm, which brings more divisions than results, to gather on a vision of a diversified, profitable and attractive EU banking sector. Concretely, this means:

- First, fulfilling the promises of the 2nd pillar of the Banking Union (i.e. no more bailouts, better protection of taxpayers, more market discipline and more consolidation). It implies more intrusive supervision for "less significant institutions" which concentrate most vulnerabilities in the current environment. Zombie banks cannot remain on the market at the expense of taxpayers and competitors, it is crucial to reduce overcapacities. If making resolution for more banks means reviewing the conditions to access funding in resolution for banks pursuing such market exit strategies, assorted with adjusted contributions to existing safety nets, this should be envisaged.

- Second, we need to reaffirm that we aim for a single jurisdiction in all prudential and regulatory dimensions, taking full advantage of our single currency and BU. It is greatly needed to develop European and international banking groups able to foster the international role of the euro and reap its economic and strategic benefits. Without it, there would be no "Union". Steps towards this goal – even small – need to be pursued in the shorter run.

Last but not least, we should be careful not to inflict new burdens on the competitiveness of our own sector, especially compared to our competitors' jurisdictions. In the short run, the implementation of the Basel 3 package may put the financing of the EU-recovery at risk. The forthcoming EU Commission proposal must respect the G20/ECOFIN mandate not to induce a significant increase of banks capital requirements.

France, with Germany, has proposed ways to achieve this in a compliant way with the Basel agreement, and counts on the Commission to take them into account, especially at a time when US authorities are considering a capital-neutral implementation. It is particularly important not to affect wholesale banking business and market activities: the EU's Capital Market Union cannot succeed without competitive EU banks able to serve corporates' needs globally.

FERNANDO VICARIO

Chief Executive Officer,
Bank of America Europe

A harmonised banking sector is essential for financing the EU's twin transition

More than a decade on from the financial crisis and despite the unprecedented economic impact, the banking sector proved to be much better prepared this time in terms of resilience, capital, and liquidity. This is mostly due to the regulatory overhaul that the international community carried out over the last decade. In the EU, the ECB has responded swiftly to the pandemic by providing banks with regulatory / supervisory relief (such as capital requirements, liquidity) to allow continued lending to the economy.

This decisive and coherent action would not have been possible without having a single supervisor across the continent. The pandemic showed us not only how important the recent reforms are, but also reminded us that completing the Banking Union and the Capital Markets Union remain fundamental to improving the efficiency of the financial sector as well as enhancing the financing options available for the real economy.

As a first positive step towards completing and strengthening the Banking Union, the EU should finalize the implementation of Basel III in a fashion that is as consistent as possible with the internationally agreed Basel capital framework. This will ensure a global level playing field and will limit the costs and risks of global fragmentation. The new iteration of EU's prudential rules should also address the issue of national ring-fencing: a true European cross-border banking sector should be fully integrated to reap the benefits of the single market. Trapping liquidity and capital behind national lines goes against the principles of the single market and does not help to foster economic growth in all member states. Introducing a fully-fledged EDIS is also key to solving this issue; in the interim, we welcome the recent ECB's position on the cross-border mergers of banks.

Intertwined with the Banking Union, the EU needs well-functioning and fully integrated financial markets, making the CMU project of paramount importance for the swift recovery from the crisis. CMU is needed to support the EU's Hamiltonian moment, but any future rules and frameworks in place should be outward looking, capital markets should not be ring-fenced across national lines. The EU's capital market should be developed in a global context. The transition to net-zero is also dependent on private finance - which in turn needs fully integrated capital markets to allow money flows to go towards green assets.

The new iteration of EU's prudential rules should also address the issue of national ring-fencing.

The pandemic has also made clear the importance of digital issues for the resilience of the economy and the financial sector. Technological development has also been identified as an essential component for building a solid foundation for long-term growth, supporting the EU's recovery and modernising its economy. In order to achieve these objectives, regulation and supervision should be technology-neutral - in other words it should be principle-based and forward looking. This is why tackling fragmentation is of utmost importance. Europe will not be able to compete globally if it has a fragmented legal and regulatory environment that stifles innovation and undermines scale efficiencies, not to mention an environment that opens the door to regulatory arbitrage. Above all, the EU must promote a level playing field around innovative technologies in financial services, ensuring that the golden principle of "same activity, same risks, same rules" remains the norm throughout the digital transition.

Last but not least, NPLs. With ECB projections showing that the pandemic is likely to lead to a significant proliferation of distressed assets, swift action by the EU must remain a priority. As such, a European unified approach to simplify and potentially harmonise the licensing requirements for third-party loan servicers or some common base parameters, would be a major step forward. Once again, harmonisation of rules and supervisory measures is crucial, and we support the recent plan to tackle Member States' divergences on insolvency, debt recovery and debt restructuring frameworks.

For all of these reasons, it is essential that the EU continues to develop a strong and integrated banking sector alongside deep and liquid capital markets in order to deliver the much-needed finance to support the twin transition of the EU – the digital and the green transformation.

LUIS GARICANO

MEP, Committee on Economic and Monetary Affairs, European Parliament

To have bank mergers the priority must be to complete the Banking Union

Over the last few months, the European Central bank has taken some steps to encourage consolidation in the banking sector. For instance, it published a new guide on their supervisory approach to mergers and suggested that they could start grating cross-border liquidity waivers if adequate intragroup financial support agreements are included in bank recovery plans.

These kinds of measures are welcome. However, they do not address the basic reasons why we have barely seen any interest from banks in undertaking cross-border mergers. It is quite simple: the central barrier to cross-border mergers is the lack of the single market for banks, and the reason for this lack of a single market is the fact that the Banking Union is not complete.

In this way, there are three political challenges ahead of us: the absence of a common deposit insurance, which means that banks are expected to build excessive buffers in host countries; the absence of a credible and predictable resolution framework; and addressing a whole host of other regulatory differences that make it extremely difficult to operate as "one bank" across the Union.

The EU should not try to undertake a new "industrial policy" for its banking sector. The priority must be completing the Banking Union.

It is well known that one of the main impediments to cross border mergers is the fact that banks have to meet capital requirements both at the European and at the national level. However, it is crucial to emphasize that this issue, the home-host problem, will not be solved until we have achieved a meaningful European deposit insurance. A common deposit insurance has been stalled for more than five years now, but recently the German government finally turned in favor of it, and there is a growing consensus on the so-called "hybrid" model. Indeed, the upcoming review of the crisis management framework presents the much-needed opportunity to finally get it done.

The second main obstacle we face is that our crisis management framework is not fit for purpose. European institutions went to great lengths to establish a common resolution framework and a Single Resolution Board. However, Member States, each in their own way, have figured out how to circumvent it.

Unless we have a predictable and uniform framework to deal with troubled banks and to facilitate market exits, we will continue to have an amalgam of smaller, more regional, more inefficient, and more politically connected banks.

Lastly, we must address the regulatory differences across countries that banks continue to face. These span areas as broad as insolvency frameworks and tax regimes. However, a clear area where decisive EU action is possible in the short term is anti-money laundering.

Today's framework leaves too much discretion to local regulators and supervisors. This creates divergences in how rules are applied and understood that are inefficient to comply with across borders and that seriously undermine joint efforts to eliminate any risks derived from financial crimes. There has been enough talk of "coordination" on this issue, it is time for common AML supervision and for a European Financial Intelligence Unit.

DR. STEFAN SIMON

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

The next five years – Europe to outline its blueprint for future generations

Europe's plans for open strategic autonomy include several priorities designed to strengthen the financial sector. Central to this is promoting the euro and fostering its status as an international reference currency.

Legislative choices will greatly influence to what extent the European Commission (EC) will be successful in delivering strategic autonomy. The various legislation covers a digital euro, data protection/localisation, onshoring of euro related investment banking services, but also Basel implementation.

The right choices need to be made if European policymakers expect banks to play their part in financing the European economy. Especially against the background of the post-pandemic economic recovery and the fact that it will still need time to develop any meaningful European capital market to fall back on.

In September 2020, the EC set out its digital finance strategy, outlining how Europe can support the digital transformation of finance while regulating its risks. While this should provide opportunities for banks and their clients via better use of data, the

focus on crypto-assets and issuance of a digital euro, it also entails clear risks.

Crypto-assets as a means of payment and exchange of value will play an increasingly important role in the financing of the EU economy. As the digital agenda of the EU economy progresses, an increasing number of industry processes will be based on blockchain/DLT e.g. pay-by-use concepts and machine-to-machine payments. This creates a demand for compatible payment solutions and the financial industry is shaping its digital strategy accordingly.

A strong and robust EU regulatory regime for crypto-assets is essential to ensure that this technology supports a competitive, financial and economic ecosystem that protects consumers, investors and businesses. This should be based on the "same risk – same rules"- approach by relying on existing regulations, adapting these or, where necessary, introducing new rules that address the novel nature of crypto-assets while retaining financial stability.

The digital finance strategy includes many concepts which are new to policymakers and do not fit into the traditional financial regulatory architecture. This might lead to an overly conservative framework, especially for banks. Linked to the push on European sovereignty, a likely reaction is to close the European market for outside stakeholders and focus on data localisation. Closing markets has however never led to better client services.

For the financial industry, crypto-assets have the potential to feature many of the elements needed in a digital and globalized financial market place e.g. real-time finality of transactions or frictionless cross-border availability. But further institutionalization is needed: the establishment of a regulatory foundation followed by at-scale participation of key members of the regulated financial ecosystem.

While Europe should focus on embracing new technologies as part of its goal of strategic autonomy, it is clear to us that this should be paired with remaining open, as many of the new policy developments have cross-border impacts.

PHILIPPE HEIM

Chairman of the Board,
La Banque Postale

Supporting proportionate regulation and hastening sustainable finance policies

Retail banks have played a major role during the crisis (financing the economy, supporting State guaranteed loans, etc.) and will be key in facilitating the way out of the crisis, by financing recovery and investments.

However, banking models face severe challenges: persistently low or even negative market rates, new customer demands or reduction of the intermediation margin. The rapid growth of bigtechs/fintechs, which disintermediate major segments of the value chain, is also affecting their profitability. Furthermore, digitalization generates very significant costs, linked to the development of digital tools and self-care, and goes hand in hand with an efficient policy in terms of security (AML-CFT, cyber risk, fraud, etc.).

The weakened retail banking models must be less vulnerable to these risks: La Banque Postale has resolutely engaged in diversification since its creation in 2006, the most recent being the subsidiarising of CNP Assurances in March 2020.

This is why I consider the EU's political priorities to be the following:

- Slowing down of legislative measures,
- Reinforcing unified and fair European supervision
- Accelerating digitalization and sustainable finance policies

EU should take international leadership in building extra-financial reporting standards.

As European banks face a growing risk of paradoxical requirements and regulatory fatigue, unproportionate procedures should be limited and legislative initiatives need to be carefully assessed and selected. This is all the more true as prudential measures and the first steps of the Banking Union have been widely implemented in recent years. Reporting burdens, for example for non-performing loans or climate risk, should not be further increased nor duplicated between supervisory silos.

Likewise, taking into account European economic specificities in prudential regulation, ensuring a fair treatment between banking and non-banking actors for the same activities, and pursuing unified supervision at European level should be a concern of paramount importance as they are closely related to European sovereignty and sound international competition. This also means establishing a balance between market and banking finance through capital calibration and avoiding national gold plating or successive layers of supervision.

Finally, I see two major priorities in the years to come: digitalization and financing the energy transition.

Digitalization has been magnified by the pandemic and open finance responds to customer needs. But it should be clear that seamless user experience and widely connected tools be not detrimental to cybersecurity nor genuine control by the customer of its personal data.

The EU has rightly initiated a very active approach in the funding of energy transition. Such dynamic should lead to international leadership in building extra-financial reporting standards and fostering access to related data. This is a matter of sovereignty and reliability of information for end-users.

Consistently, these European ambitions should be shared by private and public actors in terms of green and transition projects. In dedicating €1.5 billion for green projects in 2020, targeting €3 billion in 2023 and supporting citizen responsible consumption, La Banque Postale aims to be a major actor of a fair transition for all, including containment of social inequalities.

JOSÉ MANUEL CAMPA

Chairperson, European Banking Authority (EBA)

Regulatory completion and effective implementation

Covid-19 has sent shock waves around the world and caused significant personal and economic loss. It has evoked memories of 2008 when, following the collapse of Lehman Brothers, the financial world was shaken to its foundations. The financial sector was then at the centre of the turbulence and that event started a decade long process of regulatory reform that fundamentally reshaped the framework for financial institutions. The Banking Union was the flagship reform in the EU. However, those reforms have not been completed.

On the positive side, the regulatory framework and status of banks today is unrecognisable from a decade ago. Capital requirements increased substantially and liquidity/funding restored to its role at the heart of banking regulation. The Bank Recovery and Resolution Directive came into force and gave us a modern framework for dealing with failing or failed banks. These reforms have certainly helped banks bringing their core support to the real economy in the current context.

However, the worst economic effects of the crisis are still ahead of us for the banking sector. Banks will continue lending to the economy but those that entered the crisis with lower capital levels, poor business models and riskier exposures will face challenges. So, what are the regulatory priorities in this period of relative calm?

First, it is imperative that the third pillar of the Banking Union, a common deposit insurance framework, is established. Nine years after the measure was announced it remains elusive, notwithstanding the improvements we have seen in risk metrics across the EU.

Next is the absence of a harmonised insolvency regime for banks. National insolvency regimes are not bank specific and generally not aligned with the provisions of the BRRD. As a result, the requirements deeming a bank as failed or likely to fail are inconsistent with the domestic regime for determining insolvency.

At the micro-prudential level, there are a range of issues that have the potential to act as impediments to the effective use of the single market. Cross-border banking activity needs to be fostered through increased competition, elimination of undue burdens and the increase introduction of technology that enhance cross-border activity.

Beyond enhancing the regulatory framework, banks need to continue to enhance their strategies to ensure the sustainability of their business model. The challenges from low profitability, excess capacity and digitalization have accelerated during the COVID-19 pandemic. Cost adjustment, restructuring (including exit) and enhancement of the value-added propositions towards customers should be at the core of their restructuring.

ANTÓNIO SIMÕES

Regional Head of Europe, Group Santander

Now is the time to be pan-European

Covid-19 has accelerated the challenges European banks are facing, but also creates opportunities, especially if authorities and the private sector can share a vision and work together. Working closely with banks, European governments, the Commission and monetary authorities acted swiftly and convincingly to protect people and business s the pandemic severely disrupted reduced economies last year.

European leaders seized the opportunity to design a multi-year plan not just for recovery, but for digitalization and the greening of the economy. The biggest opportunity lies in building on this renewed unity of purpose.

The biggest opportunity is to create a true single market for financial services. Banks in Europe today operate in a fragmented market with an incomplete banking union. To do cross border business, we face barriers in everything from how deposits can be deployed to different customer protection and bankruptcy rules. We cannot freely move capital or liquidity. It is crucial to advance more quickly in aligning policies and removing barriers, developing a clear single rulebook and completing the banking union with a deposit insurance scheme.

Because of this fragmentation, European capital markets remain woefully underdeveloped, unable to provide the scale or financing options available in competing geographies. A true single market for financial services in Europe would provide the foundation for banks to achieve the scale, efficiency, and resilience needed to finance more growth and jobs.

A second opportunity lies in the digitalization of the economy. FinTechs and BigTechs have entered financial services, providing a new source of competition to banks. However, the tech companies that provide financial services are not subject to the same regulations as banks. Rules governing innovation, access to data and platforms, and well as taxation, should be brought up to date to ensure a level playing field for incumbents and new

entrants. Banks are not seeking any favours, simply not to have to compete with one hand tied behind our back.

Thirdly, while regulatory and supervisory responses to the pandemic have been prompt and quick, certain measures did not work. Specifically, banks did not use the flexibility provided to draw down their countercyclical capital buffers, which could have supported more lending. We should use this opportunity consider how to develop truly countercyclical regulation, as well as take into account the challenges to the sector from green transition and digitalization.

Last is the challenge of declining profitability, especially in Europe. There are four main factors behind low returns. First, low interest rates are pressuring margins despite higher public and private indebtedness. Second, non-bank competition, especially from new digital entrants. Third, the costs of regulatory compliance and maintaining higher capital and liquidity ratios as a result of post-financial crisis reforms. Finally, the expected increase in business-related NPLs as a result of the pandemic, especially among small and medium-sized enterprises and the most-affected sectors.

We must seize the opportunity to mitigate this last factor by maintaining measures to support firms until the recovery is well under way. This would help viable firms remain solvent, and thus avoid the drag on the economy and the banking system that their failure would entail.

Europe's biggest opportunity is to create a true single market for financial services.

In Santander, with the One Europe project I am leading, our goal is to build a better and simpler bank that puts the customer at the heart of everything we do. One Europe will exploit synergies across our businesses in Spain, Portugal, Poland and the United Kingdom to take a truly regional approach.

We expect to grow by serving our customers better, simplifying and transforming our mass market business and accelerating our digital offer through a common omnichannel strategy. We expect this will enable us to realize significant efficiency savings in the next two years, even as we improve our products and services.

Doing this is the best way we can contribute to a strong and rapid recovery in Europe.

EU BANK CRISIS MANAGEMENT FRAMEWORK

ELKE KÖNIG
Chair, Single Resolution Board (SRB)

A European solution to deal with failures of medium-sized banks in the Banking Union

In Europe, we have built our resolution framework from scratch in just a few short years. This required prioritising tasks in the initial phases. Up to now, we have mainly focused on the operationalisation of the bail-in tool, as it is the preferred resolution strategy for most of the banks under our direct remit. We have done so because the largest institutions are those that imply a larger risk for financial stability.

One of our current priorities at the SRB is to work on the transfer tools at our disposal. The latter serves the purpose of improving the resolvability readiness of Significant Institutions falling under our direct remit with transfer tools as preferred resolution strategy. Indeed, experience has taught us that the failure of medium-sized institutions can also hamper financial stability, so all banks must be resolvable.

In such cases, the MREL targets are modulated through bank-by-bank adjustments to the recapitalisation amount. However, such transfer tools are not a free lunch, and they come at a cost. Indeed, where a key driver of value for the main assets transferred are the client relations, any transfer strategy must reflect the need to maintain these client relations. Bailing in non-covered deposits might in such cases damage client relationships and thereby possibly deplete the franchise value. Therefore, banks must build up the necessary MREL calibrated to ensure a successful exit from the market in case of failure.

BRRD3 must grant the SRB with stronger powers to deal with bank failures in the Banking Union, together with the management of EDIS.

The European Deposit Insurance Scheme (EDIS) is the main missing element of our Banking Union, intended not least to break the bank-sovereign-doom-loop. It is closely related to bank resolution. Indeed, we support further exploring the use of EDIS in resolution, in combination with the SRF. However, the existing restrictive rules for the use of DGS funds to support a sale of business put into question its operationalisation. Thus, we call for the removal of DGS super priority in the creditor hierarchy, and a review of the "Least Cost Test" to provide stringent and harmonised criteria across the Banking Union.

Such amendments could provide solid funding options for the transfer tools, and subsequent exit of market of ailing medium-sized banks. Of course, the review of the crisis management and deposit insurance framework is inextricably intertwined with the discussions on EDIS that are taking place in parallel. Only EDIS would ensure a harmonised and European approach, guaranteeing the same level of protection for all depositors.

If this were not the case, it would lead us to an undesired outcome: the renationalisation of bank failures. Relying on national DGS funds and national decisions could put pressure to circumvent resolution and go for national solutions, especially in case access to DGS has lower burden-sharing requirements than the SRF. We cannot afford to go back to past mistakes based on inconsistent national solutions that inevitably reinvigorate the sovereign-bank doom-loop. Banking failures in the single market require a European approach.

All of the above is also closely linked to the need for a targeted harmonisation of the key features of bank liquidation regimes, to set the basis for a harmonised EU liquidation regime. This is important for us in order to carry out our Public Interest Assessment and respect the "non-creditor-worse-off" principle. The SRB would have administrative liquidation powers for banks under our direct remit, and National Resolution Authorities would have more consistent and efficient powers to transfer assets and liabilities in liquidation, to be funded through EDIS with a robust governance system within the Single Resolution Mechanism.

"Aller guten Dinge sind drei." BRRD3 must ensure that we have a well-functioning European solution for all banks. This requires ultimately granting the SRB with stronger powers to deal with bank failures in the Banking Union, together with the management of EDIS.

I believe in completing our framework to reduce value destruction, increase and harmonise deposit protection, ensure transparency and reliability, safeguard public funds, and improve financial stability.

MARIA VELENTZA

Director Financial Services,
DG Competition,
European Commission

Developments in the state aid and banking crisis management framework

Since the beginning of the financial crisis in 2008, the European Commission has exercised its duties as competition enforcer by assessing the compatibility of support from the public budget to the financial sector with the State aid provisions enshrined in the EU Treaty. Specific guidelines (a series of "communications") were adopted establishing minimum criteria for this compatibility assessment. Through state aid control the Commission has contributed to safeguarding financial stability by facilitating the orderly market exit of unviable banks and preventing the disorderly failure of otherwise viable entities. This has contributed to a more robust EU banking sector by fostering deep restructuring.

The 2013 Banking Communication, which is the latest revision of the financial-sector State aid guidelines, has been a stable guide as to the Commission's exercise of State aid control in that sector. Until the introduction of the EU bank resolution framework in 2015, financial-sector State aid control de facto served as the Union's bank resolution regime, ensuring a level playing field at a time when many Member States mobilised their public budgets to support their banks. It is worth noting that these guidelines introduced loss-sharing by the shareholders and subordinated creditors of aided banks. And, finally, they supported fair competition by requiring aid beneficiaries to make efforts to mitigate competition distortions.

Since 2015, State aid control in the financial sector has fulfilled these roles in complementarity with the new EU bank resolution and deposit insurance rules. For instance, the Bank Recovery and Resolution Directive explicitly recognises the applicability of the State aid framework in the context of precautionary recapitalisation or resolution; in its State aid decisions, the Commission has consistently taken into account the new regulatory setting.

The EU bank crisis management framework has also entailed the creation of new actors, attributing the role of bank supervisor to the European Central Bank within the Single Supervisory Mechanism, and the Single Resolution Board as central resolution authority within the Single Resolution Mechanism. However, the Commission's role as competition authority – contained to assessing the compatibility of State aid measures – has remained unaltered.

In the future, a holistic assessment of the crisis management framework will ensure consistency between State aid and Banking Union rules.

Six years after the entry into force of this new regulatory setting, the EU banking sector is in general more resilient, but some pockets of vulnerability remain – and the effects of the COVID crisis are still unknown. The implementation of the bank resolution framework is still ongoing, in particular with respect to banks' compliance with the minimum requirements for own funds and eligible liabilities, which serve as a bail-inable buffer to protect taxpayers and depositors in case of a bank failure. Further revisions of the crisis management framework are ongoing or being discussed, including as part of a public consultation; the economic effects of the COVID-19 pandemic - which represent a serious disturbance in the Member State economies - further underline the need to proceed thoughtfully.

The Commission is now set to review the State aid rules for banks in the context of a broader review of the EU bank crisis management framework which is to be completed by 2023. While financial sector State aid guidelines and the EU bank resolution and deposit insurance regime each follow their own logic, these frameworks are highly interdependent, and so are the decisions of the various public actors involved.

Given these interdependencies, a holistic approach towards the review of State aid rules for banks and the EU bank crisis management framework is the best way to ensure a coherent set of rules in both frameworks in the future.

A holistic analysis and revision of all the pieces of the crisis framework "puzzle" will support consistent and predictable outcomes which safeguard fair competition, promote financial stability, protect taxpayers and set appropriate incentives for banks and their shareholders and creditors.

HELMUT ETTL

Executive Director,
Austrian Financial Market Authority

Winding down smaller and mid-sized banks – A possible way forward

Since the establishment of the new crisis management and resolution framework in 2015, the number banks declared failing or likely to fail has been limited. The number of resolved banks according to the new framework is even lower. One possible reason is that for a certain type of banks the resolution framework is not (fully) suitable. But exiting the market through ordinary insolvency proceeding seems to be not suitable either due to the potential negative impact on financial market stability – leaving the supervisory authority in kind of a limbo situation to forbear the ultimate supervisory measure, declaring a bank failing or likely to fail.

Moreover, the resolution regime as such was developed to counteract the "too big to fail" hypothesis. Thus, it was created for the big, systemic banks. Therefore, it might be not proportional and too intrusive for smaller banks.

DGS could play a role in supporting the wind down of non-systemic banks, given prior fixation of strict least-cost-tests and adequate loss sharing.

For this and various other reasons, it is a consensus that there is the need for a further improvement of the crisis management and resolution framework for these so-called small and mid-sized banks – banks that are too small for resolution, but potentially too big for ordinary insolvency. For sure EDIS combined with an "EDIC" would be the solution for such problem. Unfortunately, this seems to be a rather long-term solution. Steps in between are necessary.

There are various possible ways forward, all of them with positive aspects and drawbacks. All of them are circling mostly around one crucial element – funding of winding the failing bank down. Let me try to outline one of these options: One could argue that only the systemic banks should be eligible for resolution. For smaller banks, it should be either ordinary insolvency including triggering the DGS or an alternative administrative wind down procedure, which could be developed alongside the following principles:

1. Losses have to borne by shareholders and holders of regulatory capital (AT1 and T2) first. The failing bank must exit the market. Only relevant parts of the bank should be safeguarded (e.g. covered deposits) by transferring them to other market participants.
2. There might be the need for external financing (capital and liquidity) to support the transfer-mechanism. As covered deposits are concerned, DGS could step in and support. A strict least-cost-principle-test should be a pre-condition.
3. Internal preparation of banks for the implementation of such a transfer-tool will be necessary. Such preparation could include a certain financial cushion for supporting the transfer (reserved assets) or bearing losses (additional gone-concern instruments beyond regulatory capital requirement).

As mentioned above – this is only one possible way forward. There are several others. But we should always bear in mind: losses will not vanish – they have to be borne by someone and they have to be allocated in the process of winding down a failing bank. We should strive for the most efficient way and aim for using as less public and mutualized financial means as possible.

MARTIN MERLIN

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

Evolution rather than revolution in crisis management and deposit insurance

Completing the Banking Union remains a priority for the Commission, currently working on the review of the crisis management and deposit insurance framework, with a public consultation launched in February, a high-level conference mid-March and legislative proposals scheduled at the end of the year.

EDIS is a natural complement of such a review. Seeking to facilitate interventions by deposit guarantee schemes (DGS) to finance the sale and market exit of smaller, deposit-based, banks, the liquidity support from EDIS would mitigate the lack of available funding and the risks of shortfalls in the DGS financial means, requiring the recourse to public financing.

The pooling of resources in EDIS would avoid "re-nationalising" the Banking Union and could lower bank contributions while maintaining an appropriate firepower and ensuring a more sustainable replenishment. Synergies with the Single Resolution Fund could also strengthen the resilience of the EU crisis management toolkit and deliver efficiency gains.

The Banking Union would not be complete without its third pillar, EDIS.

The ongoing health crisis reaffirms the urgency for robust financial safety nets financed by the industry in a crisis management framework for every bank whatever its location, size or business model. Such a robust framework with effective and proportionate instruments available for all banks would strengthen depositor confidence and pave the way for further market integration.

The priority should be to preserve financial stability and level playing field in full respect of the diversity in the EU banking landscape while limiting the use of taxpayer money.

Overall, the Banking Union should ensure a solid and stable banking sector in Europe, taking full advantage of the single market. Indeed, market integration generally increases access to funding for the real economy, lowers the cost of capital, contributes to risk diversification and stronger resilience to shocks. Banks in Europe need such a regulatory environment to continue contributing to the economic recovery and play their role in other important challenges ahead.

The work on the so-called hybrid EDIS, based on the coexistence of national DGSs and a European central fund, continues in the Council and in the intergovernmental context. The hybrid model would provide liquidity support as a first step and, is evolutive in nature, allowing for a gradual and conditioned transition towards loss mutualisation in the steady state.

The process for Banking Union completion also involves other components, including on mitigating the sovereign-bank nexus, reflecting upon banks' exposures to sovereigns, their financial stability implications and the need for safe assets at the EU level. Progress on EDIS should unlock some of home-host issues and ring-fencing practices.

At this juncture, one observes only one resolution case managed by the SRB and a frequent recourse to public money under national procedures. The current efforts to complete the Banking Union provide a momentum, not for a revolution of the framework, but for targeted changes to improve existing tools, ensure a broader application of the EU framework and mark the start of the gradual establishment of the third pillar.

KARL-PETER SCHACKMANN-FALLIS

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

Improving the crisis management and deposit insurance framework while preserving the diversity of the EU banking system

When the Banking Union – arguably the biggest EU reform project since the introduction of the common currency – was set up in response to the sovereign debt crisis, its core objectives were to ensure financial stability and to establish common principles for adequate banking supervision. Its three pillars have since been put firmly into place and their added value has been proven as recently as at the onset of the pandemic crisis, when regulators and supervisors across Europe acted swiftly and in unison.

The start of the review of the crisis management and deposit insurance (CMDI) framework offers the chance for measured reforms to address shortcomings identified since it entered into force. The wide scope of the European Commission's respective stakeholder consultation however suggests a much more fundamental overhaul of the entire framework.

Unfortunately, the underlying concept so far points to an insufficient consideration of institutional protection schemes (IPS), which are widely prevalent among small and mid-sized regional credit institutions in Europe, such as the German savings and cooperative banks.

Most notably, the Commission intertwines the CMDI review with its separate proposal for a European Deposit Insurance Scheme (EDIS). This is unnecessary and will not lead to any results since EDIS has been stuck in the legislative process since 2015 for failing to take account of the diversity of the EU's banking sector. Clinging on to EDIS is an impediment to finding the best European solution.

Not only appears there to be little intention of drafting a fresh proposal which would exclude IPSs from a centralised EDIS on subsidiarity grounds, there are now even additional considerations going in the same, flawed direction. In particular, this regards plans to further centralise competences at the SRB.

Contrary to this, the Commission should build on the subsidiarity inherent to the CMDI framework: A clear distinction between systemically important banks under direct responsibility of EU institutions and non-systemically important banks under national responsibility. Changing this foundation cannot be justified – neither economically nor politically. It would contradict the idea of a diverse Europe and undermine local responsibility.

The European Court of Justice's recent ruling in the so-called Banca Tercas case has highlighted the validity and the importance of preventative and alternative measures to support troubled members of a guarantee scheme from within their respective peer group. By definition, these measures are required to be economically more advantageous than mere reimbursement of depositors in the event of liquidation.

Following the reasoning confirmed by the highest court of the EU, the CMDI review should seek to strengthen the role of existing DGSs and IPSs within crisis management by committing to preventive and alternative measures. In addition, national authorities should be provided with additional tools to deal with banks going into national insolvency. This would improve the proper functioning of the Banking Union going forward and maintain the diversity of the EU banking system at the same time.

JACQUES BEYSSADE

Secretary General,
Groupe BPCE

We need to make the full use of the Banking Union as a single jurisdiction

The Banking Union (BU) is a great achievement but remains incomplete and below its potential to achieve a well-integrated Eurozone banking sector. Even within the BU, national interests still cement fragmentation along national lines and discourage cross-border banking groups. For example, not even liquidity is allowed to move freely within banking groups, not to mention capital. Considering that from a supervision perspective the BU is a single jurisdiction, such obstacles are not justifiable. This underlying flaw of the BU's first Pillar also undermines the functioning of the second Pillar, the ability to resolve significant banks and liquidate less significant banks in a way that preserves value, Shields taxpayers and protects depositors. But as long as achieving Banking Union as a single jurisdiction is not encouraged, most solutions (i.e. sale of business) have to be found at a national level. This holds back future sector integration but also risks amplifying issues in national banking sectors.

These dynamics in Pillar 1 and 2 also undermine the acceptability of any EDIS-like structure as a Pillar 3 where six years after the original proposal we are still in the dark on the direction of travel. Therefore, the first part of our response is clear: Improve the conditions for using the existing BRRD tools in the current legislation making the full use of the Banking Union as a single jurisdiction.

> "Same risks, same rules", regardless of the size of banks

The second part of our response is to step back and consider the problem at hand objectively: according to the Commission's consultation there are two dimensions to the problem. First, medium-sized banks that do not pass the PIA may be too difficult to handle for national insolvency proceedings. Second medium sized banks, especially when deposit financed, tend to struggle raising MREL. The first concern can be addressed by either harmonising key elements of national insolvency proceedings for the financial sector and, if this is too complex, the alternative is to better frame the Public Interest Assessment in a transparent manner which would allow for these banks to be resolved via SRB action.

The second concern cannot be taken at face value. We have not seen any evidence that raising MREL is a problem other than suggesting that an inability to issue may not be the bank's primary problem. Conversely, if some healthy mid-sized banks truly struggle in meeting their MREL requirement the solution would be to move forward with the Capital Markets Union.

On this basis, this is not the time to introduce another layer of special treatment into a complex framework just to solve issues that may or may not be incurred by a hazily defined group of banks. This means that the establishment of an ad hoc resolution mechanism for medium-sized banks with maintenance of their access to the Single Resolution Fund under very favourable conditions, i.e. without having to bail-in at least 8% of the Total Liabilities and Own Funds should be radically refused.

It is inconsistent with the principle "same activity, same risk, same rules" and would mean that taxpayers and DGSs indirectly subsidize these banks with insufficient MREL. The challenges we are faced with are real enough, we should not exert ourselves in adding new difficulties at national and European level.

DIEDERIK VAN WASSENAER

Global Head Research
and Regulatory & International Affairs,
ING Group

Improve the efficiency of the EU Crisis Management Framework: a key intermediate step in achieving Banking Union

The EU Crisis Management Framework has to a large extent contributed to the initial goals of strengthening the resilience of the banking system. Across the board systemic banks have become more resilient and built-up a sizeable cushion of bail-inable debt for absorption of losses and recapitalization if the situation requires so. Although differences remain, we view that amongst the most sizable EU banks there is an overall level-playing-field in terms of requirements and applications of rules throughout the Eurozone. Fortunately, in the decade after the financial crisis depositor protection has not been severely challenged which could be considered as a demonstration that banks have become increasingly resilient.

With respect to the smaller banks in the EU system the landscape and framework is more diversified. This makes the applicable resolution/liquidation rules challenging and diversified. To ensure predictability

we promote more clarity in the BRRD when defining a resolution action in the public interest or the winding up of a bank under normal insolvency law when the public interest test is not met.

Banks, irrespective of their size, that are in the scope of resolution should be subject to MREL requirements whereby the size, business model, local market and rating are duly taken into consideration thereby acknowledging that the MREL issuing capacity might be vary across countries. We welcome the proposals, currently under way by the SRB, to harmonize the public interest test and view that such a test should be applied by the SRB and no longer by national authorities.

A key challenge to address is the existing discrepancy between declaring an institution failing-or-likely-to-fail and the national triggers to initiate insolvency procedures; clarification should be made at EU level through the BRRD and the SRM regulation to establish administrative procedures that will be applicable for all banks and binding for the national insolvency regimes.

Furthermore, we envisage that more efforts could be undertaken to harmonise existing national insolvency procedures and financial means. One key element to consider is in our view to harmonise the use of DGS to finance alternative measures in liquidation, such as the transfer of assets and liabilities across the EU.

We note that only in a number of Member States DGS can be used a preventive measure; we believe the DGSD should be amended and DGS funds should only be used in liquidation. both for compensating depositors as well as alternative measures and always on a least cost basis. And in any event, to prevent an un-level-playing field, the use of preventive measures by both private and public DGSs against the background of state aid rules should be clarified.

Throughout the years the Crisis management Framework has also significantly contributed to a reduction of the sovereign feedback loop. However, there is an actual risk that dependencies are re-introduced or increased – we see this for instance when contributions into the national DGS funds are deposited in public treasury. The DGSD review should provide for clear rules to avoid this. Ultimately the European Deposit Guarantee Scheme is the best response to address this sovereign feedback loop.

SOLVENCY II REVIEW

DOMINIQUE LABOUREIX

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

Thinking long-term, through short and medium-term measures

The first lesson of the Covid-19 crisis in the insurance sector is its robustness and the strength and flexibility of the Solvency II supervisory framework. The current counter-cyclical mechanisms, including the so-called Volatility Adjustment measure, have proved to be useful to mitigate the impact of market volatility on the balance sheet of insurers. It has also enabled to avoid pro-cyclical behaviors, even if counter-cyclical instruments of Solvency II will have to be entirely assessed in light of the whole crisis. In addition, the low-for-longer economic environment has to be better taken into consideration in the Solvency II framework, and its risk-based approach, and the EIOPA answer to the Commission consultation has contributed to this debate.

For all that, the current crisis has also highlighted new or growing challenges for insurers, such as business interruption issues, to name but one. The consequent rise in insurers' reputational risk has brought to light the benefit of transparency and advice to policyholders: they are of utmost importance to ensure that there is no mismatch between expected and effective insurance coverages. Furthermore, due to the context of the pandemic and of climate-related risks, the need to address the protection gap issue has hopefully gained traction, especially when observing the heterogeneity in the level of protection across Europe.

Beyond the question of state-owned reinsurance schemes, which benefit to insured people in countries where they exist, it shows that it is important that insurers act more and more on risk prevention with clients, via their role of advice. Solvency II has met one of its objectives, namely fostering a fluid European market to improve the ability of insurers to offer policyholders all the products they need. It will be essential to pursue this trend.

> **Ensuring suitable, stable regulation conditions will be one of the main challenges in the coming months.**

From this perspective, a simplified Solvency II framework should be an important goal to keep in mind, in order to levy undue barriers to the supply of innovative and needed products by insurers. Moreover, supervisory convergence and level playing field are also essential to ensure similar policyholders' protection, irrespective of the origin of insurers and the location of the insured person. European supervisors are actively working to enhance the quality of cross-border supervision and the protection of policyholders in such context; in this regard, the development of a harmonized insurance guarantee scheme framework throughout the EU would probably help to reduce the observed heterogeneity. The freedom to provide services only makes sense in the context of a harmonized legal and supervisory framework in the EU.

Simultaneously, given their business profile, conducive to long-term investments, European insurers have a decisive role to play ensuring sound and sustainable financing conditions for corporate, especially for small and medium-sized companies, to foster economic recovery. Long-term investment was already encouraged by subsequent Solvency II revision, and one of the aims of the current review is to go further and detect potential unjustified restrictions to economy financing, in particular, long-term investment in equities.

Fostering sustainable financing conditions by insurers is of utmost importance, as insurers and reinsurers are at the frontline of the climate change challenges, as risks takers and risks carriers. The impact of environmental risks should be monitored on their solvency position as well as on the assets and liabilities quality they carry. Insurers must integrate tools and processes in their system of governance to properly identify, assess, manage and monitor climate-related risks and their impact on their business model and financial exposures.

The upcoming review of Solvency 2 will thus integrate new requirements in this regard in pillar 2 of Solvency 2. The pandemic crisis also provided a striking illustration of transition risks, with oil-related asset prices dropping in 2020. This preview of the still-to-come adjustment to a low-carbon economy should act as a warning: appropriate regulatory measures in the pillar 1 to penalize riskier investments could now be considered.

Once these adjustments are made, it will also be important to stabilize the regulatory framework to foster long-term visibility and long-term thinking.

MARGARIDA CORRÊA DE AGUIAR

President, Portuguese Insurance and Pension Funds Supervisory Authority (ASF)

Solvency II review: ensuring the regime remains fit for purpose

During the third quarter of 2021, the European Commission is expected to unveil its legislative proposals for the much-anticipated review of the Solvency II framework. The process for the review, provided for in the text of the Directive, started as early as 2019, with the European Insurance and Occupational Pensions Authority (EIOPA) conducting an in-depth and wide-ranging technical analysis at the request of the European Commission.

The package of legislative proposals is expected to complete the regulatory toolbox, by introducing macroprudential tools, recovery and resolution measures and insurance guarantee schemes. Furthermore, and although it is widely acknowledged that the framework is working well from a prudential perspective, the review will also attempt to ensure that the Solvency II regime remains fit for purpose, recognizing the current macroeconomic context.

One unavoidable issue that deserves urgent revision to ensure such recognition is the calibration of interest rate risk. The existing provisions do not capture the risk of falling interest rates when market values are already negative, which is unanimously regarded as a fatal flaw under the current ultra-low interest rate environment. In fact, such fall has been observed on multiple occasions, including, very recently, following the swift and decisive action of the European Central Bank in response to the outbreak of the COVID-19 pandemic crisis.

The required amendment will undoubtedly take its toll on the solvency position of the European insurance sector. Nonetheless, that should not preclude its inclusion in the overarching review, under penalty that the risk incurred by insurance undertakings remains underestimated, ultimately compromising policyholder protection and financial stability. The risk is already there, it is just not being adequately measured.

A phased-in approach, as proposed by EIOPA, potentially complemented with adequate safeguards in Pillar II and Pillar III, such as the consideration in ORSA and the disclosure of the solvency position without the recognition of the phasing-in, appears to be a suitable compromise way forward.

> Compromise solutions should be sought without jeopardizing the fundamental principles of Solvency II.

Another feature of the regime requiring action to ensure efficient functioning and reflection of economic fundamentals, and for which the Portuguese Insurance and Pension Funds Supervisory Authority has been as outspoken advocate, is the enhancement of the design of the volatility adjustment (VA). This mechanism was introduced by the Omnibus II Directive to prevent pro-cyclical behaviour on financial markets and to mitigate the effect of exaggerations of bond spreads. The experience gained during the first years of application of Solvency II has, nonetheless, showcased some shortcomings in its design.

One of such deficiencies relate to the country-specific component of the VA, which is intended to mitigate the effects of a widening of spreads affecting only one or a few national markets, but not the majority of national markets that are invested in bonds denominated in the same currency. This is particularly relevant for the Member State of the euro area, especially for those more susceptible to market fragmentation.

It has been observed that the activation mechanism does not work as expected, producing a 'cliff edge effect' of the country-specific increase. Notably, in periods where the spreads of a single – or few - countries would fluctuate around the trigger point, rather than mitigating market volatility, the activation of the country component translates into a larger volatility of own funds. Hence, the introduction of a factor to ensure a gradual and smooth activation of the country component and of a relative threshold calibrated as to ensure that national specific crises are properly recognized is warranted.

The above-mentioned features are just two in a myriad of issues that will certainly be extensively discussed – and negotiated – between the European legislators following the presentation of the European Commission's proposals. During the discussions, transparency and the spirit of commitment must prevail, in the sight of European unity and public-good.

Compromise solutions should be sought to solve difficult political negotiations, without jeopardizing the fundamental principles of the Solvency II Directive implemented in 2016, which led Europe to the forefront of insurance prudential framework worldwide.

JUSTIN WRAY

Head of Policy Department, European Insurance and Occupational Pensions Authority (EIOPA)

Maintaining stability of the EU insurance sector in times of uncertainty

Although financial markets have gradually stabilised after the initial sharp drop in asset prices triggered by the Covid-19 outbreak, the ongoing lockdowns in most European countries cause uncertainty and medium-term risks for the economies. In addition, potential cliff-edge effects could materialise once the fiscal measures supporting economies will fade out. Strains to demand that will reflect into insurers' underwriting and overall profitability will take some time to unfold in parallel with the deterioration of the macroeconomic environment in which a reduction of economic activity and disposable income is starting to become tangible.

The outlook for the insurance sector depends critically on the future development of the pandemic and on the resilience of the economic recovery. Capital buffers of insurers were solid in the end of 2019 and proved resilient at the time of the virus outbreak. It stands out that life undertakings are affected the most due to their higher sensitivity to risk-free interest rates that reached their all-time low levels in the end of last year. The prolonged period of ultra-low yields is further negatively affecting the profitability prospects of insurers' investment portfolios, due to reinvestment risk. In addition, the risk of deterioration of corporates' ratings could affect the market value of insurers' corporate bond holdings.

> The outlook for the insurance sector depends critically on the future development of the pandemic and on the resilience of the economic recovery.

Nevertheless, European insurers have been able to withstand the dramatic situation as, in particular, the Solvency II regime helped them to better align capital to risk, build-up resilience and enhance their risk management practices. While risks surrounding the economic growth outlook remain high, they appear to have become less pronounced. EIOPA will assess the resilience of the sector to different recovery scenarios within the European Union-wide insurance stress test carried out this year.

In its Opinion on the Review of Solvency II, EIOPA proposes to broaden the prudential regime to incorporate the macroprudential perspective. The tools seek to enhance monitoring and add supervisory powers that might be useful to address the sources of system risk.

Examples are the power to define soft thresholds for action at market level if a certain exposure increases dramatically and/or reaches a significant level, the expansion of the prudent person principle and the use of ORSA to include the macroprudential perspective, the request of pre-emptive plans (such as recovery or resolution plans) or an enhanced liquidity risk monitoring.

In addition, EIOPA also proposes that supervisors should have the power to set a capital surcharge to address one or more entity, activity- or behaviour-based sources of systemic risk or, in exceptional circumstances, additional measures to reinforce the insurer's financial position (i.e. the possibility of restricting or suspending dividend or other payments to shareholders and the possibility of restricting the purchase of the insurer's own shares).

A strong and stable insurance sector benefits the whole of society. EIOPA will therefore continue its work to ensure the early identification of risks and vulnerabilities, so that the insurance sector can continue to play a vital role in Europe's post-Covid recovery.

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FRANK GRUND

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

Macro risks are increasing the requirements for micro-prudential supervision

The impact of the coronavirus pandemic has reinforced the biggest challenge for insurance undertakings: the low interest rate environment. Moreover, this year the crisis could also have a negative impact on the ratings and quality of corporate loans, and put pressure on commercial property prices.

These macro risks result in increased requirements for micro-prudential supervision. For example, the low interest rates are posing a threat in particular to the business model of life insurers, because in the past these insurers often promised their customers interest rates which they are now finding difficult to generate on the capital market. However, BaFin does not leave it at that, but uses a proactive approach in its supervision. BaFin ensures that the guaranteed interest rate for new business remains at a level which life insurers can afford in view of their risk-bearing capacity and earnings power. Anything else would not be sustainable.

From a risk management perspective, there is no simple analytical procedure

for determining the guaranteed interest rate. However, setting a guaranteed interest rate of 0.9% without further evaluation is not considered proper risk management. In Germany, the guaranteed interest rate refers to the savings portion of the premiums that remains after the portions that are earmarked for the acquisition and administrative costs and for insurance coverage have been deducted from the gross premium.

The level of the guaranteed interest rate is limited by the maximum technical interest rate for the calculation of the premium reserve, which is currently set at 0.9%. However, when determining their guaranteed interest rate, insurance undertakings should not apply the maximum threshold, but should set a rate that is significantly lower than 0.9%. I also fully support the lowering of the maximum technical interest rate by the legislature.

BaFin has developed tools for proactive supervision and is using them in a targeted manner during the pandemic.

As at 30 September each year, insurance undertakings must submit a projection to BaFin on the impact of certain capital market scenarios on their future performance. Our analysis of these projections is based on a dual approach. Firstly, undertakings are required to determine, on the basis of local GAAP, whether they can continue to fulfil the guarantees they have given to their policyholders in the future. Secondly, BaFin considers the solvency ratios under Solvency II: undertakings need to have a solvency ratio of more than 100% in order to remain active on the market and to write new business. The ability of undertakings to meet existing guarantee obligations is currently less of a concern to BaFin than their ability to write new business.

At the European level, Solvency II is the most important regulatory parameter - and this parameter is currently being adjusted: EIOPA's proposals for the review are acceptable to a degree, but I still see room for manoeuvre. For example, the proposed changes to the extrapolation of the risk-free interest rate term structure: if these changes were to come into force, they would result in a significant additional burden for German life insurers. I am still hoping that readjustments can be made here.

GORAZD ČIBEJ

Director,
Insurance Supervision Agency,
Slovenia

The Solvency II review: a "risky" business

Covid-19 has had a huge impact on the insurance industry: financial dislocation across investment classes increased exposure in certain lines of business, such as business interruption, and life and pension products with guarantees. However, the full impact of the pandemic is not yet entirely clear, and so far, it can be said that the EU insurance industry has weathered the pandemic storm rather well and that most EU insurers and reinsurers remain well-capitalized.

This is an important lesson for the Solvency II review: demonstrating that there is no reason to fundamentally change a regime that appears to work well, even in a crisis situation. However, this does not mean that Solvency II cannot be improved. The regulatory framework must be strengthened in order to ensure that the insurance industry is capable of meeting future challenges. The pandemic has shown that black swans may well appear on the horizon more frequently than predicted in existing models. The solvency framework must also reflect the changing economic climate.

The Solvency II review must proactively help insurers to reduce the insurance protection gap.

The insurance industry plays a critical role in the management of risk. In its capacity as a risk carrier and investor, it is in a unique position to understand the pricing of risks. In their risk assessment, insurers must be vigilant in an ever-changing environment of risk and keep abreast of new emerging risks. The regulatory framework must support insurers in better managing risk by rewarding good risk management, and also by avoiding unnecessary and too complex rules and procedures. More importance must be attached to risk prevention and risk mitigation.

Supervisors must assist insurers in their drive for better risk management. They can do so by increasing the frequency of supervisory reviews, by making analyses more granular, and by regular stress testing. Supervisors must also be aware that risks, such as those related to climate change, can have on financial stability. By assisting insurers in the identification, monitoring, and assessment of these risks and by contributing to the mitigation of these risks, supervisory authorities can help to protect policyholders and to ensure financial stability.

Although sustainability is not specifically part of the Solvency II review, as it was not included in the European Commission's call for evidence, the importance of the sustainability agenda is such that this issue must receive proper attention in the review.

Finally, the pandemic has shown that proper customer information is crucial to make the insurance market work efficiently. Policyholders need to know which risks are covered under insurance policies and why certain risks are excluded from coverage. The exclusion from coverage may not be such that new protection gaps are created or that already existing gaps are increased, and this should be clarified at the onset. It is important that the insurance industry fulfills its socio-economic role by reducing the many protection gaps that still remain, in areas such as pandemics, natural catastrophes, pensions, health care, etc. The Solvency II review must proactively help insurers to reduce the insurance protection gap.

If necessary, a public/private partnership should be built in order to deal with risks which the private sector cannot bear on its own.

AYLIN SOMERSAN COQUI

Chief Risk Officer,
Allianz SE

The Solvency II Review should better reflect insurer's long-term business model

Solvency II is strongly supported by the insurance industry and the framework has proven its value since its implementation in 2016, including during the ongoing COVID-19 crisis. However, the framework is excessively conservative - if not the most conservative globally -and does not fully reflect the long-term insurance business model. Solvency II has a number of flaws to be addressed, which - if left unattended - cause an inaccurate reflection of the individual insurer's economic solvency position and reduce the sector's contribution to the economy.

The long-term insurance business model enables insurers to hold illiquid, long-term investments without the risk of forced selling, while using contractual asset cash flows to cover insurance liability payments. The value of insurance liabilities should thus be based on an interest rate term structure that is not subject to unwarranted volatility, in particular on the long end of the curve, where no reliable financial markets exist as a benchmark.

The existing Solvency II extrapolation method for risk free interest rates provides an approach that addresses the non-liquid part of the yield curve. EIOPA proposes a new extrapolation method that would add substantial complexity while increasing volatility and result in materially lower solvency ratios.

Solvency II has a number of flaws to be addressed, which if left unattended cause an inaccurate reflection of individual insurer's solvency position.

Long-term insurance products with guarantees would become economically unviable - thereby transferring market risk for old age provisioning to customers. In addition, the sector would be forced to increase the use of derivatives in hedging long-term liabilities, thereby increasing the macro-prudentially undesired nexus to the banking sector. Similarly, short-term fluctuations in credit spreads are hardly relevant in a long-term insurance context and should be removed from the regulatory solvency measurement. However, EIOPA's advice seems to reduce the effectiveness of the volatility adjustment, while rather, its general application ratio should be increased, and the risk correction should remain based on the fundamental spread.

Both, an overly volatile extrapolation method and an inefficient volatility adjustment have negative impacts on solvency ratios and are likely to force the industry into countermeasures such as substantial de-risking of asset portfolios. This would entail an exit from, rather than increased investment in real assets and cause higher sovereign bond allocations.

In turn, this tends to prolong the low interest rate environment, while at the same time reducing policyholder returns on long-term savings and pension products. Equally important, the divestment from real assets would particularly affect green investments like infrastructure thereby challenging the sector's support of the real economy in the transition to a carbon-neutral future.

In summary, the Solvency II review is an opportunity to fix selected flaws of Solvency II to better reflect the long-term business model and related risks in regulation - without reducing policyholder protection or macro-prudential stability. At the same time such enhancements would foster the sector's contribution to political priorities like the Green Deal and addressing the pension gap in Europe – an opportunity that should not be missed.

MIREILLE AUBRY

Head of Prudential Regulation Standards & Foresight, Covéa

Long-term business risk profiles differ from raw market downside fluctuations, their resilience should be plainly recognized

The Solvency II "2020" review should not be a missed opportunity to improve the framework and regulators should focus on the pressing need to render prudential regulation more fair to economic valuations of long term business models and their true risk exposures.

The resilience of long-term business models to short term financial movements stems from their stable resources that allow a long-term stance to investment choices and strategies. The stable resources are not uniquely sourced from the duration of insurance products based on the cash flows of their insurance guarantees. As important is the ability to pursue business as a going concern (renewals, future premiums, new clients). Own funds also contributor to the stability and length of resources. Their amount can even exceed the amount of the technical liabilities with a duration potentially infinite.

Against the backdrop of the stable resources of long-term business models, insurers put in place ALM policies and actions that seek performance over time while commanding to all possible vulnerabilities, the main one being the forced sale of assets with market losses. For that, ALM warrants adequate coverage of cash outflows with cash inflows including buffers to cover possible deviations. This is proved by the Solvency II quantitative data reported by insurers.

One year of inforce business cash outflows on average typically represent 8% of the total value of technical liabilities. This shows the limited exposure to the total sale of investments of a business model receiving premiums before paying any claims. This exposure is then further reduced due to ALM techniques by which a significant share of investments is fixed income with regular redemptions forming highly predictable cash inflows immune to changes in market values. Additionally, a significant share of the liabilities in the balance sheet is made of own funds of the greatest quality. These own funds have durations far beyond those of the insurance contracts liabilities and commensurate with the duration of the undertaking.

Consequently, risk exposure to short term movements is on average nil. With fixed-income average durations across sovereigns and corporate securities of 8 years, and considering a proportion of fixed income of 70% among the total investments, a typical average amount of highly predictable asset inflows immune to market fluctuations makes for almost 9% of the total value of the technical liabilities, and even 12% in the case of general asset portfolios making use of cash in-flows derived from assets backing own funds. These secured and immune to short term market movements cash inflows show their excess above cash outflows.

These features command a review of the Solvency II framework that makes the entire way towards offsetting spurious volatility and appreciating the low risk to short term market movements of long-term business models. A stronger focus to going concern is also required. Last, despite the current strong bias towards low for long interest rates, insurers cannot be left totally unprepared in their balance sheet against other pathways such as interest rates revivals. The risk-free interest rate curve needs to be sufficiently stable to be reflective of these cases.

GIANLUCA SANMARTINO

Head of Group Enterprise Risk Management (ERM), Generali

The challenges and the opportunities of the Solvency II 2020 review

The Solvency II regulatory regime is now entering into its 5th year of application but it has been under consideration and development since the early 2000s. Years of analysis and research have led to the creation of a prudential regime that is now regarded as a global benchmark.

Therefore, the fundamental pillars and metric of the regulation, such as the risk-based approach and the total balance sheet and market-consistent methodology, should not be questioned. However, the current economic environment, characterized by low-for-long interest rates and an unprecedented economic crisis, has further highlighted a number of issues related to the architecture and calibration of the Solvency II structure that deserve further analysis.

First, the recent financial markets turmoil has resulted in short-term excessive volatility of insurers' solvency positions. This is an "artificial" volatility as it does not correspond to a real change of the insurer's economic fundamentals, but rather to a flawed evaluation of insurance liabilities. As a matter of fact, insurance liabilities are not traded and priced on the financial markets but calculated according to a defined model.

The financial turmoil has resulted in short-term artificial volatility of insurers' solvency positions.

As a consequence, any market turbulence, while immediately reflected in the value of listed assets, is not as correctly replicated on the liability side of the balance sheet. This leads to an asset-liability divergence with a consequent impact on insurance companies' Own Funds. This problem has been partly mitigated by the Volatility Adjustment which should definitely be improved by focused corrections against some of its overly conservative and not fully economic aspects. Addressing the excessive volatility of solvency ratios is an objective to achieve independently of the occurrence of a crisis.

Second, the classic investment strategy of insurers - and life insurers in particular - is to invest in a portfolio of corporate bonds that is specifically designed to match expected payouts and expenses. This implies that assets are generally held to maturity, to replicate the average duration of the product's portfolio, and thus short-term fluctuations in the market prices of bonds are irrelevant. Against this structure, the capital requirements for corporate bonds are based on the assumption that insurers sell all their bonds portfolio at low prices in a situation of economic stress. This approach does not reflect the economic reality of the insurance business and should be somewhat compensated by taking into account the average holding period of the bonds portfolio.

Third, according to the EU legislator, insurance liabilities should reflect both the mean expected value of payments to policyholders (Best Estimate) and the uncertainty attached to it (Risk Margin), along with the transfer value approach. Hence, the Risk Margin should lead to a market value assessment of the insurance liabilities by reflecting the "cost" of uncertainty surrounding non-hedgeable risks. However, the Risk Margin prescribed calculation and calibration, first of all the "cost-of-capital" rate, is questionable and its revision is advocated, given the disproportionate impact that Risk Margin can have for certain categories of products, which does not seem to reflect their proper market value.

ALBAN DE MAILLY NESLE

Group Chief Risk & Investment Officer, AXA Group

Solvency II review: fostering insurers' long-term investment capacity

The Solvency 2 regulatory regime is now entering into its sixth year of application. Up to today, the robustness and consistency of this prudential regime have enabled European players to provide consumers with attractive products while preserving their financial strength even in times of crisis.

Yet, to be in a position to respond to the major challenges that lie ahead, foremost among them the Green Deal and the imperative economic recovery plan beyond the crisis, there are a number of elements of this prudential framework that are worth examining. Indeed, insurers' capacity to constitute the very core of long-term institutional investors should be fully mobilized for such objectives cannot be achieved only with public investments.

Insurers' capacity to invest over the long-term is based solely on their ability to offer long-term products. Long or very long-term reciprocal commitments between policyholders and insurers allow for potentially extremely long investment horizons, in a wide variety of assets, with buy and hold strategies that are specific to the insurance sector.

The Solvency II review should enable insurers to fully play their role without compromising the framework's overall balance.

Nevertheless, while this capacity to offer long-term products ought to be encouraged, some of EIOPA's technical proposals to the European Commission could make long-term products much more costly, with foreseeable consequences such as:

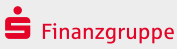
- Creating a potential protection gap in Europe with a shrinking offer of savings products for pensions or protection due to the increasing cost of capital, and this, in the European context of population ageing.
- An expected movement of divestments from risky asset classes matching inforce business to mitigate the lower solvency levels, at a time when we need investments in companies and in infrastructures to fund the economic recovery.

We should acknowledge that the current economic environment as well as the ambitions for the green transition call for adjustments to the framework that, if well-defined and kept to the essential, would enable insurers to fully play their role without compromising the framework's overall balance. To that end, we are convinced the following should be envisaged:

- Adjusting the standard formula to allow for negative interest, for it is the main macroeconomic change since the Solvency II regime's implementation;
- Reducing capital requirements by counterbalancing the introduction of negative rates with a lower risk margin; the vast majority of actors, including EIOPA, find the standing risk margin to be too conservative;
- Reducing the volatility of the solvency ratios as it leads to a higher capital charge notably for long-term products and long-term assets, which ultimately leads to higher costs for consumers.

In conclusion, AXA, like most actors in the market, maintains the current system works rather well and requires only a few well-targeted adjustments to unlock the investment capabilities the Public Authorities are calling for, while preserving a long-term product offering together with a high level of protection for policyholders.

We thank the **Portuguese EU Council Presidency** and **the partner institutions** for their support to the organisation of the Eurofi April 2021 Seminar

INSURANCE SECTOR GLOBAL ISSUES

JONATHAN DIXON

Secretary General,
International Association
of Insurance Supervisors (IAIS)

Navigating uncertainty: the importance of a global supervisory response

In February, the IAIS published its Roadmap which sets out an ambitious work programme for the next two years during a period of continued uncertainty for the insurance sector given the Covid-19 pandemic. Assessing and mitigating risks to the stability of the global insurance sector, while helping our members to address accelerating risks and opportunities, sits at the heart of the IAIS' Roadmap.

The pandemic highlighted the importance of consistent global standards and supervisory cooperation to maintain financial stability. Despite the significant challenges during 2020, the IAIS progressed work to finalise and implement key reforms such as enhanced global standards on macroprudential supervision (the Holistic Framework for the assessment and mitigation of systemic risk) and the global Insurance Capital Standard (ICS). We also maintained momentum on our supervisory guidance on a range of emerging and accelerating trends, such as climate change, fintech and cyber risk.

The Roadmap presents a broad range of planned projects in four thematic areas: risk assessment and the maintenance of financial stability, including ongoing assessment of potential vulnerabilities arising from the impact of Covid-19.

In 2021, we will undertake our Global Monitoring Exercise (GME), which is an assessment of systemic risk at the sector-wide and individual insurer level and covers more than 90% of the global insurance market.

The pandemic highlighted the importance of consistent global standards and supervisory cooperation to maintain financial stability.

Last year the IAIS adapted the GME to focus on the impact of Covid-19. This year we will continue to monitor the impact of the pandemic on the global insurance sector. Running this exercise last year provided supervisors with access to global data so they could share their experience on any emerging vulnerabilities. In December, we published the results of this analysis in our Global Insurance Market Report. It concluded that the global insurance sector had demonstrated both operational and financial resilience, aided by supervisory measures providing operational relief and by monetary and fiscal support measures in financial markets in certain regions.

Delivering on key post-crisis reforms, including further refinement of the ICS during the current five-year monitoring period and the consistent implementation of the Holistic Framework.

Earlier this year we marked an ICS milestone with the completion of the first year of the monitoring period. Despite the operational challenges of 2020, the first year of ICS monitoring saw strong participation and engagement from insurance groups. Participation in the ICS monitoring period will grow in 2021, with additional insurance groups participating.

Importantly, this year allowed for the first ICS discussions amongst group-wide supervisors in supervisory colleges, which provided valuable input and feedback to further enhance the ICS.

The ICS will create a common language for supervisory discussions of Internationally Active Insurance Groups' solvency and enhance global convergence among group capital standards. We are also making good progress with assessing implementation of the Holistic Framework and in the coming months will report on implementation across our membership.

Supporting members in addressing the risks and opportunities of key trends, especially those accelerated by the Covid-19 crisis. Activities include: work to address climate risk and sustainability; supervisory perspectives on the pandemic protection gap; measures to increase operational resilience of insurers; supervisory guidance on responding to FinTech and cyber risk; supporting activities to implement risk-based solvency regimes in emerging markets and developing economies; and new endeavours in the area of diversity and inclusion.

Implementation support and assessment, specifically reinforcing our extensive programme of member support to help insurance supervisors understand and implement our standards, through training, peer exchange platforms and implementation assessment exercises.

Over the next two years, we will continue to work collaboratively with our colleagues in the other international standard-setting bodies and with our broad range of stakeholders on these important topics. We will also embed emerging lessons learned from the pandemic to further improve the cross-border coordination and collaboration we saw between insurance supervisors over the last year.

PETER BRAUMÜLLER

Vice-Chairperson,
European Insurance
and Occupational Pensions
Authority (EIOPA)

ICS: the time to engage is now!

The development of the Insurance Capital Standard (ICS) by the International Association of Insurance Supervisors (IAIS) as part of its comprehensive group-wide Common Framework (ComFrame) for the supervision of Internationally Active Insurance Groups (IAIGs) has been, since its inception, recognized as a key step for the enhancement of global financial stability as well as consumer protection.

It is thus extremely important that EU groups actively engage in the ICS development, enabling the IAIS to collect data from different European business models in order to ensure a proper calibration and risk sensitiveness of the ICS that can match the reality in the EU. It's important for European IAIGs not yet participating in the ICS monitoring period to understand that it is in their own interest to participate, to secure an ICS that continues to reflect the sound basic principles of Solvency II and which can truly foster global convergence and consistency of supervisory practices.

Working with its membership from all over the world, the IAIS has already achieved substantial progress in the development of the ICS, with the agreement of ICS 2.0 in 2019 representing the culmination of that progress.

In EIOPA's view, ICS 2.0 represents a significant step in the direction of the implementation of sound risk-based supervisory frameworks at a global level, enhancing the level playing field for European insurers as well as their competitiveness.

Even before its expected adoption by 2024, the ICS is already shaping the development of supervisory frameworks throughout the world. These should be very positive news both for large international groups as well as for the supervisors in charge of controlling them.

EIOPA has always supported the development of an ICS that reflects the basic sound principles of Solvency II. Such an approach does not mean that the global standard should mirror Solvency II. It is reasonable to expect that a global standard may need to be less granular and allow some limited room for jurisdictions to accommodate national market specificities.

Despite big progress on ICS development, strong engagement on the EU side remains critical.

EIOPA strongly believes that Solvency II should become one of the practical implementations of the international standard. Upon finalization of the ICS, legislators should be open to adjust our European system if that is needed, with the aim that European groups are only subject to a single capital regime.

The development by the United States and other jurisdictions of an Aggregation Method (AM) – not part of the ICS – aspires to measure group capital adequacy by leveraging existing legal entity requirements through simple adjustments and scalars.

EIOPA still has reservations concerning whether reconciling the current diversity in approaches across jurisdictions in such a manner can effectively ensure sufficient comparability and a level playing field compared to the ICS.

While we are open to the arguments in favour of the Aggregation Method, EIPOA holds the view that discussions around AM should not distract the IAIS from work needed to complete the ICS.

The High Level Principles for the comparability assessment between the AM and the ICS, recently under public consultation by the IAIS, already provide significant reassurance that the comparability assessment of the AM will be subject to high standards. The assessment will be based on data which should evidence similar results between AM and the ICS over time and under different economic and market conditions, ensuring that the level of prudence under the AM is at least the same as for the ICS.

Let's not fool ourselves: the road towards the finalisation of the ICS is still very long and the effort required is still huge. Nonetheless, effort will be worth it as international standards are the best response to fragmentation – particularly relevant in businesses like insurance and reinsurance that heavily rely on scale and diversification.

The information collected during the monitoring period will by and large determine the final design of the ICS. This is why a high level of participation in the ICS development is so critical. If Europe's IAIGs want to see one single risk-based ICS that reflects the well tested principles of Solvency II and promotes a level playing field between IAIGs headquartered in different parts of the world, then they must take part. Indeed, the time to engage is now.

ALBERTO CORINTI

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

Lessons learned by insurance supervisors from Covid-19 crisis

What lessons can insurance supervisors draw from the pandemic crisis? At the outset of the crisis, the main response from supervisors would most likely have focussed on the need for emergency and crisis tools. After experiencing more than one year of ongoing crisis, I think the response would mainly focus on lessons for enhancing supervision in normal circumstances. In some way, the pandemic has served as a catalyst and has made visible gaps that are not directly related to the crisis.

The first area to mention is certainly IT innovation. The crisis has boosted the use of digital tools to design, price and distribute products, with a number of implications in terms of collection, storage and use of data. These developments can certainly help to better satisfy consumers' need, promote insurance protection and streamline contract relationships. At the same time, they could expose to risk of market misconduct, endangering consumer protection, or to a number of risks, such as cyber, operational, legal and reputational risks, which are relatively new for supervisors, but represent a potential threat to companies' solvency and financial stability. The challenge for supervisors is therefore to ensure a "healthy" use of technologies. A proper understanding of these changes and their risk implications is the first, challenging goal for supervisors.

IT innovation could also simplify the relationship between firms and supervisors. During the emergency, supervisors took a set of measures to help insurers ensure business continuity. We must now think about whether and how we might permanently introduce simplification in the prudential framework. We should avoid unjustified reporting burden and reduce complexity in supervisory processes. Here I think there is room for improvement in many jurisdictions.

In some way, the pandemic has served as a catalyst and has made visible gaps that are not directly related to the crisis.

This leads to another important lesson: it is essential, now more than ever, that consumers remain at the centre of the business. This is not only a principle of good market conduct. It is the only way for companies to reinforce and stabilize their relationship with consumers, which is characterized by a progressive reduction of physical contacts, in a context of dynamic markets with multiple players and innovative ways to design and offer products. How supervisors will promote and enforce this principle will be key.

For example, the extent of lockdowns has not only affected consumer's behaviour, but also the "value" of some insurance products (i.e. MTPL, travel). In this context, insurers should assess potential unfair treatment for policyholders and take remedial actions. In Italy, some companies have lost an opportunity to show their attention to consumers' rights when making this assessment. This is an attitude that supervisors have to address, even though traditional tools are sometimes not effective in this regard.

Another area where the crisis has highlighted the need for improvement is the macro-prudential dimension of supervision. As shown by the pandemic, supervisors should be able to monitor risks that, in one shot, could affect a large part of the sector and generate reactions that, in turn, could impact the financial system. These types of inward and outward risk call for specific tools. We need forward-looking tools, what-if analysis, effective cross border cooperation and proper powers of intervention. This is key in the context of the potential longer-term effects of the current situation.

The expected persistence of low interest rates, the economic uncertainties and the potential materialization of increased credit risk require a supervisory focus that goes beyond the microanalysis.

Finally, yet importantly, the crisis has highlighted a significant protection gap. Households, businesses and professionals experienced a crisis that was unique in terms of size and extent, and often found themselves without the necessary protection. We must now ask ourselves how the insurance industry can improve its ability to protect the society and contribute to a new phase of development in the post-COVID economic system. Here, there is a variety of areas to focus: regulation, solutions for public-private cooperation, technology, insurance product range, distribution networks, insurance and financial education.

This is something that goes beyond supervision, but where supervision should be part of the solution.

STEFANIE OTT

Head Qualitative Risk Management, Swiss Re Management Ltd

After Covid-19 – an even more resilient insurance sector

The ongoing pandemic is not a black swan event for insurers and regulators. This is thanks to the fact that the insurance industry already considered pandemics in their risk modelling. Large systemic events do however unfold in unexpected ways. With Covid-19, we saw unexpected losses in the areas of business interruption and, in particular, with respect to Non-physical Damage Business Interruption (NDBI). On the other side of the balance sheet, the uncertainties in the financial markets, compounded by a low interest rate environment, created challenges.

This unique combination of severe effects on both sides of the balance sheet underscores the systemic impact of the pandemic. So, what lessons can we learn from this pandemic in order to manage a future systemic shock to the insurance industry, and our economies, better?

The Covid-19 pandemic has highlighted the fact that resilient economies need to be built in order to manage systemic shocks. A society that has internal economic buffers is in a much better position to withstand any external shocks that it may face. Resilience to systemic shocks, such as pandemics, which do not diversify, requires a combined effort between the state and insurers. Public Private Partnerships (PPP) would create preparedness for such extreme events by pre-funding the costs. If reinsurers provide their global view and expertise on risk, primary insurers tap into their local network for claims management and states makes use of their logistics and risk bearing capacity, then future extreme events can be withstood much better.

The economic stimulus packages released around the world play an important role in the global recovery effort. These packages should also be used to address issues such as climate change which are pertinent to the insurance industry. For instance, funds should go into decarbonising the energy sector, building climate change resilient cities, protecting public health and to the restoration of natural assets and ecosystem services. This will help ensure that extreme weather hazards, such as hurricane related storm surges, will no longer materialize into huge property losses if we protect coastal wetlands.

The insurance industry coped well with Covid-19 – but there are lessons to be learned for the future

The protection gap is another element that needs to be addressed if we are to make our economies more resilient. Insurers can take the lead in developing solutions and regulators can help by providing the regulatory frameworks needed to facilitate this. Initiatives such as the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) complement regulatory efforts as they force companies to put a price tag on risks that formerly did not appear on their balance sheet.

While it is currently not mandatory, there are over 1000 public and private sector organisations around the world, including Swiss Re, that support the TCFD giving it global credence. Expanding the TCFD's use would help bring about consistency, and improve the quality, of sustainability reporting as opposed to developing new frameworks which may only lead to confusion and hinder the progress that's been made. It is only by jointly developing such frameworks, as well as pooling and sharing data and expertise, that we can move quickly in developing more resilient economies and building new insurance solutions that will close the protection gap.

The insurance industry continues to play an important role in society and, as such, we must ensure that it remains operationally resilient and trustworthy. It is only by taking a global approach, and by making sure that we apply operational resilience frameworks that take the diversity and sizes of different businesses into account, that we can ensure that the industry continues to be society's trusted partner in times of need.

JEAN-JACQUES BONNAUD
EUROFI

Preserving social and economic roles of the Insurance sector in the post pandemic world

The Insurance sector will be confronted with two sorts of challenges in the present and next future.

Firstly, one has to mention the challenges presented by the immense environmental transformations triggered by climate and the sustainability stresses, which produce a growing magnitude and frequency of natural catastrophes such as floods, hurricanes, big urban fires and wildfires, destruction of crops. Not mentioning the possible costs of covering the negative consequences of the sanitary constraints imposed by States on the earnings of firms, whenever they are not entirely addressed by state subsidies, these sustainability stresses will imply massive and unexpected expense increases within the insurance and reinsurance sectors. It is clear that regulatory costs will also be faced by the European insurance sector. They are due to the unexpected increase of these risks and will come in addition to the rising burden of operating costs.

This is no doubt that cost efficiency is thus essential for the sector, which requires these regulatory costs to be evaluated in particular against the necessity to maintain the competitiveness and risk mitigation role of the European sector. This is all the more important in a context of interest rates set at low and even negative levels to address inflation issues, which further inflate the longer-term liabilities of insurance undertakings and related provisioning.

Such evaluation should lead to a renewed concertation between the sector and the EU authorities, regarding beyond the technicalities of Solvency II, on an accurate understanding of these new types of risks.

A second and additional problem, which also questions the regulatory framework, will arise as soon as the end of the Covid19 pandemic will allow for an economic recovery. In this context, worldwide, the States as well as the private sector are projecting to spend enormous amounts of money, which will raise a financing problem.

These expenses are crucial in particular in the EU, to relaunch the economy and address beyond those already planned before the pandemic, the long-term investment in infrastructures of all kinds, e.g., pharmaceutical, renewable energy, new materials, digitalisation, telecoms, ... necessary to speed-up to the much-needed green transition and the enhancement of innovation capabilities.

The Insurance sector will be confronted with two sorts of challenges in the present and next future.

Should there not be any increase of interest rates, it would be even more essential to provide the insurance sector with a regulatory framework enabling it to further channel the individual's savings towards long-term equity investments of listed or non-listed companies, well beyond the mere sovereigns and corporate borrowings, the financing of which will be further indirectly supported by ECB non-conventional monetary policy.

Indeed, insurance companies are essential for addressing the financing of these needs. Firstly, they are a privileged channel between the EU economy and the savers, whose ability to assess risk is limited. In addition, due to the specificity of their business model, they have the unique ability to invest in medium to long term horizons, which match with most of the public and private expenses envisaged.

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5

FUTURE STEPS OF THE CMU

ISSUES AT STAKE

CMU is crucial for the EU with the increased funding needed for supporting the post-Covid recovery, the EU Green Deal and digital transformation The new CMU action plan published in September 2020 completes the previous ones with additional actions for making capital market financing more accessible to EU companies in particular SMEs and a stronger focus than previous plans on increasing retail participation and further integrating EU capital markets.

The Ecofin council has since prioritized these objectives, emphasizing in particular the first one, for which legislative proposals – concerning notably the simplification of listing rules, the setting up of a European Single Access Point for corporate information and the review of the ELTIF and securitisation frameworks and of prudential requirements – are due to be delivered by the Commission by the end of 2021.

The CMU project however faces two types of challenges. Firstly, implementation challenges, due to the breadth of the project and the urgency of its implementation, which are not easily compatible with the usual timing of European legislative processes. Secondly, challenges related to the post-Covid macro-economic and monetary context that tends to favour debt financing and liquidity hoarding.

NEW CMU ACTION PLAN

RODRIGO BUENAVENTURA

Chair, Spanish Securities and Exchange Commission (CNMV)

Towards CMU: how to incorporate safely a more retail-oriented market

CMU is an essential component to achieve deeper markets, better investment choices and healthier financing by companies. It acquires even more relevance in pandemic times, as we have seen how important for companies is to have enough equity and for investors to have diversified portfolios across different Member States. But we have also seen, thanks to Brexit, how relevant is to have diversification on financial centers. A polycentric financial marketplace is not only more competitive but also more robust. This is compatible with a polycentric financial supervision, bound together by tighter coordination mechanisms and a stronger ESMA.

One aspect that merits attention is the coincidence of new entrants into the markets in the SME spectrum and the increased participation of the retail investors. While these two trends, taken individually, are worth supporting, we should be extremely careful when combining them, especially if at the same time we promote a lowering of disclosure requirements by issuers. Those three ingredients could be a dangerous combination for the following reasons. Firstly, the retail end of the spectrum may lack the training and experience needed to assess SMEs. Secondly, research coverage is very thin for the SME part of the listed companies. Thirdly, SMEs are frequently subject to higher volatility and default rates, making them the riskiest part (also the most promising sometimes) of the investment spectrum. The ingredients for mis-selling, losses and possibly a withdrawal of confidence in equity markets from retail investors would be served if we stimulated both processes at the same time.

Collective investment key for diversification and risk reduction in a retail-oriented CMU.

I genuinely think that the only intelligent way of promoting at the same time the new flow of SMEs and an increased retailisation of the buy side is to promote retail investors accessing this new market through collective investment. Collective investment schemes run by professional managers provides both diversification, which is key when we talk about SMEs, and research capabilities that are absent in that niche, hence reducing risks and increasing return for retail investors. Actually, these types of vehicles could even be incentivised from a policy perspective vis-a-vis direct investment in single SME stocks.

Collective investment schemes could also professionalise SMEs through their role of stewardship, which is becoming more popular in the area of sustainable finance. Nevertheless, the role of Asset managers in SMEs markets should be closely monitored by supervisors to avoid any market abuse situation and keep confidence in primary and secondary markets.

Capital markets have withstood the COVID crisis remarkably well and the extreme volatility we observed in March-April 2020. Although IPOs were quite scarce in 2020, we have seen a clear surge in 2021. But even during the direst times, companies that were already listed and that required financing found relevant demand at fair prices in EU equity and fixed income markets. Some Spanish companies, for instance, led the biggest secondary equity offerings in 2020 and being already listed made a real difference for them compared to what would have been the case as a non-listed company. The depth shown by EU capital markets was truly remarkable in that sense.

It is obvious that we need to bring more companies to the listed world, from all sides of the spectrum: large and small, traditional and innovative. To do that, lowering costs and reducing the time required to access the market is appropriate, but when doing so we should not lower investor protection. The key for strong and stable capital markets is long-term trust from investors as well as the development, improvement and refinement of an appropriate financial education that allows, to all investors, a better understanding of risk in the investment decision making.

JOÃO NUNO MENDES

State Secretary,
Ministry of Finance, Portugal

Capital Markets Union: supporting recovery and the green and digital transitions

The *motto* of the Portuguese Presidency - "This is the time to deliver: a fair, green and digital recovery" - encapsulates the unique challenges at this juncture in time: i) the absolute priority to relaunch the economy and the recovery; ii) the sense of urgency, at EU-level, of the implementation of the Recovery and Resilience Facility (and the approval of national recovery and resilience plans) and iii) the unique opportunity to ensure a green and digital transition.

The response to the Covid-19 pandemic saw an unprecedented scale of public support to businesses and employment, a combination of liquidity measures and working capital support that has helped European businesses weather the crisis.

Financial stability and resilience must be monitored closely. The phasing out of public loan guarantee schemes and moratoria on loan obligations must be timed carefully, mitigating the short-term risks for the economy and the banking sector.

Financial institutions played a crucial role, and although the European financial sector has entered the crisis better prepared, the risk of contagion from the real economy to the financial system, namely through non-performing loans, must be acknowledged and addressed.

Financing the recovery is a pivotal challenge going forward and a *"true Capital Markets Union is key to an efficient and robust European financial architecture"*[1]. Moreover, the CMU is also key for a stronger international role of the euro.

Capital markets have an increasing role to play in accelerating the recovery and the green and digital transformation, complementing bank financing, and mobilizing additional capital for investment and recapitalisation of EU corporates.

The Portuguese Presidency welcomes the European Commission´s new Capital Markets Union (CMU) Action Plan and the Council Conclusions adopted in December, which we consider to be very comprehensive. In this regard, the awaited KPI on CMU will be important to measure progress in implementation.

Capital markets have a growing role to play in the recovery and green and digital transition, mobilizing additional funds to recapitalise EU firms.

We have been supportive of advancing actions that improve market access conditions for smaller firms, supporting them in recovering from the aftermath of the Covid-19 crisis and diversifying their funding sources. In this regard, we would highlight the importance of strengthening the role of securitisation in providing additional financing to the real economy.

We also look forward to the Commission´s proposal on the Single Access Point which, in our view, has great potential in improving accessibility of relevant information on European companies.

The progress in the implementation of the CMU must also be seen in conjunction with the work in other areas, such as the implementation of the Next Generation EU Recovery Fund, the Banking Union, the Digital Finance Strategy and Sustainable Finance.

For example, the Portuguese Presidency is committed to making progress on the Regulation of Markets in Crypto-assets (MiCA) and the comprehensive framework on digital operational resilience for EU financial entities (DORA), which also contribute to the CMU. The implementation of the Capital Requirements Regulation/ Directives review, allowing to phase-in the reforms in such a way that the critical role of banks in supporting the recovery is not hampered and, also, encouraging more long term and equity financing to SMEs.

The Commission's proposal on the EU Green Bond Standard should contribute to promote the development of the market and consolidate the role of the EU in green financing. We see great opportunity to expand the existing capital markets products toolkit to better suit the recapitalisation needs of European corporates which have seen their equity base eroded due to the COVID-crisis.

We have mentioned the role of securitization, but we also see with great promise the progress in the development of hybrid solutions in some EU countries and see the potential to share knowledge and best practices in this regard.

1. Euro Summit meeting (11 December 2020) – Statement

LAURA
VAN GEEST

Chair of the Board,
Dutch Authority for
the Financial Markets (AFM)

Working towards high quality supervisory outcomes across the EU

The AFM fully supports the objectives of the CMU and encourages the EC in its efforts to further strengthen the CMU by striving for liquid, transparent and accessible EU capital markets. A healthy financial system breathes with two lungs: 1. a robust banking system, and 2. resilient and diversified capital markets. It is key for the EU to keep working on stronger integrated capital markets in order to avoid over-reliance on the banking system. The AFM encourages the regulatory efforts taken so far. However, Europe's financial system is still very much dependent on banks and the strong home-bias in bond and equity markets indicate that markets are not yet fully integrated.

Overall, we believe that the Commission is focusing on the right topics in its current CMU action plan. We especially endorse proposals that lead to central solutions for EU wide problems. Such as proposals concerning a European Single Access Point or a consolidated tape.

Furthermore, there is still a significant need as well as high potential for increased participation of retail investors in EU capital markets. EU investors' overall participation in capital markets is relatively low. However, the demographic changes (ageing population) across the Union require larger retail participation. At the same time, retail participation increases the opportunities for SME funding. The AFM believes that efforts should be made to further increase the level of investor protection. In order to enable the retail investor to enter into cross-border transactions, they should be able to expect similar high quality supervisory outcomes across the EU.

Larger retail participation must go hand in hand with improved investor protection. We hope that the upcoming Retail Investment Strategy by the EC acknowledges this need and aspires to raise the bar for investor protection. As a market conduct supervisor, we will also look with a bit more caution to proposals that might even jeopardize investor protection, such as introducing a new category of qualified investors, or to proposals to soften for instance listing requirements for SMEs.

For EU markets to function properly, the geometry of supervision should follow the geometry of the business.

In order to effectively supervise cross-border retail financial services, we believe that specific attention must be paid to issues related to the current passporting regimes. The AFM encourages the EC to analyse both the positive and negative aspects of the current passporting system and the supervisory challenges thereof in order to look for solutions that will empower NCAs to effectively protect investors domestically. While being a cornerstone of the single market, the current system – with 'home' and 'host' responsibilities - imperils the effective protection of investors that are engaged in cross-border transactions.

We can also fully support any further work to strengthen supervisory convergence, or even further centralization of certain supervisory tasks. We believe that cross-border problems require cross-border solutions. Individual supervisors are not always able and in the position to effectively supervise individually. Therefore, for a well-integrated and functioning CMU it is key that ESMA and the national authorities further build on the work currently undertaken in their efforts to collectively address cross-border risks.

However, convergence also has its limitations, it will not make full use of the potential efficiency and effectiveness gains, nor does it eliminate the risk of regulatory arbitrage. The ultimate convergence is centralization of direct supervision. We believe there is a strong case to be made to centralize supervision on markets that are cross-border by nature, where the risks are cross-border related, rules are harmonized, and we see a risk of regulatory arbitrage. This would in our view logically lead to centralization of certain supervisory tasks at the wholesale side of the capital markets.

To sum up: For EU markets to function effectively, high quality supervisory outcomes are required. Regardless as to whether the supervised entity (firm/business) is primarly offering services on a local or cross-border basis. Supervision should therefore be organised accordingly.

For EU markets to function properly, the geometry of supervision should follow the geometry of the business.

THOMAS BOOK

Member of the Executive Board, Deutsche Börse Group

The EU as a key player in financial markets – not the playing field

This year's Eurofi Forum in Lisbon comes at a historical moment for our financial markets. The EU is facing a critical juncture: we urgently need to finance our recovery plans from the Covid-19 crisis, as well as drive the green and digital transformation at full speed. The unprecedented pressure on public finances and bank balance sheets makes it indispensable to foster deep and thriving capital markets to finance these ambitions.

However, key metrics show that EU capital markets are still significantly less developed than in other leading jurisdictions. In 2020, looking at primary markets, there were 1,415 IPOs, of which 60% happened in the US and China. Only 7% took place in the EU. Similarly, if we look at the ratio of market capitalization to GDP, the US is at 148% while the EU lags behind at 53%.

The EU has sent a strong signal of unity with the EU Recovery Package. And the rapid implementation of the new CMU Action Plan is critical to support the EU's efforts going forward. However, the time has come to strategically make the EU a key player in the global financial arena by building synergies between existing areas of reform and taking leadership in new strategic growth areas.

This includes redefining our financial services landscape by linking the eurozone and CMU reforms to the strategic objectives of the international role of the euro initiative. To this end, we need a fit for purpose regulatory framework that supports our markets and strengthens the resilience and competitiveness of the EU's financial market infrastructures (FMIs). As Executive Vice-President Dombrovskis and Commissioner McGuinness put it: We need to "reinforce the EU infrastructure that underpins our financial system".

Against this background, the European Commission's strategy to promote the "openness, strength and resilience" of EU financial markets is a vital step in the right direction to complete the CMU agenda. It highlights the importance of EU FMIs, as well as key EU markets, to strengthen our financing capacity and stability.

> The time has come to strategically make the EU a key player in the global financial arena.

In this sense, three aspects are paramount:

1. You cannot have a CMU, deal with the impact of Brexit and ensure a sustainable recovery from the COVID-19 crisis without functioning, deep and liquid secondary capital markets that allow for a robust price discovery process and efficient capital allocation. ESMA's recent market structure report reveals very high fragmentation (more than 250 venues; versus 60 in the US) and overall low levels of transparency since the introduction of MiFID II. More than 50% of the volume is still traded off regulated exchanges.[1] Paired with recent developments, such as the significant rise of payment for order flow schemes, it is therefore critical to simplify the EU equity market structures and effectively limit "dark trading" to increase transparency and general measurability for end-investors.
2. To support long-term and sustainable growth, it is essential to continue strengthening the EU's resilience and financial stability and reducing our overreliance on offshore markets. Achieving our "Euroclearing" objectives must be a priority, as well as securing the Euro Area's well-functioning and liquid exchange-traded derivatives (ETDs) market. The mandatory "open access" rules for ETDs run counter to these objectives, put financial stability at risk and should be revisited, also in light of the fact that no other jurisdiction is applying them. And we need to consistently and systematically build up euro-denominated markets to reduce the dependencies and reliance on third countries.
3. Finally, the EU should continue to take global leadership in new strategic growth areas such as sustainability. The EU can be the global leader in this sphere, set the standards, be competitive while having a role model function and defending our core values. Other jurisdictions start following us on this path, we can be bold and ambitious.

Let's embrace this broader perspective of openness, strength and resilience across the board – bring a balance into the relationship of the size of our real economy and our population with our financial industry – and make the EU and its capital markets global leaders that deliver in the societal interest to provide for a sustainable outlook for future generations!

1. ESMA, Annual Statistical Report on Securities Markets 2019, November 2020.

BERNARD SPALT

Chief Executive Officer,
Erste Group Bank AG

Capital markets and the pandemic: the new CMU action plan in light of the post-Covid recovery

As we try to grasp the massive economic effects of the Covid-19 pandemic, we must realize that a crisis is not only a destructive force, but also a chance to reconstruct. Developing the EU's capital markets, and ensuring access to market financing, will be essential in this respect. We are convinced that better-capitalized companies and a vibrant capital market are two of the most essential ingredients to rebuild Europe's economy.

The second CMU action plan has its focus on three pillars:

1) support of green, digital, inclusive and resilient economic recovery by making financing more accessible to European companies;
2) make the EU a safer place for individuals to save and invest long-term;
3) to integrate national capital markets into a genuine single market.

With all of these angles Erste Group can highly associate and we do believe they cover key elements of the path to economic recovery. In our initial assessment we found that the CMU action plan covers four areas that are of strategic importance for the further integration and development of EU capital markets. These are measures:

- to incentivize retail investment (e.g. through adjustments of MiFID rules on advice);
- to promote equity investments (e.g. through reduced capital requirements);
- to foster financial literacy and,
- to improve protection of intra-EU investments.

Without a doubt, all of those measures are important as they will contribute to an overall strengthening of Europe's capital markets. While the CMU action plan is a comprehensive plan addressing both short-term and mid-term targets, we must realize that the economic pressure stemming from the pandemic is tremendous and that there is an obvious need to prioritize.

Generating growth for Europe's post-Covid-19 economy depends on higher levels of equity, especially for our SMEs

We consider measures to improve the equity base of SMEs particularly important – not without reason are they often referred to as the "backbone" of the EU economy. Almost 60 percent of the continent's GDP and 70 percent of the jobs depend on this sector. In smaller countries these ratios can be even higher. Most of the SMEs are not publicly listed and heavily rely on bank financing. Just as during past crises, slumping revenues during the pandemic have eaten into these companies' capital, limiting their ability to borrow and take risks, which ultimately hampers investment in new business areas such as green technology.

Having the post-COVID business environment in mind, we must think of possibilities to strengthen the equity base of SME. Such possibilities are partly reflected in the points mentioned above, but also in other areas of the action plan such as the idea of a European Single Access Point (ESAP), simplified access to public markets for SME, the review of European Long Term Investment Fund (ELTIF) regulation, the promotion of referrals for SME to market-based financing options as well as the review of the securitization framework.

Apart from these initiatives there is also a lot the private sector can do. Erste Group has for instance started an equity initiative for SMEs more than 10 years ago and we recently further increased our efforts in this area. From a practical point of view, creating a legal framework throughout the EU, which enables such initiatives even further and also strengthens retail investments is of key importance. Here we see a need on the EU level to spread best practices across member states.

The situation is even more pressing as the pandemic has triggered a large increase of private savings, which could partially be used by retail investors to contribute to and participate in the economic recovery within the EU.

Generating growth for Europe's post-Covid-19 economy depends on substantially stronger market financing and higher levels of equity, especially for our SMEs. The CMU action plan is an adequate tool to contribute to achieve this but needs to be followed by bold political decisions on all levels.

Ultimately, better capitalized SMEs and a more integrated capital market will help to advance what Europe really needs to become more crisis-proof: ambitious digitalization and sustainability agendas.

RIMANTAS ŠADŽIUS

Member, European Court of Auditors

A way forward for EU capital markets – the auditors' view

As the Union's independent external auditor, the European Court of Auditors (ECA), not only assesses implementation of the EU budget, but also the performance of EU institutions and bodies in reaching their objectives. Among others, we evaluate actions of the European Commission, the European Supervisory Authorities, the European Central Bank as a banking supervisor and the Single Resolution Board. The ECA has been publishing reports on the EU's financial and economic governance since 2014. One of our recent reports deals with the Commission's work on the development of EU capital markets and building the Capital Markets Union (CMU).

In this report, titled "CMU – Slow start towards an ambitious goal", we concluded that the Commission has indeed pursued a number of legislative initiatives and other measures to implement its 2015 CMU action plan, yet no catalytic effect was observed. Many of the measures that the Commission was able to take within its remit only addressed narrow areas in the pursuit of the CMU objectives. So far, they did not lead to the highly anticipated structural shift from bank to more market funding for businesses in general, and SMEs in particular.

We observed that large discrepancies between Member States persist in the size of the SMEs' financing gap and the availability of funding sources. Access to capital markets remains expensive and burdensome, especially for SMEs. The so-called 'debt-equity bias' is a disincentive for the development and integration of capital markets. Other issues, such as a lack of harmonized insolvency proceedings and the general diversity of company law across the EU, are well known. The Commission's new 2020 action plan strives to address many of the issues identified.

Certain actions, such as simplification of listing rules for public markets, can contribute to more market funding and private risk sharing, if implemented well. A simplified system of providing relief from withholding tax, as recommended by the ECA, could also bring significant improvements. However, without political dedication in building a truly European capital market and further measures to tackle key cross-border barriers, it will be difficult to deliver added value for EU businesses and investors. Hence, support and joint decisions by Member States is required, which so far have proved to be problematic.

Fostering efficient local capital markets will be key for building a genuine CMU.

Fostering efficient local capital markets will be key for building a genuine CMU. Indeed, capital markets in Europe remain highly concentrated and strikingly heterogeneous among Member States. Thus, the first step would be to render local capital markets deeper, more liquid and better aligned with regional counterparts. This will require willingness, comprehension, substantive efforts and delivering real structural reforms.

To tackle the needs of Member States, in particular with less developed capital markets, action at both, national and EU-level, is required. We recommend to establish a comprehensive EU-wide strategy bringing together all relevant public sector actors, such as EU and Member State authorities as well as promotional banks, in order to identify and address the needs of local and regional capital markets and businesses seeking market financing.

We recommend that the Commission use more actively all available tools, such as technical support and country-specific recommendations, to incentivize and help build financial ecosystems across Europe, not relying solely on national initiatives or demand. The coordinated creation recently of the legal framework for covered bonds simultaneously in three Baltic States is one example.

Another necessary action to address key cross-border barriers to investment is the reinforcement of financial literacy specifically among SMEs, primarily start-ups that are looking for ways to fund their not always "bankable" ideas. Although this mainly falls under the remit of Member States, the Commission can still play a critical supporting role via existing European programmes and by promoting best practices.

The ECA will continue to report on the EU's progress towards a single market for capital. We have recently started an audit to assess whether EU actions helped to develop an effective single market for investment funds to benefit consumers and businesses, while ensuring financial stability.

MARKUS FERBER

MEP, Committee on Economic and Monetary Affairs, European Parliament

Capital Markets Union: fewer action plans, more action!

Improving European capital markets has been a long-standing goal of the European Commission and the European legislator. Even before this policy objective has been officially christened "Capital Markets Union", the idea was very much part of the EU's financial services agenda.

Yet, progress has been frustratingly slow. If you look at metrics such as stock market capitalisation as percentage of GDP, the European Union lacks far behind countries such as the US and the UK and even many Asian jurisdictions such as Japan, Hong Kong or Singapore.

At the same time, the European Union's corporate financing model remains heavily skewed towards bank financing while many European retail investors keep having fundamental reservations against equity investments despite fewer and fewer attractive investment alternatives in times of ultra-low interest rates and bond yields.

The United Kingdom, arguably the most liquid and most highly developed capital market in Europe, leaving the EU has dealt another blow to the EU's attractiveness as a financial centre. In the absence of equivalence decisions, the European Union has cut itself and its businesses off from an attractive financing hub - at least for the foreseeable future. In this sense, Brexit highlights that the Capital Markets Union project is needed more than ever.

The general recipe is clear and the most recent Capital Markets Union action plan presented by the European Commission in September 2020 contains many of the right ingredients. Improving cross-border access to company information, facilitating access to public markets for small and medium sized companies and retail investors alike, making long-term investments more attractive and reducing uncertainty in relation to cross-border investments through tax and insolvency harmonisation are no-brainers in theory.

What is more needed than ever is not yet another rehash of the same ideas in a new action plan, but meaningful execution.

However, a lack of progress on the CMU is not attributable to a lack of good ideas, but to a lack of execution. Many of the core ideas in the most recent Capital Markets Union action plan are old friends from previous iterations.

What is more needed than ever is not yet another rehash of the same ideas in a new action plan, but meaningful execution of those ideas. Unfortunately, many of the sensible ideas, the Commission and the European Parliament have been consistently calling for have been frustratingly hard to implement in practice, often due to fundamental resistance by the Council that stubbornly refuses to touch delicate subjects such as insolvency law and taxation.

Brexit can be the wake-up call that is needed. The Council's "Next CMU" working group that came up with a few very sensible proposals is an encouraging sign that a more pragmatic approach might finally take shape. The upcoming reviews of MiFID II and Solvency II as well as the Basel III implementation package can be the first litmus test if the Council actually means business in relation to a more ambitious approach to the CMU. It would definitely be time.

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EUROFI POLICY NOTES

PUBLIC AND PRIVATE SECTOR VIEWS

AIFMD AND ELTIF REVIEWS

GABRIELA FIGUEIREDO DIAS

President, Portuguese Securities Market Commission (CMVM)

ELTIF and AIFMD reviews: the challenge to meet investors' needs

The 2015 Action Plan on Building a Capital Markets Union was aimed at strengthening the link between savings and growth, with the ultimate goal of promoting a truly single capital market across the EU. The results, however, fell short of expectations, making it crucial that we get the new CMU action plan on track, decisively focusing on a "CMU for people and businesses".

Efficient, stable and participated capital markets provide more options and better returns for savers and investors and offer businesses additional funding choices. This will be decisive for the competitiveness of the EU 27 block and our strategic global agenda.

But the context and the market itself have been through rapid and deep transformations. The pandemic crisis, Brexit, digitalization and ESG, together with the CMU Action Plan, impose policy and regulatory updated responses making the right tools available to achieve the intended results and requiring measures and contributions of varied nature, sectors and wills.

The asset management sector surely plays a critical role in this process.

The new CMU plan includes an innovative proposal that could evolve to banks directing SMEs to providers of alternative funding. Although posing relevant challenges, bridging banking and non-banking financing should be incentivized, as it creates awareness and opportunities to a wider financing market, with benefits for all parties. For countries with lower levels of financial literacy and high levels of corporate indebtedness this could be particularly beneficial, allowing smaller companies to get more visibility on alternative equity funding.

Funds need flexible solutions, while granting proper protection to investors and financial stability.

The European long-term investment funds (ELTIFs) and Alternative Investment Fund Managers Directive (AIFMD) reviews, among other measures, should become important pieces of this project. But in both cases, the major challenge is to ensure that the revised frameworks provide flexible solutions for investors and businesses, while ensuring adequate protection for retail investors and financial stability.

The revised ELTIFs regime should design these funds as a true alternative for both retail and professional investors, to accelerate their uptake by investors and channel long-term financing to companies and infrastructure projects, in particular those contributing to the objective of smart, sustainable and inclusive growth.

Despite a strong consensus around its success, the AIFMD requires reflection both on the macroprudential and the investors' perspectives, particularly in the areas of reporting, delegation, risk management, supervision coordination and convergence and proportionality. The new framework must make AIFs resilient to other crises and avoid them spreading or amplifying risks throughout the financial system.

But above all, we need an efficient and coordinated supervisory response, in order to ensure proper risk management and avoid future crises that would be detrimental to investors' interests, for the funds' industry and the society in general. This concern is also extensive to UCITs and particularly to MMFs. Regulatory changes need to be complemented by harmonised and effective supervision to foster more investment and sustainable growth. This also requires asset managers, investment advisers and distributors understanding investors' needs and risk profiles and offering transparent, comparable and suitably designed and marketed products, that offer the expected returns.

Taken together, the envisaged enhancements should indeed increase investment, return and trust in the asset management sector, offering a relevant contribution to our desired Union. Building the CMU is an ambitious, yet not an easy goal to achieve. But capital markets and asset management cannot ignore the call to participate in the European economic recovery.

A consistent, persistent and cohesive contribution from EU 27 asset management to the new CMU is critical to returning to long-term growth, to finance the green and digital transition and to a more inclusive and resilient society.

UGO BASSI

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

Asset Management: a year of review

The year 2021 is a significant year for the EU asset management sector as the European Commission prepares its proposals on the reviews of the AIFMD and the ELTIF frameworks. While this work is still ongoing, a number of policy areas have been identified from the public consultations aimed at further facilitating EU AIF market integration and enhancing prudential tools where necessary while supporting the overall achievement of the Capital Markets Union.

The AIFMD Review

Since its adoption almost a decade ago, the AIFMD has contributed to the development of the Single Market for Alternative Investment Funds, established an effective supervisory regime, improved transparency for investors and regulators, the monitoring of market developments and has set out new tools for market oversight.

In June 2020, the Commission published a report for the EU co-legislators on the functioning of the AIFMD, providing an assessment of the experience of industry and regulators in applying the AIFMD. The report concluded that the framework was generally functioning as intended but that it could benefit from some targeted improvements and clarifications to improve its implementation and efficiency of operation.

In terms of the feedback to the public consultation some early issues have been identified that will be subject to further analysis including the lack of a depositary passport, the availability and use of liquidity management tools, reviewing data reporting requirements, the differential treatment of custodians of AIF assets and the fragmented market for loan originating funds.

At the same time, we must bear in mind that the AIFMD is still a relatively new framework, particularly compared to UCITS. While ensuring adequate levels of investor protection will remain our key priority, we must also support the further development of the EU AIF market and provide investors with access to a wide range of investment opportunities while ensuring a level playing field for EU managers and their overall competitiveness.

2021 is a significant year for the EU asset management sector.

The ELTIF Review

Since the introduction of the ELTIF framework, the uptake of the ELTIFs has remained relatively modest. Only four Member States have domestic ELTIFs with only 28 funds launched to date and the total asset base remains below EUR 2 billion.

Based on the High-Level Forum on the CMU report of 2020 and stakeholder feedback to the ELTIF public consultation the Commission services have undertaken a focused review of the ELTIF framework. The aim is to introduce targeted improvements to the ELTIF regime given its potential to play an important role in providing capital investment to the real economy and supporting long-term sustainable economic development. While the review is still ongoing, the following policy themes are particularly noteworthy:

- Reducing barriers to investments and finding a balanced approach to the marketing and distribution of ELTIFs to retail investors while improving the attractiveness and usability of the ELTIF regime for the professional investors. These potential amendments need to be assessed in the broader context of the risk-benefit analysis of increased retail investor participation, higher uptake in ELTIFs and applicable investor-protection safeguards;
- Broadening the scope of eligible investment assets and strategies to include structures such as fund of funds or other indirect investments that support the ELTIF label and its objective of long-term sustainable growth;
- Reviewing the portfolio composition, diversification requirements and the concentration limits in a manner that would introduce more flexibility for managers and provide appropriate diversification;
- Amending the redemption policies and the frequency, liquidity management tools and life cycle of ELTIFs in a manner that does not compromise the integrity of the funds, protects the interests of the investors and facilitates the execution of the investment strategies pursued by the managers.

These policy considerations mainly pursue the twofold objective of promoting the ELTIF market by broadening access to these investments and facilitating a broader range of investment strategies while ensuring the necessary levels of investor protection.

The Commission is aiming for Q4 2021 to submit its AIFMD and ELTIF proposals to the co-legislators.

NATASHA CAZENAVE

Managing Director,
Head of Policy and
International Affairs,
Autorité des Marchés Financiers
(AMF)

Revamp ELTIF to direct more long-term financing towards European companies?

The persistence of low interest rates and the necessity to finance a quick economic recovery has reignited the debate around the ability for retail investors to access riskier investments than those currently offered through UCITS funds.

The AMF supports the democratisation of investments in private markets, provided that a sufficiently protective framework is in place. Yet, striking a balance between retail access and retail protection is not an easy task. Alternative investment funds (AIFs) differ considerably in nature, risk profile, and authorisation and regulatory requirements, thus making the creation of an EU one-size-fits-all regime for retail AIFs hazardous. Instead, the AMF considers that the ELTIF is the right vehicle to foster retail participation in AIFs.

The forthcoming review is the opportunity to consider broadening the scope of the eligible portfolio assets for such funds and recalibrating some of the features of the current framework in order to make it more attractive and facilitate the access of retail investors to private markets.

AMF advocates for ELTIFs to offer certain features and safeguards when they target retail investors.

At a time of an unprecedented pandemic crisis, the ELTIF review may bring many benefits to the overall EU economy: investors would gain from a more diversified pool of assets with potentially higher returns and savings could be channelled more efficiently towards the financing of non-listed companies and small and medium enterprises.

Nevertheless, apart from the inherent investment risk from investing in non-listed or small businesses, ELTIFs display certain characteristics – namely the intrinsic illiquidity of their portfolio assets and their restricted redemption policy – which need to be carefully assessed and calibrated.

According to IOSCO's 2018 recommendations on liquidity management, funds should offer a redemption policy consistent with the liquidity profile of their underlying assets to avoid the so-called liquidity mismatch. Another challenge to consider is the difficulty of valuing non-listed assets in the absence of a secondary market that supports the price discovery process.

In order to address such risks and adequately protect investors, the AMF advocates for ELTIFs to offer certain features and safeguards when they target retail investors. Importantly, their closed-ended nature should be maintained. Nevertheless, to take into account the fact that retail investors may need to access their savings before an ELTIF reaches maturity, liquidity could be organised through the development of a secondary market for example. Another possibility would be to foresee occasional and limited liquidity windows. In any event, the distribution of ELTIFs to retail investors should be conditional on the performance of suitability assessments and the provision of investment advice.

Investing in non-liquid assets demands a long-term investment horizon, certain risk tolerance and capacity to bear losses that not all retail investors are able to withstand. This is a major difference with most UCITS funds available to retail investors. It is essential that retail investors understand this distinction in order to adjust their investment expectations, accordingly.

LAURENT VAN BURIK

Head of Division of Legal and
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Surveillance du Secteur Financier (CSSF)

Delegation rules under the AIFMD: need for clarification, adjustment or complete revamp based on the supervisory experience of national regulators?

The review of the AIFMD, enshrined in the Directive itself aims to complete the work of the CMU, of which the AIFMD is one of the founding pillars. Its primary purpose is hence to introduce legislative proposals designed to tackle hurdles for completing the Single Market for AIFs, with an emphasis on the experience acquired in applying the AIFM, its impact on investors, AIFs and AIFMs.

The AIFMD seeks to achieve a coherent approach of supervisory authorities to the risks of the financial system, to provide a high-level investor protection and also to facilitate AIFM market integration. The current AIFMD provides for rules on delegation, further specified by Article 82 of its Delegated Regulation 2013/231. This article includes a series of parameters for the delegation of AIFM functions to third-parties, including provisions on when the AIFM would be considered to

be a "letter-box" entity. This regime was further complemented by a July 2017 non-binding ESMA Brexit Opinion in the area of investment management.

This opinion focuses on technical aspects of delegation arrangements such as the due diligence to be applied by an IFM (e.g. operational risk management policies and procedures), a focus on supervisory aspects as well as clarifications on the substance requirements (human and technical resources) as well as expertise on the selection of potential delegates and the effective monitoring of those.

Considering the purpose of the AIFMD and the aim of the review of the AIFMD, the experience of NCAs in applying the AIFMD has not evidenced any specific deficiencies relating to the delegation framework that would need to be addressed. To the contrary, experience has not evidenced any issues linked to delegation of investment management functions or to the current delegation regime. Further, an ESMA "Supervisory Coordination Network" has operated between 2017-20 where all EU NCAs had been requested to present Brexit related cases of fund managers and MiFID firms, focusing on delegation and substance aspects.

Experience of NCAs in applying the AIFMD has not evidenced specific deficiencies in the current rules that would require or justify a complete revamp.

The SCN discussions have shown that delegation rules work effectively, and only a very small number of cases revealed issues which were usually related to an inadequate application of the AIFMD rules rather than problems in relation to the AIFMD delegation regime itself.

If nevertheless the view is taken that substance should be given to the existing AIFMD delegation rules, those could cover specific aspects of the existing framework such as provisions on the control of the delegates, the requirement for a specific delegation policy addressing specifically initial and on-going controls (e.g. on the basis of the EBA guidelines on outsourcing).

Further controlling measures could include an ongoing review of the organizational set-up of the delegate as well as other aspects in accordance with a risk-based approach and potentially more specific provisions on exchanges between NCAs directly involved in the delegation of AIFM core functions.

VERENA ROSS

Executive Director,
European Securities and Markets Authority (ESMA)

Enhancing the AIFMD framework in the forthcoming review

The AIFMD has provided a solid framework for alternative investment funds in Europe. It gave a basis for consistent supervision of alternative managers in the EU, thus reassuring investors in Europe and the world that alternative investment funds are grounded in a credible regulatory framework.

Since its creation in 2011, ESMA and the national competent authorities have exchanged practical experiences in supervising firms in accordance with the AIFMD rules.

We have noticed many areas of the framework that should evolve in the current review. In addition, the recent COVID-19 related stresses highlighted some areas that could be further improved.

The current AIFMD framework requires changes covering areas such as reporting, availability of liquidity management tools and leverage. There is also merit in greater harmonisation of the UCITS and AIFMD frameworks in many areas.

The current AIFMD framework requires changes covering areas such as reporting, availability of liquidity management tools and leverage.

More broadly, it is time to create a true Single Rulebook for investment management by making greater use of directly applicable regulations rather than directives which need to be individually transposed by the different Member States. Many key regulatory matters covered by the AIFM and UCITS Directives are left to national discretion which adds to regulatory complexity and risk of regulatory arbitrage for investors, market participants and authorities.

One area that we believe deserves specific attention is that of delegation and substance. These rules deserve to be updated, both in the area of the AIFMD and UCITS.

In many cases, AIFMs and UCITS management companies delegate to a large extent the collective portfolio management functions to third parties and only perform some control functions internally (notably risk management functions). In particular, portfolio management functions are often largely, or even entirely, delegated to third parties within or outside of the group of the AIFM or UCITS management company.

We recognise that such extensive use of delegation arrangements can increase efficiencies and ensure access to external expertise, taking into account the global nature of financial markets. However, we also see that they may increase operational and supervisory risks.

Therefore, ESMA believes the extent of delegation should be clarified to avoid the risk of letterbox entities. Consideration should be given to specifying and complementing the existing broad qualitative criteria to clarify which core functions should always be retained by the licensed entity.

THOMAS SCHINDLER

Global General Counsel,
Allianz Global Investors GmbH

Should retail investors consider investing in AIFs and ELTIFs?

The success of the UCITS brand and the establishment of UCITS as the default investment fund for retail investors in Europe has created a strong focus on the most liquid assets classes.

Despite the continuing low interest rate environment prompting investors to explore new avenues, retail investors continue to invest through UCITS and the limited range of strategies available in this structure.

Could EU Alternative Investment Funds (AIFs), including European Long-Term Investment Funds (ELTIFs), provide retail investors with access to investments unavailable in UCITS funds? What sets such alternative funds apart from UCITS and what would make AIFs and ELTIFs suitable and attractive to retail investors? Since AIFMD governs fund managers and not the funds, there are many different types of AIFs and a broad spectrum of fund characteristics. Therefore, a differentiated approach to this question is needed.

A number of AIFs have been set up and function very much like UCITS, geared towards the specific needs of retail investors. Their investment strategies usually permit investment in certain assets or a portfolio weighting just outside the scope of the UCITS requirements, creating the opportunity for retail investors to broaden their investment exposure whilst maintaining liquidity as well as the subscription and redemption features UCITS are known for.

The many different types of AIFs and broad spectrum of fund characteristics require a differentiated approach.

Investing in less liquid assets, the purpose of many AIFs and ELTIFs (which provide long-term financing for infrastructure projects, SMEs and unlisted companies), means that early redemption is usually unavailable, restricted, or only possible at a significant cost for the investor. As such, only retail investors who do not need liquidity should consider investing in such funds. Some AIFs maintain a portion of more liquid assets, often reducing potential performance of the fund. Moreover, the liquid assets portion may not suffice to cover an extreme situation in which all investors seek to redeem.

In practice, many AIFs and most ELTIFs are set up for professional investors only. The combination of large unit sizes and initial investment requirements, capital calls and restrictive redemption make such investment funds less suitable for retail investors. Adaptation of such AIFs for investment by retail investors would not make sense as retail interests would inevitably and irreconcilably collide with those features offered to professional investors.

For a well-informed decision to invest in AIFs and ELTIFs, retail investors need additional information from distributors on all features typical to AIFs but not present in UCITS. Retail investment in less liquid strategies will require more extensive customer due diligence, appropriateness and suitability testing, and a clear understanding of the target market.

More affluent and financially literate retail investors may then find investments in AIFs and ELTIFs an interesting and attractive investment proposition, allowing them to access asset types and investment strategies that enhance and are complementary to more traditional UCITS investments.

CHRISTIAN EDELMANN

Co-Head EMEA Financial Services,
Oliver Wyman (UK)

How blockchain technology can kickstart ELTIF investing

The European Long-Term Investment Fund was supposed to throw open the doors of the cloistered kingdom of unlisted companies and real assets to ordinary investors. Six years later, the rush hasn't happened.

This should be a golden era of ELTIF investing for institutional and retail investors alike. The pandemic has prompted governments to tap taxpayer money to keep the economy afloat. Still more is needed to fund innovation and infrastructure to achieve a broad-based recovery and deliver on the climate agenda European governments have promised. At the same time, low interest rates and much easier access to public markets have pushed investors further out on the risk curve.

Yet retail investors have been reluctant so far to dive into ELTIF portfolios. At the end of 2020 assets under management of ELTIF funds across the EU stood at just €1.5 billion.

What's the holdup? A lot has been written about fairly technical details such as the authorisation process, prospectuses and disclosures, and specific details on portfolio composition. Yet in our view, the biggest stumbling block is liquidity.

ELTIF assets are long-term in nature but the lack of modern technology and standardisation increases the liquidity challenges in several ways. First, selling assets requires material legal resources; it can take months for contracts to be finalized, and cross-border transactions present still more challenges.

Likewise, the registration process typically costs €300,000 in legal expenses, compared with roughly €30,000 to €40,000 for a typical European mutual fund.

What's more, each private debt loan is a bilateral contract often spanning 100 or more pages, requiring manual intervention in administration. And ELTIF funds also suffer from a lack of a standardised template for regulatory reporting and communication between manufacturers and distributors.

Blockchain technology can help. It would allow for real-time distribution of everything from the most current asset valuations to legal information needed for an asset transfer.

Blockchain technology can help democratize markets that have traditionally been dominated by the largest firms and wealthiest investors.

Hours and days could turn into fractions of a second. It would also help the EU create and distribute the lingua franca needed to standardise these products and underlying investments across firms and borders.

A blockchain-driven platform for secondary trading might also attract a new cadre of retail investors concerned about liquidity. Private assets are often viewed as an insular world of asymmetric information, and blockchain could help lift the veil.

That would help democratize markets that have traditionally been dominated by the largest firms and wealthiest investors. For retail investors, it could provide access to true alternative investments. For advisors and distributors, it could provide a differentiated value proposition.

Blockchain technology won't turn ELTIFs into the hottest retail investments overnight. But it could help to create buzz for an investment product that, so far, hasn't lived up to its potential.

RETAIL INVESTMENT

MARIA LUÍS ALBUQUERQUE

Retail investors and capital markets need each other to succeed

European households have on average high savings rates, and yet too little of those savings produce the best outcomes for both savers and the economy at large. Therefore, the first compelling reason to change the current situation is the need to ensure that savings generate fitting returns to each person's objectives, be it an adequate retirement income or children's education. Long term savings, as in these two examples, should not be put in bank deposits. There, nominal returns are getting ever lower, and real returns are actually negative.

So, the imperative to change comes first and foremost from the need to provide our citizens with the tools to build better financial futures for themselves.

That implies not only designing or adapting legal and regulatory frameworks, but also increasing the level of financial literacy so that each individual is better equipped to understand financial products and make the right choices.

Looking at retail investment as a source of funding for economic activities, there's no dispute that these resources could, and should, be channelled to investments that match the longer-term nature of household's savings. Developing the funds industry, promoting an equity culture, generalising auto-enrolment occupational pension systems, and, most of all, rebuilding people's trust in the financial system, are critical if the EU wants to deliver on its ambitious goals of becoming more competitive and sustainable, while taking full advantage of the benefits of digitalisation. All available resources will have to be pooled to cope with the tremendous investment effort required.

> The need to provide our citizens with the tools to build better financial futures for themselves.

In the crisis spurred by the Covid-19 pandemic, the immediate response of support to the economy, though much needed, led to a sharp increase in indebtedness, both for sovereigns and corporates. The banking sector, backed by regulators' flexibility and the monetary policy stance, has contributed significantly to stabilise the economy in this first phase. However, if we are to avoid the risk of an extensive destruction of productive capacity across the EU, debt, and in particular bank debt, is not the answer.

Companies, including small and medium size companies, must have increased access to equity through the capital markets if they are to be effectively supported over the long recovery process ahead. Developing the instruments which promote retail investment engagement, while assuring the necessary investor protection, may actually prove decisive for the survival of many viable businesses. Innovative businesses, growing businesses, in order to be successful in Europe, also depend critically on available funding through capital markets, including that provided by retail investors.

The post-Covid recovery challenge adds to the urgency and relevance of what was already recognised as the necessary way forward. The Commission's new action plan, appropriately called "A Capital Markets Union for people and businesses", sets an ambitious roadmap with targeted and specific measures, taking on board many of the recommendations put forward by the High-Level Forum on CMU.

The actions in the new CMU plan directed at increasing retail investor participation in capital markets, if delivered as intended, do address many of the relevant problems identified, but they are no silver bullet, because there is no such thing in such a complex reality. Culture, namely the lack of a risk culture as seen in other geographies, also plays an important role, and that will take longer to change. Also, powerful instruments in influencing people's decisions, like taxation, are not under the Commission's remit, and therefore could not be considered in the action plan.

For the agreed actions to produce the desired impact, however, more needs to be done. All actors need to take ownership of the plan and do their share. That means swift decision processes through the Council and European Parliament, but also in Member States. Decision makers must recognise the importance of developing integrated and efficient capital markets, and act to put our common goals above protectionist temptations and vested interests. It will not be easy, but it will definitely be worth it.

GUILLAUME PRACHE

Managing Director,
BETTER FINANCE

Addressing conflicts of interest for a CMU that really "works for people"

The recent Capital Markets Union (CMU) Action Plan, sparked by the Covid-19 crisis, aims to put equities back at the heart of the EU economy funding and reduce the reliance on bank funding. In the aftermath of the global health pandemic, the EU economy will be in dire need of new capital financing in order to stimulate a swift recovery as well as innovation, sustainable investments and growth.

As the main source of long-term capital, EU households have a key role to play. But inviting EU savers to participate more directly in capital markets comes with a certain responsibility: investing in the EU's CMU must be safe, fair, and trustworthy.

To achieve this, the EU must first effectively address conflicts of interest in "retail" financial services (distribution and execution) and create a bias-free environment which stimulates competition and upholds clients' best interests.

BETTER FINANCE has long voiced its concerns regarding the misalignment between the interests of financial services providers and those of their individual, non-professional clients. Perhaps the most detrimental practice in this field is that allowed by "non-independent" advice.

Paying commissions or non-monetary benefits to investment advisors for their "advice" (actually for their sales) to "retail" clients has gradually and significantly steered EU households away from direct ownership of the EU economy to packaged, fee-laden financial products, as there are no commissions on listed securities and low-cost index funds (ETFs) – only on more "packaged" retail investment products.

BETTER FINANCE demonstrated how heavily fees weigh on long-term real (after inflation) net returns. Moreover, research by the European Securities and Markets Authority (ESMA), and other research reports, consistently found that – on average - cheaper, passively managed products (e.g., index ETFs) largely outperform the more expensive, actively managed products in net terms.

A "CMU that works for people" must uphold high standards of retail investor protection.

This high level of fees can largely be blamed on "inducements" because the commission for a non-independent "advisor" (actually a sales person) will eventually be borne by the retail client through the fees paid for the product .More problematic, , receiving remuneration or non-monetary benefits for particular products, creates an inherent conflict of interest between the provider and the client: according to MiFID II, investment firms must *"act honestly, fairly and professionally in accordance with the best interests of its clients"* (Art. 24).

Besides the conflicts of interest generated by non-independent advice, a recent scandal involving retail equity trading revealed an additional source of conflicts of interest affecting retail investors: the payment for order flows (PFOF). The stand-off between professional and retail investors following the GameStop case shone the spotlight on the issues with PFOF, that were largely ignored before.

PFOF impairs the retail broker's duty to act in the best interest of its clients and to obtain the best possible execution result. A CFA Institute report demonstrated that a ban on PFOF in the UK by the Financial Supervisory Authority led to *"an increase in the proportion of retail-sized trades executing at best quoted prices from 65% top 90% between 2010-2014"* and also narrowed down price spreads for large cap equities. In addition to poorer execution, PFOF can hinder competition among market makers and securities markets themselves and hurt price formation.

Therefore, BETTER FINANCE recommends to policy makers to urgently ban inducements for all retail investment products (i.e. all "PRIIPs" and pension saving products such as PEPP) as the main source of conflicts of interests in retail financial services, at the very least for independent advice, for portfolio management and for "execution only" transactions. The High Level Forum for the Capital Markets Union has made the same recommendations to the European Commission last year.

ANTE ŽIGMAN

President, Croatian Financial Services Supervisory Agency (HANFA-CFSSA)

Are we failing retail investors?

One of the cornerstones of the new CMU is to increase retail participation in capital markets. The consensus on the how to deliver these objectives has historically been the following: a) increase transparency (more information), b) increase the quality (better information), c) streamline and simplify the information (more accessible information for the average retail investor). While we have come a long way on transparency and quality, work still needs to be done on the simplicity front.

Thanks to regulatory efforts, the retail investor has now easy access to an abundance of information under various sectoral rules (MiFID, UCITS KID, PRIIPs, IDD), but the way this information is presented is often anything but simple and understandable to the average person. The combined effect of high volumes of cryptic information is likely to produce one of two possible reactions of average retail investor: 1) treat the information document as an annoying and verbose user agreement, scroll down and click "agree", or 2) try to read it, give up and opt-out of the capital market entirely.

Both supervisors and legislators are stuck between on the one hand needing the informed consent of the retail investor with regards to the full extent of the risks and rewards involved, and on the other hand keeping the information simple enough for it to be digestible by non-professionals.

We risk turning the information presented to retail investors to protect them into a liability shield for the benefit of financial service providers.

In some cases, this balancing act is just not achievable, and we risk turning the information presented to retail investors to protect them into a liability shield for the benefit of financial service providers. However, opting for simple may get us back to misleading, which then prompts us to incessantly review and improve the information at investors disposal. So far, this has historically led to the scope of the information requirements becoming progressively larger, which in turn, may well be one of reasons the average investor or SME still turns to the banking system, because of the comforting simplicity of a banking loan. Increasing financial literacy, especially for citizens of less established capital markets, will play a major part, but this still does not mean that the average person will be interested or has the time to go through pages of complex information.

Furthermore, information on some products simply cannot be simplified enough for retail clients without it being misleading in some way, not without someone sitting in the retail investor's corner and filling in the financial knowledge gaps, having at heart the interest of the client, not distributor or manufacturer.

This is where a network of financial advisors can play a vital part. Promoting independent advised sales could go a long way to secure a buy-in from the retail market. Instead of trying to educate everyone, why not provide those that need it with additional support?

How the actions from the CMU action plan will be implemented remains to be seen, but key will be to ensure consistency between the different legislative proposals, requiring close coordination both within the Commission and within the co-legislators, which has sometimes been difficult to achieve. However, it should be clear that transparent and simple does not mean risk free, and that capital markets will always have their ups and downs.

STÉPHANIE YON-COURTIN

MEP, Vice-Chair of the ECON Committee, European Parliament

Empowering all citizens to become active consumers in financial products

Mobilising savings for a green and digital economic recovery is not just one of the objectives of the Capital Markets Union. It is a unique opportunity to unlock new funding for SMEs and corporates. It is a political imperative as citizens are demanding closer alignment between economic decisions and long-term sustainability goals.

The recent GameStop events in the US are a cautionary tale on direct retail investment in financial markets without appropriate consumer protection safeguards. In the EU, such safeguards are seemingly in place and should remain.

Our ultimate goal is to empower citizens to become active consumers in financial products, just as they are more and more active in scrutinising products in shops. There is still much to do to promote safe retail investment, with increased awareness, tailored information and renewed trust.

Firstly, we need to raise awareness that financial products are part of citizens' daily life, whether they are offered insurance when renting a car or buying

appliances, they request a mortgage to buy their new home, or they save for retirement thanks to life insurance contracts or other financial products.

Increase consumers' attention to saving for longer-term goals is crucial to unlock financing potential in the EU's economy. Financial education is not only a matter for school and university courses, but rather as a life-long learning project. Work place trainings and regular financial checks are two concrete suggestions to tackle financial literacy in the EU.

Secondly, consumers should have access to information on all financial products, tailored to their needs and their understanding of financial markets. The EU has made a quantum leap with the PRIIPs Regulation, on the verge of being finally applicable across the whole investment landscape after ten years of debate.

So close to the finish line, better is the enemy of good: we will further improve the PRIIPs KID in the medium term. Most importantly, the PRIIPs Regulation has focused all distributors and providers on the value provided to end consumers, rather than the value they could derive from selling products.

A holistic review of the EU rulebook on distribution should aim at empowering retail investors with relevant information to make informed decisions every step of their financial way. Integrating all dimensions of costs, performance, sustainability and rights for consumers, in an interactive digital format tailored for each consumer's needs, is an inspiring horizon for the next generation of consumer protection rules.

Ultimately, consumers will actively invest and use their financial power if and only if they regain trust in financial intermediaries.

Consumers need to know and see that their financial interlocutors are their partners, and not just vendors. This renewed trust will come from a change of culture by financial intermediaries.

Co-building saving strategies together with consumers rather than offering ready-made packages and products; actively looking for the best investment solutions, tailored to each consumer's needs, rather only presenting in-house products; fostering regular dialogue with each other rather than relying on passive disclosure: all these changes can be implemented in the short-term.

CHRISTIAN STAUB

Managing Director Europe, Fidelity International

Restoring retail financial balance in the post-pandemic era

A natural human response to times of uncertainty is to save resources. And few years have been as uncertain as the one just past. European households reacted to the Covid 19 crisis by increasing their savings rate to more than 17 percent in the third quarter of 2020; the second highest level since records began in 1999, according to Eurostat.

However, savers have been reticent about moving this money from bank accounts into investment accounts. Eurostat data also shows that the investment rate bounced between 8 and 9 percent during the same period. This is a range that has held firm since 2012, and one that is yet to recover from the effects of the 2008 financial crisis, when the rate was above 11 percent.

These numbers tell multiple stories, but one that immediately stands out is about opportunity costs. A euro earning next to zero interest in a bank is one that doesn't contribute to an economic recovery or grow over time in a pension.

This adds up quickly over many households and many years. The European Fund and Asset Management Association estimates that the wealth of European households would be around 1.2 trillion euros higher had they reduced their bank deposits between 2008 and 2019 and invested in stocks and bonds instead.

Policy dilemma

And so, policymakers surveying a post Covid-19 landscape face a difficult challenge. Businesses, and to some extent national treasuries, will be keen for these savings to flow back into the economy via consumption.

But to only focus on short-term consumption as a route to economic recovery would be to miss a great opportunity to revive retail participation in the EU's capital markets, and channel those savings into the type of long-term prosperity that was foregone in the past decade.

We need an investment-led recovery as much - if not more than - a consumer-led recovery.

We therefore welcome the CMU's ambition to stimulate retail participation in markets through programmes such as PEPP, a pensions dashboard and a clean-up of product disclosure standards. We also welcome the upcoming MiFID (and IDD) distribution reviews.

But our post-Covid world requires both a rapid response and one that builds on Covid consumer behaviours in their more positive aspect - a continent-wide shift online. We believe that online financial health and planning tools, built on Open Finance standards and situated within the wider financial inclusion agenda, should be a fundamental cornerstone of policy going forward.

Stimulating financial health

Financial planning tools have a double benefit when it comes to 'retail participation': they both bring long term retail market participants and support strategic investment over event-driven speculation.

This is particularly important in an era where gamified access to speculative market trading is becoming ever easier. The instinct to save can very easily turn into a desire to take increased risk when periods of uncertainty lift.

So, we must do what we can, as soon as we can, to engage potential retail investors, restore public trust in capital markets and stimulate participation. Or risk another lost decade of low investment.

FAUSTO PARENTE

Executive Director, European Insurance and Occupational Pensions Authority (EIOPA)

Closing the pensions savings gap with simple, scalable products like PEPP

Estimates put close to 20% of EU citizens at risk of poverty or social exclusion in older age. This makes pensions adequacy and coverage becomes a priority for governments.

Yet, for many people pensions are a complex and confusing, and this makes people reluctant to invest in long-term savings products. The challenge is to overcome these barriers and to stimulate interest and action.

First, there is a need for clear and transparent information.

The pensions landscape varies considerably across Europe, but better information on gaps in sustainability and adequacy will help countries identify the emerging gaps in theirs system. This type of information will not just help governments in their decision-making. With the right information, people will also be able to make better decisions on how to save for retirement.

Simple, scalable, digital-first products will demonstrate the benefits of CMU to European consumers.

This year, EIOPA will be supporting the implementation of the Action Plan on the Capital Markets Union (CMU) with the provision of advice on the development of pensions dashboards that will help strengthen the monitoring of pension developments in Member States.

With the help of a network of experts, and making use of existing best practice, EIOPA will also map the functional feature of a tracking tool, including how best to present information. We will also provide advice on how to communicate and launch the service.

The goal is to create an attractive, easy-to-use tracking system that provides people with comprehensive information – in other words, a system that meets the needs of savers – so that it is easier to engage people with their retirement planning and encourage them to take action if they see shortfalls in their pensions adequacy.

Second, there is a need for pension products that meet the needs of today's workers. This means designing long-term savings products for people who change jobs frequently, or work on a freelance or casual basis.

Products like the pan-European pension product, or PEPP.

The PEPP is a portable, transparent, cost-effective personal pension product. Savers will be able to take their PEPP with them when they move jobs or countries and the Basic PEPP will offer an affordable and capped default investment option. In addition, savers will receive clear and comparable information about performance and will be able to switch providers if they would like but also with costs being capped.

PEPP also paves the way for more long-term investment in equity-like instruments, in order to increase the potential for better long-term returns for investors and foster sustainable economic growth. Simple, scalable, digital-first products will be key in demonstrating the benefits and the value of a Capital Markets Union to European consumers.

Improving pensions adequacy and coverage are difficult – but not impossible – challenges. Focusing on the demand side and engaging savers in their retirement planning with clear and transparent information will help not only to close the pensions gap, but also provide a source of valuable funding to strengthen the Capital Markets Union.

SIMON JANIN

Head of Group Public Affairs, Amundi

Preserving access to qualified financial advice for retail investors is key for the success of CMU !

Covid-19 crisis has led to an unprecedented increase in European households' savings, especially in cash and deposits. According to estimates made by the European Central Bank, the total of Eurozone household financial assets flows was more than 700 billion euros at the end of 2020, against 570 billion euros a year before. For France only, 220 billion euros were saved in 2020, 60 billion higher than last year[1].

Still, nothing guarantees that this idle money will be invested in the economy, notably in a context where citizens are mostly (64%) pessimistic about the European post-covid-19 recovery[2]. Recent ESMA's analysis[3] showed that while equity UCITS have delivered a nearly 9% net performance during the last decade, only 10% of European households invest in mutual funds.

Therefore, initiatives that aimed at increasing retail investors' participation in financial markets are key. And one can only fully support the new action plan of the European

Commission on Capital Markets Union published in September 2020 which sets out the objective *"to make the EU an even safer place for individuals to save and invest long-term"*. Among the new measures which are supposed to support these objectives - the review of ELTIF Regulation together with the promotion of long-term investment, in particular trough the promotion of employee share ownership - should be engaged in priority.

However, these measures will prove to be effective only if there are not counterbalanced by others. Indeed, among the 16 actions of the new action plan, one that could potentially have unintended consequences pertain to the announced assessment of rules applicable to the remuneration of distributors, with possible amendments of the related provisions in MiFID II. While any initiative that goes towards more transparency should be welcomed, it is nevertheless essential to avoid adopting radical measures that would in the end go against the interests of retail investors, and their ability to access to qualified financial advice, whatever their investment capacity.

It is essential to avoid radical measures that would in the end go against the interests of retail investors.

In this respect, retrocessions of management fees play a key role in remunerating the cost of advice. Conversely, in countries where a ban of these so-called 'inducements' has been adopted (UK, NL), access to financial advice has since then revealed to be particularly challenging. As provided in a study dedicated to the Dutch market[4], *"some groups of consumers are struggling to pay directly for financial advice"*. And as regards the UK, recent figures published by the FCA (2020) show that the global cost of ownership for the investors (including the cost of advice) remains high – leading to exclude the less worthy part of retail investors (with financial assets below 200 000 £).

1. Stat BdF: https://www.banque-france.fr/presentation-trimestrielle-de-lepargne-des-menages https://www.banque-france.fr/statistiques/epargne-des-menages-2020t2
2. https://ec.europa.eu/commission/presscorner/detail/fr/ip_20_1975
3. https://www.esma.europa.eu/sites/default/files/library/esma50-165-1106-asr-performance_and_costs.pdf
4. A commission ban for financial advice : Lessons learned from the Netherlands, Fred de Jong, University of Amsterdam, 2017

EQUITY FUNDING

MARIO NAVA

Director General, DG for Structural Reform Support, European Commission

Equity or debt? Last time we needed trust, now we need future perspective!

The financial crisis of 2008 was a crisis of debt – triggered by debt handed out by banks as loans, fuelled by repackaged debt, wreaking havoc on interbank debt markets and culminating in the sovereign debt crisis. 2008 and the following years we also experienced a crisis of trust: banks, supervisors, even governments did not trust each other. So, one might say debt is very much about trust – the trust that someone honours his promise to pay back. The evidence seems to suggest that we have fixed our trust-issues over the last decade: the banking sector is stable, reinforced by better EU level regulation and strengthened pan-European supervision. Governments agreed to have the European Commission issue debt for the first time in history to fund a recovery program macroeconomic significance.

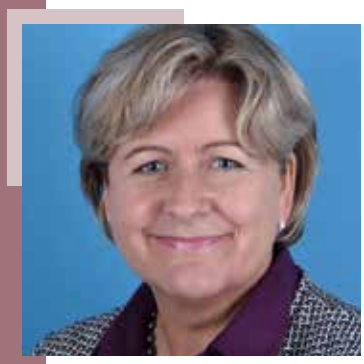
Unlike debt, equity is about future perspective: when you buy a share, contrary to debt, there is no promise that you get your money back, there is only a (hopefully well-grounded) perspective that the company succeeds. Looking at the current stock-market, future perspectives do not seem to be the issue. Here of course the low interest environment helps. But the stock-market is not the economy, and while companies associated with the digital economy may have profited, many brick-and-mortar business have suffered and piled on debt. Should we help them to convert their debt into equity?

As you will read in any economist's article at some point: It depends.
First, what is clear is that the future will be green and digital. Therefore, subsidising carbon-heavy businesses of the past will not help. Investors know that and are seeking green investment opportunities. Therefore, one important measure is to help investors identify green investments, as the European Commission recently did by developing the EU taxonomy for sustainable activities. Another measure is to actively support reforms in Member States to carry out reforms to develop green finance ecosystems or green bond markets. The Commission does that through the Technical Support Instrument.

Second, equity is most important for start-ups and innovative companies and difficult to access especially for SMEs. Therefore, the European Commission has launched several initiatives to foster access to equity: the Capital Markets Union to unlock more investments, also for SMEs.

The Single EU Equity Financial Instrument to support European businesses' growth, research and innovation. Venture EU, the Pan-European Venture Capital (VC) Fund-of-Funds programme to further address Europe's equity gap by investing in VC Funds-of-Funds. The European Innovation Council Fund which just provided a first equity investment of EUR 178 million in breakthrough innovation.

Third, if the economic outlook brightens, equity becomes more attractive, debt more sustainable. This is the real solution for which we have to work, and the European Commission does: The Recovery and Resilience Facility, making €672.5 billion in loans and grants available, gives perspectives that the EU will emerge stronger and more resilient from the current crisis.



ELKE KALLENBACH

Deputy Director for International Financial Market Policy, Federal Ministry of Finance, Germany

Boosting the German VC Ecosystem

Start-ups are a key driver of structural change. They put new, innovative ideas into practice, create jobs and safeguard the foundations for future prosperity and growth in Germany and Europe. People who start new businesses can be valuable innovators, and they play a tremendously important role in the development of the German economy.

The Federal Government has therefore set itself the objective of improving legislation and tax rules for venture capital and of making Germany more attractive to venture capital.

In recent years, Germany's venture capital market has advanced significantly. In particular, Germany is doing comparatively well in the area of early-stage financing for start-ups, thanks in part to the many public funding programmes in place at the federal and state (*Bundesländer*) levels.

However, despite the international attention directed towards Germany's start-up scene, the venture capital market in Germany remains too small, especially when compared internationally or when viewed in relation to the size of the German economy. In some countries, venture capital investment is many times higher

than in Germany. Start-ups in Germany have inadequate access to capital especially when it comes to second-stage and third-stage financing.

For this reason, the German government has already adopted a number of instruments to promote financing for innovative start-ups.

This support is provided both (a) indirectly via funds such as the ERP/EIF Fund of Funds and KfW Capital's ERP Venture Capital Fund Investment programme, which invest in private venture capital funds and (b) directly via public funds such as the High-Tech Gründerfonds (HTGF) and coparion, which invest directly in start-ups. In addition, the German government set up a €2 billion programme to help start-ups during the coronavirus pandemic. For regulatory reasons, and to ensure consistency with EU competition and state aid law, funding from these instruments is typically contingent upon significant contributions from private investors. In this way, such funding expands the amount of financing available on the German venture capital market.

Germany is committed to improve financing opportunities during the capital-intensive scale-up stage.

Closing remaining gaps: Germany is committed to improve financing opportunities during the capital-intensive scale-up stage. To this end the German government is currently setting up an €10 billion equity fund for emerging technologies (*Beteiligungsfonds* für Zukunftstechnologien, or *Zukunftsfonds* ("Future Fund") for short), which will be set up at KfW. With this Future Fund the German government will multiply its existing funding structure both quantitatively and qualitatively.

Moreover, the German government proposed several regulatory and tax-related measures to increase Germany's attractiveness for investment funds (VAT exclusion to management fees of VC funds, new tax regulations for employee investment schemes, less red tape and more flexibility for investment fund managers).

SEBASTIEN RASPILLER

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

Developing equity funding is much needed and should rely on a result-driven strategy

As the world slowly emerges from a challenging year, the outlines of the post-Covid era begin to take shape, calling for new ways to repair the damage done by the crisis to the corporate sector.

Most of the emergency support schemes have focused, and rightly so, on keeping the economy afloat by providing liquidity to companies, through direct subsidies, furlough schemes, tax and loans moratoria and state guaranteed loans. An unavoidable side effect has been an increase in corporate debt. In France, it has risen by €217bn in 2020. Cash holdings by companies have also increased dramatically (€200bn). This big picture hides very different situations across companies, some faring fairly well, and others emerging badly bruised from the crisis.

A severe economic downturn automatically decreases the levels of equity capital in the economy, via reduced profits, higher debt and the use of cash holdings to meet payment deadlines. These equity losses act as shock absorbers and help businesses go through crises. However, a sustained lack of equity is damaging to the economy, by increasing the risk of viable companies going bankrupt and of debt overhang situations, in which companies prioritize debt reduction strategies over investment and employment plans.

Boosting equity financing is critical now, with government intervention if necessary, especially for SMEs which do not have access to capital markets.

Boosting equity financing is therefore critical now, with government intervention if necessary, especially for SMEs that do not have access to capital markets or professional investors. This support should come with terms and conditions: assistance has to be targeted towards viable firms and to involve the private sector. The aim is to use the resources, information and incentives of the private actors to ensure a good use of taxpayers' money.

The situation calls for a comprehensive strategy. This is what France is trying to do, with a mix of horizontal policies (such as cuts in production and corporate income taxes), and specific measures addressing different situations. For instance, the recently announced *"prêts participatifs et obligations Relance"* scheme targets companies affected by the crisis but with manageable levels of debt and investment plans to finance.

The scheme rests on up to €20bn of "equity loans" (subordinated long-term debt) and subordinated bonds, with a public guarantee of up to 30% of first losses at the portfolio level. For viable firms struggling to meet their debt repayment deadlines, a clear debt restructuring plan is needed. France has reinforced public restructuring committees that help devise solutions with all stakeholders of struggling companies and is reforming bankruptcy procedures to make them more effective.

The European Commission's decision to prolong and expand the scope of the Temporary Framework has freed up some policy space to implement new instruments to help companies rebound from the crisis. The involvement of financial actors will be critical in ensuring that these schemes are a success. Beyond public support to the financing of our economy, we should lift the barriers to investments in equity by the private sector: the Solvency II review is a not-to-be missed opportunity in this regard.

JESÚS GONZÁLEZ NIETO-MÁRQUEZ

Managing Director BME Growth, Bolsas y Mercados Españoles (BME)

Equity financing in the post-Covid reality

A year after the pandemic hit our systems we are still speaking about recovery and rebuilding from a crisis that is still peaking. Measures have been established to counter the devastating effects of the Covid-19, but we must not forget the overarching goal of building a resilient and robust financial system capable of absorbing shocks and generating growth.

SMEs are at the core of growth generation: they increase the productive fabric, allow for larger investor participation, and provide for solutions to demands in new fields, such as ESG. In certain ways, the recovery measures put in place in the second half of 2020 have alleviated some of the most acuciating concerns for SMEs, but we need to consider a change in paradigm to fully unleash their potential.

Equity funding is based on investor trust and capability to invest, their access to equity issuing procedures is paramount to create value. Investors must be given the tools to access the financial system in effective ways: they must be able to understand and decide amongst the different investment options available, and that stems, inevitably, from a more comprehensive financial culture and education. Investors with a deeper knowledge will better understand their risk profile and widen the investment base, to fund SMEs.

Investor participation at the heart of SME funding.

Capital raising can certainly stem from different sources and making use of already established channels needs to be taken a starting point to give visibility to SMEs while providing investors (and their intermediaries) for a trampoline to consider these investments an option when drafting their portfolios.

At the same time, companies need to be able to raise capital without having to deal with excessive burdens that drive investment away from their projects. Policy makers need to understand and assess carefully the impact that current regulation may have in discouraging investments. The EU is rightly proud of taking investor protection with the relevance it merits, but there is still room for allowing companies to approach a wider and more diversified base of investors while preserving their rights.

Easing the requirements for SMEs to be listed, to open secondary issuances and to be rightly covered in research, as well as a carefully dimensioned tax regime, paired with tax incentives, need to be assessed to level the playing field for SMEs vis-à-vis the rest of companies.

Finding the balance on these measures should be considered as a means to grant SMEs access to financing in aims of continuing towards the funding chain: allowing for growth and for moving on the next step of the regulated markets.

We cannot ignore the opportunity window offered by the review of MiFID II, and furthermore, we need to understand it as a chance to make our financial system more dynamic and inclusive, taking one decisive step forward in the completion of the CMU.

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SECURITIES AND DERIVATIVES CLEARING

KLAUS LÖBER

Chair, CCP Supervisory Committee, European Securities and Markets Authority (ESMA)

The priorities of ESMA's CCP Supervisory Committee

2020 has seen the establishment of the new supervisory regime for CCPs under EMIR 2.2, a key part of which is the new CCP Supervisory Committee (CCPSC). The appointment of the Chair and the two Independent Members completed the establishment of the CCPSC and, with it, the implementation of the enhanced regimes for the recognition of third country CCPs as well as for supervisory convergence for EU CCPs.

As concerns EU CCPs, further enhancing supervisory convergence is a key priority of the CCPSC. Building on regular exchanges of views and discussions amongst national competent authorities (NCAs) and relevant supervisory decisions and opinions on EU CCPs' initiatives (such as the validation of significant risk model changes), the CCPSC has two primary instruments to further promote common supervisory practices and culture:

- **CCP stress tests:** Annual CCP stress tests measure the level of resilience of CCPs against common stress scenarios and identify issues for follow up via regulation or supervisory actions. The CCPSC is about to embark on the next round of CCPs stress tests, building on experience gained and having regard to new or emerging stress scenarios (such as cyber resilience).
- **Peer Reviews:** Peer reviews of NCAs' supervisory activities towards CCPs have been successful in defining best practices and identifying, where relevant, inconsistencies or divergencies in the application of EU regulatory requirements. The CCPSC has recently completed the 2020 peer review and will soon launch the 2021 exercise.

Looking at third country (TC) CCPs, the review of EMIR introduced a two-tier recognition regime, whereby those third country CCPs qualifying as systemically important for the financial stability of the Union or of one or more of its Member States (so-called Tier 2 CCPs) are subject to EMIR requirements on an ongoing basis. Ahead of the end of the Brexit transition period in September 2020, ESMA adopted temporary recognition decisions (following the Commission's temporary equivalence decision), which expire on 30 June 2022. This enabled a smooth transition for UK CCPs from the EU CCP to the third country CCP regime under EMIR, with two UK CCPs having been recognised as Tier 2 CCPs: ICE Clear Europe and LCH Limited. In respect of TC CCPs, the CCPSC will face three major priorities:

- **Direct supervision of Tier 2 CCPs:** An efficient direct supervision framework will ensure that Tier 2 CCPs comply with EMIR requirements on an ongoing basis, as the case may be under comparable compliance still to be decided.
- **Review of the Tier 2 CCPs' recognition:** The CCPSC is mandated to assess whether the services provided by Tier 2 CCPs, or some of them, are of a systemic nature that is too substantial to be safely provided from outside the Union. The CCPSC will carefully analyse potential risks, dependencies and stability implications that result from the current situation and potential evolutions. It will also look at costs and benefits of a potential relocation of clearing services.
- **Other TC CCPs' recognitions:** The CCPSC also has to review the TC CCPs that were recognised before the entry into force of EMIR 2.2, in order to determine if any of them would qualify as Tier 2 CCP. Finally, in 2021, the CCPSC will process pending applications for recognition of the SEC-regulated US CCPs, following up to the recent Commission equivalence decision adopted under EMIR.

JOCHEN METZGER

Director General, Payments and Settlement Systems, Deutsche Bundesbank

All for one and one for all

With the adoption of the Capital Markets Union Action Plan 2020 a few months ago, the EU Commission started a new and important chapter in the achievement of a single EU capital market. It was Alexandre Dumas who once wrote "all for one and one for all": The same sentiment could be applied to the capital markets union.

In the belief that 27 economies together can achieve more than each one individually, the intention is that the EU will unleash enhanced economic power by providing cross-border financial services both internally and externally, thus increasing its importance and its resilience at the European and international levels.

In particular, with increasing cross-border trading of shares, bonds and derivatives, the economic opportunities of a united capital market will soon present themselves to the member states and lead to sustainable growth. Against this backdrop, the continued removal of cross-border impediments and increased transparency are essential for a level playing field.

CCPs have always played a key role in this respect as they reduce counterparty and settlement risks, thus contributing to secure and continuous

economic growth. The new supervisory framework EMIR 2.2 enhances the resilience of these important players.

The recently enacted CCP Recovery and Resolution Regulation augments the regulatory framework with a powerful recovery and resolution regime and completes the picture and the mission initiated at the Pittsburgh summit in 2009. Binding recovery and resolution plans in conjunction with adequate tools to deal with crises will generate more predictability, safety and confidence in the European capital market and ultimately increase trust in the EU's financial system.

In that context, ESMA performs an important function through its supervisory convergence work by promoting the standardisation of supervision practices and compiling a single rulebook for EU financial markets.

In the area of CCPs, ESMA supports the Member States' authorities in the coordinated supervision of EU CCPs by issuing peer reviews and stress tests and by participating in CCP colleges and in the CCP Supervisory Committee, and, in future, in CCP resolution colleges.

ESMA performs an important function through its supervisory convergence work.

Outside of the EU, ESMA's supervision of systemically important third-country CCPs ensures that the high EU standards are not being eroded.

This European approach has fully proven its worth in terms of coordinated and harmonised supervision, precisely because it allows the local specialisations of the CCPs to be optimally taken into account by the respective national authorities. This is crucial since not all CCPs clear the same products, and many have different risk profiles and varying legal systems, but it also enables a consistent methodology to be reinforced, best practices to be defined and thus the goal of achieving a single capital market to be fostered.

However, this will not be the end: with the advance of digitalisation, a changing clearing landscape will emerge. New market players will bring with them new opportunities, but also new risk.

Questions are arising concerning, in particular, how to integrate these new players into the single capital market. The answer for that can only be "same activity, same risks, same rules".

NATHALIE AUFAUVRE

Director General Financial Stability and Operations, Banque de France

Adding predictability to resiliency: the post-Covid challenges of margining

The Covid outbreak in spring 2020 triggered extreme market moves in some financial sectors like equity markets. In addition, the global financial system had to adapt quickly to lockdown measures that were imposed in all jurisdictions. In this unprecedented context, EU CCPs and their members proved remarkable financial and operational resilience. Margin collection continued smoothly, without any member default and EU CCPs deployed business continuity plans to carry out their activities on a fully remote basis.

While this crisis has showed that post-2008 reforms were useful, including clearing mandates and CCP regulations, some events at global level have raised questions on the preparedness of actors, especially the liquidity capacity of some non-banks to meet higher margin calls.

EMIR is a robust framework for CCP resilience that involves close cooperation and supervisory convergence and has just been complemented by a regulation on recovery and resolution. Yet, EU authorities pay close attention to the above-mentioned vulnerabilities, and have therefore undertaken policy work at ESMA and ESRB level to enhance the stability of the clearing chain.

Financial actors need more predictable margin practices, without weakening CCPs' first defense lines. In this respect, the clearing membership of EU CCPs should remain subject to high liquidity and operational standards. Similarly, collateral eligibility should remain limited to highly liquid assets, and any broadening should be closely monitored to ensure this does not create additional liquidity risk for CCPs.

Predictability should help limiting margin procyclicality. Margins should be calibrated so that their level would remain adapted through the economic cycle, while smoothening peaks and troughs. More specifically, authorities should deal in priority with fluctuations of initial margin models and monitor discretional changes. While EMIR already requires CCPs to implement anti-procyclicality tools in their IM models (e.g. floors, buffers) they could be subject to further guidance, including possible steering power from authorities and transparency. More generally, CCPs could disclose more granular, frequent data on margin breaches and increases. EU authorities could develop enriched disclosure standards in this regard.

Beyond CCPs, and to better consider liquidity strains at ecosystem level stemming from margin requirements, transparency should be improved on uncleared markets and vis-à-vis client clearing practices. End-users might be subject to liquidity pressures through collateral restrictions or add-ons set by clearing agents or bilateral counterparties. In June 2020, the ESRB issued recommendations on this issue that national authorities are now implementing.

While the EU should not wait to take action, international standard-setting bodies will have a key role to play too. While CCPs are a sizeable part of the question and the CPMI-IOSCO Quantitative Disclosures could be refined, we welcome the holistic approach on assessing margin practices in the financial sector that FSB, CPMI-IOSCO and BCBS have together embraced. We think this ambitious work will result in substantial supervisory outcomes and proposals.

DANIEL MAGUIRE

Chief Executive Officer,
LCH Group and Group Head,
Post Trade, LSEG

The need for a diversified clearing ecosystem

CCPs are an integral part of the financial ecosystem. They support financial stability through robust and resilient risk management frameworks and diversified memberships spanning multiple jurisdictions, forming deep pools of liquidity. CCP membership is a key feature that contributes to making a CCP resilient to market shocks and defaults.

This has been illustrated during the Covid-19 associated market stress, where CCPs have successfully preserved financial stability. The anti-procyclicality measures enshrined in LCH's risk management framework ensured that margin increases were highly predictable with limited impact on our members' liquidity requirements. For e.g. the largest daily increase in total margin called during March 2020 was only at 3.5% despite the volatility observed on markets.

LCH's SwapClear serves customers in 62 different jurisdictions, has registered services in 11 jurisdictions and clears products in 27 different currencies. Internationally integrated businesses bring material benefits to users across jurisdictions, especially in the case of OTC derivatives markets which are truly global. They should be supported by consistent global and supervisory oversight based on cooperation and proportionate deference mechanisms.

> ..."the Euro market is predominantly traded outside EU borders (75%)"... "EU firms' clear more non-Euro currencies than Euros"

Jurisdictions approach to supervision varies from direct registration requirements to full deference. Some impose the use of local settlement systems and require CCPs to deposit collateral in their local currency on local central banks deposit accounts, giving them visibility on all flows in the currency they manage. EMIR 2.2 introduces the direct supervision of systemically important CCPs and direct application of EMIR requirements.

As such, a Tier 2 CCPs (such as LCH Limited) is subject to requirements at least as demanding as EMIR. This further enhances cross-border supervision of third country CCPs (TC CCPs) and ensures EU firms remain competitive by accessing to global markets and CCPs supporting these.

Accessing global markets is key for EU firms, as the Euro market is predominantly traded outside EU borders (75%) but also because EU firms' clear more non-Euro currencies than Euros. EMIR ensures that EU Firms' hedging activities are supported by a strong supervisory framework. It enables them to access global pools of liquidity and compete with their international peers on a level playing field.

Unfettered access to global markets by EU participants and financial stability are the principles for a successful economic recovery and EMIR provides the foundations upon which market participants and CCPs can operate on a cross-border basis in an open manner leading to economic growth and prosperity.

Market fragmentation would only increase financial stability risk and costs. The EU could draw inspiration from its peers and some of the requirements of EMIR. For example, it could require TC CCPs of systemic importance to the EU to use local settlement systems and deposit local currency cash at the local Central Banks.

This would further improve financial stability through increased oversight capabilities over international Euro flows, ensuring continuous monitoring of market activity but also an additional liquidity tool to be used in case of market stress.

HAROUN BOUCHETA

Head of Public Affairs,
BNP Paribas Securities Services

EU and third-country CCPs: the risk of fragmentation?

The end of the Brexit transition period marks the start of a new regulatory paradigm between the European Union and United Kingdom especially with regard to UK central counterparties (CCPs).

In the EU, two important regulatory trends have emerged during the past few months.

First, the European Commission has reinforced the framework for managing CCPs' risks through the adoption of EMIR 2.2 but also with the recent adoption of the CCP Recovery and Resolution regulation (which includes a second tranche of skin in the game). In particular for third-country CCPs, EMIR 2.2 has allowed the enhancement of third-country CCPs supervision by ESMA through the revised recognition mechanism.

EMIR 2.2 has also introduced a reinforcement of the application of EMIR key provisions for third-country tier 2 CCPs, considered as creating a systemic risk to the EU. However, with regard to euro-denominated OTC derivatives, EU authorities still consider Europe is too dependent to UK CCPs and does not benefit from sufficient supervisory powers.

Second, the European Commission has granted the UK a temporary equivalence decision for CCP clearing services in order to preserve financial stability, with the grace period running until the 30th of June 2022. In the meantime, the European Commission is encouraging EU-27 market participants to migrate their risk exposures from UK CCPs. Through a recent communication, the Commission reiterated the expectation that EU clearing members and market participants reduce excessive exposures to systemically important UK CCPs, in particular their euro-denominated OTC derivatives exposures.

There are clearly more questions than safe bets here and It is also important to understand the point of view of non-EU clearing members clearing euro transactions and the strategies they will follow. Could the European Commission take a strong stance and impose through regulation to non-EU clearers to clear euro-denominated instruments in the EU? If not, the risk could be to further fragment the derivatives markets and not control the potential risks or outcomes.

A relocation policy of euro clearing that would only involve EU-based clearers will damage those firms and would not meet the expected political goal of EU institutions.

The end of the transition period has evidenced the necessity to adequately anticipate and coordinate the impacts on financial markets of structural regulatory changes. While the trading of shares has not undergone any major issues, due mostly to an effective anticipation by the industry, the trading of OTC derivatives – IRS and CDS - has suffered negative effects for both EU and UK financial markets. The lack of coordination in the application of the derivatives trading obligation (DTO) has generated a significant shift of the dealing volumes on US venues and penalized both EU and UK market volumes.

To avoid the risk of fragmentation, authorities should take into account political, risk and competition considerations. Maximising liquidity is key to CCP efficiency, providing clearing members with cross-margining benefits and clients with larger liquidity pools.

A relocation policy of euro clearing that would only involve EU-based clearers and market players will damage those firms and would not meet the expected political goal of EU institutions. Indeed, to achieve this goal while maintaining CCP efficiency and financial stability, EU authorities will have to work closely with the industry to define the relevant measures to be implemented within a reasonable timeframe.

SECURITIES POST-TRADING

JOCHEN METZGER

Director General, Payments and Settlement Systems, Deutsche Bundesbank

How to steer the DLT pilot regime? Navigating between potential and challenges

Technological change is the driving force of our times – and Covid-19 has further accelerated the pace of change. Digital technologies are advancing in all segments of finance: contactless payments have boomed during the pandemic, robo-advisors offer fully automated investment tools to customers, and distributed ledger technology (DLT) looks set to play a much more important role in securities settlement in the future.

A crucial factor for all new technologies is the regulatory environment – without a stable and predictable set of rules, innovations face strong headwinds that may prevent them from taking off. At the same time, regulators need to ensure that consumers do not board vessels that are too risky for them and the market as a whole. In other words, regulating emerging technologies is about striking a balance between potential and challenges. The EU has developed a pilot regime to steer and stabilise the development of DLT for trading and securities settlement.

In essence, the initiative is about creating a kind of "regulatory sandbox" in the EU for the development and operation of market infrastructures based on DLT. Having a ring-fenced sandbox means that newcomers are able to play and experiment in a safe and supervised environment. The regulation takes the form of a pilot regime and has four main objectives: first, to create legal certainty for DLT market infrastructures within the EU; second, to support innovation in the EU by removing barriers to the application of new technologies in the financial sector; third, to safeguard consumer and investor protection and market integrity; and fourth, to guarantee financial stability.

Creating a pilot regime for DLT market infrastructures is the right approach. However, we need to keep two key issues in mind. First, when we enable this pilot to gain speed and take off, we need to be able to call it back and force a safe landing at any time if its objectives are not met. There are, of course, reasonable limits incorporated into the pilot regime, concerning both the duration and certain value thresholds to limit the size and risk of the regulatory sandbox. Nevertheless, we need to communicate to the market that winding down the regime will be a viable option if significant risks are identified that cannot be addressed in any other way.

The second key issue is that we need to prevent fragmentation of the European settlement landscape. New solutions based on DLT promise to increase the efficiency of securities settlement, but this depends on the specific design and development of the market. Creating many different non-interoperable DLT sandbanks or islands each with its own settlement asset will not enhance overall settlement efficiency in Europe. The sandbox concept is good but there would have to be a common one without major barriers to transactions, meaning that DLT infrastructure providers would need to ensure a high level of interoperability with existing legacy systems.

DLT offers significant efficiency gains for the European settlement landscape. However, we can only achieve these gains if we find the right balance between enabling potential and mitigating challenges. Avoiding fragmentation will be key to reaping the benefits of the pilot regime.

NIELS BRAB

Head of Group Regulatory Strategy, Government Relations & Political Affairs, Chief Regulatory Officer, Deutsche Börse Group

DLT is good, except when it's not (regulated)

Yes, the EU finds itself at a crossroads. With unprecedented public debt levels and pressure on the monetary policy as well as the banking system, the untapped growth potential by boosting the EU's capital markets becomes critical now. With the Brexit being a reality, the time has come to act – and the reflections around sovereignty and a stronger Euro are the right way ahead.

But in all this misery, there are also some good news: The G20 reforms have paid off! Despite all the turmoil and volatility over the past year, markets remained stable. Let us not forget that the post-trading sphere is playing a key role in this context as the backbone of security, stability and reliability in the financial system – fundamentals that should never be compromised.

This is where the CSDR comes in – and it is fair to say that we have come a long way: Shorter settlement periods or significantly enhanced organisational and prudential requirements for CSDs are only some of the key fields of progress. While it is good to ensure the functioning of the framework, a full sweep review occurs misplaced

given that certain requirements have never been phased in, such as the settlement discipline regime. And after all the impact assessments and years of preparations, it would occur premature to simply change or delete certain requirements at this stage.

This holds in particular true for the buy-in regime, notably considering that the Eurosystem still faces significantly higher settlement fails than other leading jurisdictions. Enforcing discipline is needed – as it means that market participants need to stand in for what they promised and cannot simply get away with misbehaviour to the detriment of the integrity of the EU's markets, such as non-delivery of securities.

By contrast, it makes sense to review some aspects that require adaptations to bring the EU's endeavour on the CMU front forward by strengthening the post-trading integration and making the internal market more efficient, resilient and competitive. These include, for example, the need to boost cross-border competition by enhancing the passporting regime and streamlining the approaches by NCAs, the ability of CSDs to service intra-group, or the ability to provide ancillary banking services.

...ensure the CSDR remains future-proof while safeguarding its fundamental stability and integrity prerogatives.

Let us not forget to highlight the importance of technology in this context. With the next big digitalisation wave in full swing, it will be key to ensure the CSDR remains future-proof while safeguarding its fundamental stability and integrity prerogatives. The DLT Pilot Regime proposals should therefore still find the right balance between innovation and security, respecting the principle of "same business, same risk, same rules", avoiding conflicts of interests and ensuring technology-neutral legislation.

When Deutsche Börse Group made the markets electronic in the 90s, we did not see any regulatory relief for our business case. History illustrated that we were nevertheless successful. Today, Deutsche Börse Group has a number of DLT based offerings on the market – again, without receiving regulatory relief.

If new technology is claimed to be incompatible with fundamental principles of financial regulation, we should carefully reflect if it is our fundamentals or the technology that is not fit for purpose.

GUILLAUME ELIET

Head of Regulatory, Compliance and Public Affairs, Euroclear S.A.

Making the DLT pilot regime a success for the EU

As a financial market infrastructure, Euroclear has always been supportive of the development of new technologies that could make the financial markets safer and more efficient. On DLT, we already highlighted the potential of this technology in several strategy and legal publications, and we are involved in different initiatives to explore and leverage its benefits. Like many market players, we believe DLT has the potential to reshape in some ways the securities markets, by introducing new services and new players.

This reshaping has the potential to bring benefits in terms of efficiency and transparency, but market authorities need to be careful on how this transformation takes place. EU regulators have a crucial role to play in setting the fundamental objectives of the DLT pilot regime. We believe that the reform should be based on two main drivers: (i) bring benefits to the EU and its CMU (ii) do not compromise on the safety and stability of the financial system. The EU will achieve the digital finance agenda's ambitious targets only if it successfully manages to combine these two elements.

The objective must be to develop DLT technology, not for itself, but as a catalyst for a more integrated and safer CMU.

Indeed, creating a space for DLT into the regulatory landscape should not only serve the mere objective of developing a new technology. It should also bring benefits for the CMU, contribute to better market integration and help the development of more cross-border flows of funding. In this respect, the DLT pilot regime should be designed in a way that avoids creating market fragmentation, which would be detrimental to issuers and investors. While the current proposal aims to test very innovative concepts such as the combination of trading and post-trading within one single legal entity, questions remain on whether it would be in line with the necessity to offer issuers and investors more open, interoperable and competitive markets.

The introduction of DLT may lead to exemptions justified by some feature of the technology, to the extent however that they do not result in increased financial stability and systemic risks. The legislative framework must, in this respect, remain technology neutral. To ensure a certain level of security, a common feature of most analysis was to highlight the importance of having a market infrastructure dedicated to operating the DLT platform and performing key roles such as ensuring the integrity of the issuance, managing the governance, performing the due diligence, etc. We believe this role of gatekeeper, which was also supported by the High Level Forum on CMU, could bring additional safety and thus confidence in the new regime.

Euroclear is supportive towards the project of setting up a pan-European experimentation zone for DLT, which can indeed be a great additional tool to bring the EU forward in the digital age. The objective must be to develop DLT technology, not for itself, but as a catalyst for a more integrated and safer CMU. The political discussions at the European Parliament and European Council shall keep firmly this objective.

SWEN WERNER

Managing Director, Digital Product Development and Innovation, State Street Bank and Trust

The DLT pilot regime – a path to Europe's 'next-gen' market infrastructures?

Distributed ledger technology (DLT) is a foundational technological innovation that could bring long-term benefits to create more efficient markets. The European Commission's proposed DLT pilot regime aims to support the digital transformation of financial markets. If adopted, it would allow the operation of market infrastructures based on DLT.

The pilot regime adopts a sandbox approach to creates certain exemptions from specific requirements embedded in EU legislation such as MiFID or CSDR. At present, there are over 50 countries which have implemented comparable 'sandboxes' that allow for temporary relief from certain regulatory obligations in order to promote experimentation particularly in the field of emerging technologies.

Previous consultations from the EU Commission concerning new technologies showed that many respondents, aside from some of the current infrastructure providers, believe that the existing EU framework is insufficiently technology neutral. This could undermine the successful deployment of new technologies such as DLT. The pilot regime is a way to address this issue:

- it recognises the potential need for regulatory change in light of new technologies,
- identifies areas that may be insufficiently innovation friendly,
- requires those seeking to create a DLT market infrastructures to prove that existing EU rules are incompatible with DLT.

The real success is the engagement model created between the private and public sector and the transparency around such engagement.

Consequently, the barometer of success for the pilot regime is not necessarily its widespread adoption, since the regime should only be used if existing regulation would not allow for it.

The real success is the engagement model created between the private and public sector and the transparency around such engagement. Nevertheless, the scope of the pilot regime is limited, i.e. restricted to illiquid securities, subject to a sunset clause and participation is only foreseen for CSDs and MTFs (multilateral trading facilities). This could create unintended outcomes:

- Participation is limited to central infrastructures only: DLT-based networks are decentralised networks by design. This implies the redistribution of roles and activities that currently reside across existing market infrastructure and their users. The pilot regime does not fully allow for this level of experimentation to happen.
- There is continued uncertainty about the exit strategy: there is insufficient clarity on how a successful business model, developed as part of the pilot, can achieve a general stay once the pilot regime expires. This may increase the risk for investors to engage in building such models.
- National regulators are creating potentially more attractive alternatives: various Member States are in the process of amending their national securities law to allow for the creation of securities that are issued in digital form using DLT.This may be more attractive than the pilot regime

The pilot regime is a welcomed example of how EU regulators can flank technological innovation with regulatory flexibility. However, additional effort will be needed to allow for greater levels of decentralised market structures to evolve, which will be beneficial to financial markets in Europe and contribute to the efforts of creating a deep and innovative capital markets union.

ALEX DOCKX

Executive Director, Securities Services Industry Development, JP Morgan

Improving CSDR settlement discipline to support CMU objectives

The creation of an integrated and efficient European capital market – the goal of the CMU project – is among the most important goals currently being pursued in the EU.

A crucial element of this framework is the safety and efficiency of the arrangements required to finalise securities transactions. There is a clear flow in operations and interdependency between trading and post-trade processes, with efficiencies passing through from one to the other.

In that context, the objective of the CSDR Settlement Discipline Regime (SDR) – to increase settlement efficiency in the market and decrease settlement fails – is the right one. We commend the European Commission for recently consulting on the details of the regime to make sure they are fit for purpose. For example, we believe that a targeted, appropriately calibrated cash penalty regime – as currently envisioned in the SDR – will have a positive impact on settlement efficiency on a standalone basis, sufficiently penalising sellers while compensating buyers for late delivery, ultimately leading to lower settlement fails.

However, we believe one particular provision of the SDR – the mandatory buy-in regime – risks reducing the efficiency and liquidity of European capital markets, leading to greater costs to investing in European securities, contrary to CMU aims. The issue is with the mandatory nature of the buy-in regime for non-CCP cleared transactions, which makes it insufficiently flexible by removing investors' choices and ignoring the particular liquidity profile of the securities.

This is likely to fundamentally impact liquidity providers' ability to make markets. To adjust for the expected cost of being bought-in, market makers may have to add a premium to their prices – widening the bid-offer spread – or they may simply not make an offer price on an enquiry. Asset managers, in turn, may not be able to obtain the securities they want on behalf of investors, and thus may have to make sub-optimal investment decisions or may have to pay a liquidity premium. Issuers could also be negatively affected, with issuance ability and pricing related to the expected liquidity of the instrument.

A mandatory buy-in regime for non-CCP cleared transactions could negatively impact market liquidity and increase costs to end-investors.

Ultimately, a mandatory buy-in regime for non-CCP cleared transactions could negatively impact market liquidity and increase costs to end-investors. This could be especially the case in times of stress when markets become more volatile, and bid-offers and settlement failures increase. Furthermore, while negatively impacting all asset classes, these effects are likely to be disproportionately detrimental to less actively traded or illiquid securities, including instruments issued by SMEs, and high yield and emerging markets securities, which already suffer from lower liquidity and higher costs of trading.

The result is that a measure which was meant to improve settlement efficiency and stimulate European capital markets is likely to come at a high cost. We would therefore suggest replacing the mandatory buy-in regime for non-CCP cleared transactions with a discretionary one, while keeping a strong and robust penalty regime. Such an approach would significantly improve settlement efficiency in the EU and serve the ultimate goals of the CMU.

FRANCISCO BÉJAR

Deputy Chief Executive Officer, Iberclear (BME)

EU securities post-trading priorities

We are living in an unprecedented time, socially distanced and heavily relied on digitalization and innovation. Here we are, yet again hit by another crisis but by health crisis this time which has paralyzed economies around the globe. The world economic and geopolitical orders will most probably change depending on the policies and strategies countries will and are employing not only in order to recover from the pandemic-led crisis and mitigate the risks but also to achieve the goals they have set for the future. Therefore, we need to complete the Capital Markets Union (CMU) now more than ever, or the stakes are too high.

In September 2020, the European Commission published its Action Plan to boost the CMU by tackling some of the remaining barrier to a single market for capital. One of the barriers, which hinders the cross-border investments and transactions, is the fragmented post-trade landscape or the lack of common CSD ecosystem.

To create a common CSD ecosystem, we need more simplified and harmonized rules such as Central Securities Depository Regulation (CSDR), Settlement Finality Directive (SFD) and Financial Collateral Directive just to name a few. For this, we need (i) to clarify and harmonise the passporting procedures and enhance cross-border provision of services, (ii) facilitate the servicing of domestic issuance in non-national currencies, and (iii) strengthen the supervisory convergence among the national competent authorities.

EU needs common CSD ecosystem to complete the CMU

Indeed, the consultations issued by the European Commission on CSDR and SFD are in line with the recommendations of the High-Level Forum on CMU and are on the right direction. However, to achieve even better results, it is also important to resolve tax-related matters, simplify the CSD links framework and employ technological innovations.

In the meantime, we have to implement the Settlement Discipline Regime, which is a crucial part of the CSDR and needs further improvement regarding the buy-ins regime, rules on penalties and on the reporting of settlement fails. Rules on buy-ins should be differentiated by the markets, instruments and transaction types. Also, cleared and non-cleared transactions should have same buy-ins regime to avoid de-incentivising central clearing. As for rules on penalties, negative interest rates should be taken into account and some types of transactions should be exempted from the scope.

Digitalisation, the global trend which is evolving very fast and further accelerated by the pandemic, is one of the European Commission's six priorities. Therefore, the European Commission's Digital Finance Package is very timely and highly welcomed.

However, it is important to ensure the level playing field, clarity, and proportionality of the new legislations, Markets in crypto-assets (MiCA), Digital operational resilience act (DORA), DLT Pilot Regime, and their interaction with existing legislations.

Trading volumes have soared during the beginning of the pandemic and the volatility has gone wild. Yet, financial markets infrastructures proved to be resilient and functioned smoothly. However, we have to take another step forward to better CSD legislations to create common CSD ecosystem, complete the CMU and thus, contribute to the well being of people in the European Union.

HÉLDER ROSALINO

Board Member,
Banco de Portugal

Are the actions being taken enough to support the CMU and to strengthen the international role of the euro?

The European institutions, as well as national authorities, are taking actions towards a more integrated, harmonized and efficient financial markets in the euro area, and in this way to enhance the international role of the euro.

The European Commission has recently launched some important initiatives. First, in December 2018, the Commission communicated on the need to move "Towards a stronger international role of the euro". In that communication, the Commission concludes that "strengthening the international role of the euro will require the further strengthening of the structures of the Economic and Monetary Union, including through the adoption of all pending proposals for completion of the Banking Union and decisive progress on the CMU".

Second, a digital finance package was adopted on 24 September 2020, comprising a digital finance strategy and legislative proposals on crypto-assets and digital resilience. Some of the proposals are directly targeted to facilitate innovation and make Europe a more integrated and innovative market while addressing the emerging risks, namely the "Legislative proposals on crypto-assets to draw on the possibilities offered by crypto-assets, while mitigating risks for investors and financial stability" and the "Legislative proposal for an EU regulatory framework on digital operational resilience – Prevent and mitigate cyber threats".

This package also includes a "Retail Payments Strategy for the EU", by which the Commission points out that the development of efficient international payments, including remittances, as well as the issuance of a Central Bank Digital Currency by the Eurosystem, could enhance the international role of the euro and the EU's 'open strategic autonomy'.

Third, a communication entitled "The European economic and financial system: fostering openness, strength and resilience" was disclosed on January 2021. Two of its pillars relate to strengthen the international role of the euro and to develop further EU financial market infrastructures and increase their operational resilience.

This communication includes as a key action the promotion of euro-denominated investments, the facilitation of the use of the euro as an invoicing and denomination currency and a better understanding of the obstacles for its wider use. At the same time, it also establishes that the Commission and the ECB will jointly review a broad range of policy, legal and technical questions emerging from a possible introduction of a digital euro.

Last, the European Commission announced the revision of both the Central Securities Depositories Regulation (CSDR) and the Directive on settlement finality in payment and securities settlement systems (SFD). The proposals embedded in the CSDR and SFD reviews are moving in the right direction, towards a more competitive and levelled playing field European market. All efforts put on the harmonization of definitions, interpretations and implementation issues, as well as streamlining reporting, are very much welcomed.

The ECB and NCBs are also taking important actions in the market infrastructure and payments field to consistently concur to the increased efficiency and integration of financial markets in the euro area. It has to be highlighted all the work done by the Eurosystem in the development of the infrastructure for large-value payments, for post-trading services for financial instruments and for instant retail payments and, still to come, the provision of a central liquidity management system, the development of a single collateral management system and the improvement of the efficiency and safety in cross-borderpayments.

Despite the relevance of the abovementioned initiatives, it has to be acknowledged that a more integrated and energetic European financial market depends also on the capacity of the European players to compete internationally, to innovate and to mitigate the risks arising from their activity.

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CONSOLIDATED TAPE AND SINGLE ACCESS POINT

HANZO VAN BEUZEKOM

Board Member
Dutch Authority for
the Financial Markets (AFM)

Towards a transparent Capital Markets Union

In September 2020 the European Commission adopted a New Capital Markets Action Plan. An important goal of the action plan is to stimulate market-based finance to sustain the recovery and the long-term growth to finance the green and digital transition of the economy. In order to make sound investment decisions, investors in capital markets must have access to a broad range of information about companies and financial products. In this article, I would like to highlight two actions of the Commission's action plan which can stimulate the development of transparent capital markets:

1) Post-trade consolidated tape for equity and equity-like instruments;
2) and the building of a European Single Access Point (ESAP).

In the AFM's view, a real-time post-trade Consolidated Tape Provider (CTP) is an essential part of the CMU. A CTP would allow consolidation of market data at low cost, enabling market participants to get a comprehensive and accurate view of the market and facilitating price discovery.

A CTP is needed to address the negative effects of fragmentation of markets and to counteract the market power of trading venues in selling market data. It would contribute to the CMU and a single market in the EU while it would supplement best execution policies for retail investors by improving the availability of common reference price information resulting from a fragmented market. Current barriers to the emergence of an equity CTP are the limited commercial rewards, the strict regulatory requirements, competition by data vendors and problems with data quality.

We recognize there are some preconditions for the establishment of an equity CTP like sufficient data quality to make it meaningful, mandatory contribution, sharing of revenue with contributors, appropriate funding by users, full coverage and IT-aspects to face the challenge to make it operational in a short time frame. Whilst the AFM is supportive of establishing a CTP, we also note the practical constraints that should temper expectations. The operational preparation will take a few years, but if the preconditions mentioned above are taken into account, we are confident a CTP should have added value for market participants even without the UK participating.

Another essential part of the CMU is the building of a European Single Access point for companies' information. Therefore, the AFM supports the Commission's initiative in the creation of a European Single Access Point (ESAP), as financial information is currently fragmented across different databases in different member states and difficult to access.

A central access point will enhance the accessibility of financial and non-financial information. In order to make the establishment of ESAP successful in the AFM's view the Commission should adopt a phased approach. Whereby in the first stage ESAP serves as a platform to access all public information of companies with securities listed on EU Regulated Markets. When this is successful, the Commission could consider to enlarge the scope of ESAP to for example non-listed companies.

VERENA ROSS

Executive Director, European Securities and Markets Authority (ESMA)

Increasing CMU's transparency and fairness – Insights on the ESAP and the EU CT

A well-functioning and integrated market for capital across the EU requires a high level of transparency and the accessibility of comprehensive and reliable information. As outlined in its CMU action plan, the European Commission intends to cope with this challenge by establishing a European Single Access Point (ESAP) for corporate disclosure and an EU Consolidated Tape (CT) for market data.

ESMA fully supports the creation of a single access point to financial and non-financial regulated information, including sustainability information, based on a harmonised digital format. The ESAP is expected to enable cross-border investments and enhance the visibility of less known entities, including SMEs.

To achieve this aim, the ESAP needs to (i) be implemented in a progressive way (to avoid the risk of building an overly complex and thus inefficient architecture), (ii) cover comparable information rendered in machine readable format (giving cross-border investors access to easily consumable data), and (iii) be underpinned by a clear data governance accompanied

by data checks (to ensure the highest quality of the data and the protection of investors).

Given its expertise and its extensive experience in designing and managing large scale EU-wide public IT and data systems, ESMA is in an ideal position to setup and run the ESAP. Of course, the project needs to be matched with adequate resources.

Together with the ESAP, ESMA views a CT for equity as a must-have feature of the CMU, to enable investors to access meaningful information at pan-European level. The creation of a real-time post-trade EU CT for equities will give a reliable view of liquidity across the Union and mitigate the fragmentation of markets.

Looking back, MiFID II laid out the requirements applicable for CT providers but left the creation of a CT open to a market-led initiative, which did not materialise. It appears that the lack of commercial and regulatory incentives for potential providers, the competition of unregulated data vendors as well as shortcomings in the quality of OTC data prevented its emergence.

ESMA stands ready to assist the Commission with its expertise to create the ESAP and the EU CT that will move the EU closer to a fully-fledged CMU.

Now, looking ahead, to reap the full benefit of an EU CT certain conditions need to be met, notably the mandatory contribution of high-quality data by trading venues and Approved Publication Arrangements (APAs), the sharing of revenues with contributing entities, the operation of the CT on an exclusive basis, and the definition of a strong governance framework.

The Commission is expected to soon clarify its proposals on both projects. Regardless of the approach taken, ESMA stands ready to assist the Commission with its expertise to create the ESAP and the EU CT that will move the EU closer to a fully-fledged CMU.

In a wider perspective, this commitment is in line with ESMA's objectives and priorities, including the support of the sustainable finance and digitalisation agenda, as well as the need for transparency and data quality in securities markets.

NATASHA CAZENAVE

Managing Director,
Head of Policy and International Affairs, Autorité des Marchés Financiers (AMF)

It's time for a post-trade data tape

In light of the implementation of MiFID II and amid a highly fragmented trading environment in Europe, the need for a consolidated view of trade data remains unaddressed.

Such a consolidated view of trade transparency, the so-called consolidated tape (CT), is to date the missing part of European financial markets. Despite MiFID II setting a dedicated framework for such a tape to operate, the tape itself is yet to emerge, notably due to a lack of business incentives and the existence of several barriers such as data quality.

However, this consolidated tape could provide much needed transparency on where and how trades happened. It could not only ensure market players are able to determine where liquidity lies, to monitor trades appropriately and to perform transaction cost analysis, but it could also help them manage risks or document their best execution policy.

The upcoming review of the MiFID II framework and in particular MiFIR transparency rules, is an opportunity to remove the existing obstacles (whether these come from MiFID or not) and provide the right framework for the emergence of a European consolidated tape.

The first building block could be to first set up a real-time post-trade transparency tape.

What type of consolidated tape could be contemplated?

Some have advocated for a pre-trade consolidated tape enabling real-time order routing and offering a live European best bid and offer. However, given the competitive trading environment and the high volume of orders, at this stage the advantages of such a pre-trade tape do not seem to outweigh the costs that would be incurred to make it viable operationally.

Instead, the first building block could be to first set up a real-time post-trade transparency tape consolidating relevant data from trading venues, systematic internalisers, and approved publication arrangements reaching a significant market share in the relevant asset classes.

Similarly, in order to ensure an efficient mechanism from its inception, it could cover equity instruments first, and once operational, be broadened to cover bonds and derivatives.

An appropriate framework bringing together all providers and users of the consolidated tape (CT) data could help ensure maximum support for the project. In particular contributing participants could be entitled to a share of the CT revenues, for example through an appropriate redistribution fee determined based on their contribution. Furthermore, transactions that do not contribute to price formation, such as transactions benefiting from a pre-trade transparency waiver (e.g. technical trades), might not provide entitlement to any remuneration.

Importantly, the CT's governance and financing structure could also take into account the current lack of data quality. As an example, any entity reporting poor quality data could be penalised.

Let us hope the Commission will put forward an ambitious proposal in the coming months.

STEPHEN BERGER

Managing Director,
Global Head of Government & Regulatory Policy, Citadel

Consolidated tapes for equities, bonds and OTC derivatives are key to enhancing the efficiency, competitiveness and resiliency of EU capital markets

The European Commission has correctly concluded that a "true single market cannot exist without a more integrated view of EU trading". In its September 2020 Capital Markets Union (CMU) action plan, the Commission identified the core benefits of a consolidated tape (CT) in equity markets, including improved price transparency, greater competition, and enhanced information for investors. A CT would also increase resiliency by providing reliable reference prices to support uninterrupted trading even in the event of an outage at a primary trading venue.

Likewise, in its January 2021 roadmap to foster the openness, strength and resilience of Europe's economic and financial system, the Commission highlighted how a CT in the non-equity markets would encourage trading to take place on transparent trading platforms, increase market depth, and make EU markets more attractive for both issuers and investors.

The myriad benefits of CTs for each of the equity, bond, and OTC derivatives markets far outweigh the implementation costs. Further, the diverse beneficiaries far outnumber the limited cadre of trading venues and intermediaries who, despite casting doubt on CTs, remain well equipped to compete in a more transparent marketplace.

Experience in North America with CTs that are appropriately tailored to their respective asset classes provides overwhelming evidence of their value and viability. To begin with, EU real-time post-trade CTs should be developed for equities, bonds and OTC derivatives. They should be comprehensive, require mandatory contribution of both on- and off-venue transaction data, disseminate information immediately upon receipt, and allow only targeted and limited deferrals for larger sized trades.

Numerous academic studies demonstrate that increased post-trade transparency, in the form of real-time public reporting of transaction prices and sizes, narrows bid-ask spreads and enhances liquidity.

First, this transparency empowers investors to accurately assess execution quality, demand accountability from liquidity providers, and obtain best execution. Second, it removes information asymmetries and allows all liquidity providers to better manage risk, and in turn, more confidently quote prices, commit capital, and warehouse risk across all market conditions. Finally, real-time public reporting makes markets more resilient, especially in times of stress, by ensuring that new information is efficiently assimilated and reflected in current price levels.

In parallel, the Commission and ESMA should remain committed to resolving the current deficiencies they have wisely identified with respect to the scarcity, quality, timeliness, and accessibility of MiFID II post-trade transparency data for bonds and OTC derivatives. For example, the vast majority of off-venue OTC derivative transactions with systematic internalisers are currently entirely exempt from MiFID II transparency requirements.

Policymakers and market participants have repeatedly highlighted the critical role of CTs in achieving truly integrated EU capital markets. The MiFID II review provides a crucial opportunity to finally realize the benefits of CTs while also addressing underlying shortcomings in the transparency regimes for the equity, bond and OTC derivative markets.

NICHOLAS BEAN

Head of Electronic Trading Solutions, Bloomberg

A principled compromise, not compromised principles, can deliver a CTP

In my last EUROFI article of September 2020 I discussed the value of transparency data in Fixed Income (FI) markets where I concluded that solving the ongoing issues around post-trade data would provide the most meaningful return. In this article I would like to highlight the challenges of MiFID II in bringing such FI data to the market.

MiFID II anticipated a commercial entity producing a Consolidated Tape (CT) and being authorised as a Consolidated Tape Provider (CTP). Yet, as everyone is painfully aware, no commercial entity has taken up this 'opportunity'. Understanding why this is the case is critical to ensuring the upcoming revision of MiFID reflects the lessons to be learned from this experience.

Despite being the legislation's objective, a reasonably large part of the community understands that commercial entities will not seek to be CTPs as there is no commercial rationale for them to do so. Far fewer people understand why.

Running a CTP presents five key challenges to commerciality: product

quality, product latency, product scope, product value and competition from Approved Publication Arrangements (APAs) and Trading Venues (TVs).

Product quality: Data sources (APAs and TVs) publish information of variable quality and conformance. However, the market expects a CTP to provide uniform aggregated data. Thus, to meet this expectation a CTP would have to expend significant cost to clean and standardise the data.

Product latency: A Systematic Internaliser sends data to an APA, which publishes it to the market. A TV publishes its own transparency data to the market.

CTPs will always publish data after both an APA and a TV as it goes through the technical steps of collection, cleansing and republication. Thus, any latency sensitive customer will go directly to the 'source'.

Product scope: The vast majority of Government Bonds do not produce per trade prints. Corporate Bonds do have per trade prints but only circa 3% of transactions do so immediately. The remaining 97% do so approximately four weeks after execution via the deferral's regime.

Would you pay at 4 weeks or take it for free at 4 weeks and 15 minutes?

Product value: A CTP can only monetise trade-prints in the first 15 minutes of publication. Considering the Corporate Bonds and deferrals issue set out above, this means that from 0 minutes to 40 320 minutes the majority of meaningful trade prints are deferred, from 40 320 to 40 335 minutes the CTP can sell the data, and from then onwards the data is public domain material. Therefore, you can pay for data at 40 320 minutes or receive it at no cost from 40 335 minutes.

Competition from APAs and TVs: 'Cost+' is shorthand for the 'cost of producing and disseminating data and may include a reasonable margin'. Per the current rules, an APA or TV would have to sell data to a CTP at cost+. Thus, when a CTP resells the data it would do so at cost++ which may outweigh the expense of collecting the data directly from a short list of key APAs/TVs.

In closing, while these challenges explain why a CTP has not emerged under the current regime, it is still possible for a commercial entity to provide a CT to the market. We just need to work with the likely commercial candidates - as well as users - to find a principled compromise, without compromised principles, within a revised regulatory framework.

DANIEL MAYSTON

Head of Market Structure and Electronic Trading, BlackRock

Now is the time to deliver the European consolidated tape

The past two decades have seen successive pushes to make European capital markets more transparent. The first iteration of MiFID in 2004 significantly increased post-trade data availability. The introduction of MIFID II and MiFIR gave a second push towards standardisation with the ultimate aim of 'setting the conditions' for the emergence of consolidated tape providers. But to date, Europe still does not have an authoritative, comprehensive solution for any asset class.

Its continued absence represents a market failure and a hurdle to achieving the Capital Markets Union. Delivering it would bring many benefits to Europe's evolving capital market, market participants and, crucially, end-investors such as retail savers and pension funds: investors would have a full picture of the market when they make trading and investment decisions; risk managers the ability to assess liquidity faster and more transparently – particularly important during stress events like last year's; and retail investors transparency into fair prices on all venues, with more visibility of the 'value for money' which they receive from their service providers.

The ongoing review of MiFID II provides an excellent opportunity to make the EU consolidated tape a reality, rather than an ambition.

It would deliver ecosystem-wide benefits by addressing the current challenge of increasingly costly and complex licensing requirements for market data; by making regulatory initiatives more data-driven; and by reinforcing trading resilience and continuity in the event of exchange or venue outages.

Realising the consolidated tape should therefore be an important priority for EU policymakers and financial market participants, and an integral part of CMU. In line with the impetus of the CMU Action Plan, we believe a single consolidated tape provider per asset class should be mandated and overseen by ESMA, with clear delivery guidelines and technical specifications. Inconsistencies in market data reporting and distribution arrangements must be fixed, and fair commercial arrangements overseen by robust governance processes put in place.

We see the delivery of a consolidated tape following a three-stage process, with a real-time post trade tape for equities and ETFs coming first; followed by an extension to bonds and other instruments; and – in time – the development of a pre-trade European Best Bid and Offer metric. A pre-condition of achieving this will be to facilitate high quality source data through pre-defined standards; a regulatory framework that mandates contributions to the tape and shares its revenue equitably; and the underpinning of strong governance arrangements.

The ongoing review of MiFID II provides an excellent opportunity to make the EU consolidated tape a reality, rather than an ambition – and in doing so improve savers' and investors' confidence and outcomes; allow a full view of the single market for capital; and drive its competitiveness at the international level.

NICOLAS RIVARD

Head of Advanced Data Services, Euronext

An end-of-day execution analysis file – an effective solution to the identified use-cases

Given the current trading landscape, it is imperative to consider the added value of a mandated consolidated tape (CT) for equities compared to existing solutions. The question of use-cases is the critical starting point.

A study produced for the European Commission by Niki Beattie and Market Structure Partners identified and analysed 14 use-cases for the CT on the basis of which it recommended the establishment of a real-time post trade CT in the first instance, followed later by a real-time pre-trade CT. However, the overwhelming majority of the use-cases identified, which are already serviced today by existing vendor or in-house solutions, do not require a real-time CT and could be met by the creation of an end-of-day tape.

An end-of-day execution analysis file would represent the most appropriate solution.

It is important to underline that there are a myriad of issues one must consider when looking at a real-time CT: (i) a real-time pre-trade CT would, given the number of venues in Europe, advertise a misleading sense of liquidity, which, were it to be used for best execution purposes, would create a flawed and easily gameable benchmark to the detriment of investors, especially retail; and, (ii) a real-time post-trade CT would, while not raising the same level of policy concerns as real-time pre-trade, be costly to set up and manage but also divert precious time and resources from key initiatives that would strengthen the EU's capital markets.

Instead, it is our view that policymakers should focus on a scope design which balances meeting as many of the identified use-cases as possible, against avoiding potential problematic policy evolutions in respect of best execution and achieving a cost effective outcome for the industry. Fortunately, a solution based around an end-of-day execution analysis file would satisfy these requirements.

An end-of-day execution analysis file containing post-trade data enhanced with trade sides and available volume at execution time would represent the most appropriate solution to address the need for consolidation. Such a file would cover 100% of data sources and carry post-trade data together with information on liquidity available at execution. It would enable market participants to assess fragmentation and available liquidity across venues, as well as to support execution analysis allowing investors to validate the execution provided by their brokers. It would constitute a distinct offering and would not burden market participants with duplicative costs.

In any event, a number of principles must underpin any CT, notably it should: (i) cover 100% of data sources (venue and OTC) to maximize transparency, (ii) be underpinned by improved data quality, and (iii) be based on the principle of mandatory contribution and mandatory use by all market participants, including mandatory payment.

As a pre-requisite to any form of consolidation, it is essential to radically improve practices in terms of data completeness, accuracy and timeliness of reporting, as well as establishing standardised practices in the flagging of trades and granularity of time stamps across all data sources. It is paramount that this type of work be headed by an independent and neutral body, such as ESMA.

NEXT EUROFI EVENTS

THE EUROFI FINANCIAL FORUM 2021

8, 9 & 10 SEPTEMBER 2021

LJUBJANA – SLOVENIA

THE EUROFI HIGH LEVEL SEMINAR 2022

23, 24 & 25 FEBRUARY 2022

PARIS – FRANCE

THE EUROFI FINANCIAL FORUM 2022

7, 8 & 9 SEPTEMBER 2022

PRAGUE – CZECH REPUBLIC

RELAUNCHING SECURITISATION

DOMINIQUE LABOUREIX

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

Deepening the EU securitisation market: a key step for the Capital Markets Union

Securitisation can play a decisive role to support the objectives of the Capital Markets Union but needs to be properly regulated to address financial stability considerations. The EU financing market still relies heavily on banks. Securitisation, through diversification of funding sources, risk diversification and liquidity upgrade, can help deepen the Capital Markets Union. Banks that outsell or protect assets through securitisation may benefit from liquidity and/or preferential risk weights and get more flexibility to provide funding to the real economy. However, securitisation is a complex product that can endanger the financial stability when inappropriately used and hence deserves a robust framework.

To this end, increased attention has been paid to the regulation of the EU securitisation market in the wake of the Great Financial Crisis. A new simple, transparent and standardised (STS) framework has been adopted to fix the weaknesses identified during this crisis. This framework has been crucial in strengthening the investors' confidence. EU legislators also intend to improve further the framework in 2021 by introducing (i) a more risk sensitive approach to deal with the securitisation of non-performing loans and (ii) a differentiated regulatory treatment of STS synthetic securitisations.

However, the market has not yet fulfilled its potential. In 2020, primary public ABS issues in Euro fell by ca 40% from 2019 (from €39 bn to €22 bn). The low level of holdings by insurers is also a striking feature. Although the new framework entered into force in January 2019, the market is far from mature. The Covid-19 crisis has played a role in this regard. However, apart from short-term considerations, wehave to admit that the securitisation framework has not reached all its promises yet and still needs some fine-tuning to help support its revival.

Refining the securitisation regulatory framework remains a priority. Securitisation, in its well-designed form, may be part of the solutions to face post Covid-19 crisis challenges, such as: accompanying NPL off-loading, capital freeing, through an efficient significant risk transfer (SRT) assessment, and further expansion of the ABCP segment in order to support the European real economies and meet their financing needs. Developing green securitisation is also a promising tool. Accordingly, EU regulators should continue improving the framework by implementing a risk-based approach, consistently with financial products subject to similar credit, liquidity and agency risks. This would facilitate origination and investment in a wider range of operations. Areas of improvements may include: (i) developing a EU label for sustainable securitisations; (ii) removing remaining barriers, through a careful risk sensitivity evaluation, by reassessing the calibration of capital and liquidity requirements to encourage investments by banks and insurers.

The upcoming reviews of Solvency II and the securitisation framework provide the ideal opportunity to progress on these questions.

FAUSTO PARENTE

Executive Director,
European Insurance and Occupational Pensions Authority (EIOPA)

Securitisation: an appropriate treatment to ensure policyholder protection

What is special about securitisations is that they should not be special. In other words, the prudential framework for insurers, including capital charges, should reflect the riskiness of the securitisation. Only through such treatment can the principal aim of protecting policyholders be best realised.

Not treating securitisations does not mean discriminating against them. Insurers and pension funds should have the opportunity to invest in securitisations. Indeed, where justified Solvency II makes a risk-based distinction in its treatment of spread risk between asset classes.

EIOPA provided advice on the recalibration of spread risk charges for the identification and calibration of infrastructure investments in September 2015 and infrastructure corporate investments in June 2016; on reducing reliance on external credit ratings and the treatment of exposures to regional governments and local authorities in October 2017; and on the treatment of unrated debt in February 2018.

EIOPA provided advice on more favourable but still prudent treatment of

securitisations as long ago as 2013. EIOPA proposed a category of securitisations with lower capital requirements as there is clear evidence that many securitisations displayed lower spread volatility and performed well from a fundamental credit risk perspective.

This advice was subsequently implemented. These qualifying securitisations have to meet a number of criteria on their structure, the quality of the underlying assets, underwriting processes, and on transparency. In the meantime, insurers among others have benefitted from the introduction of simple, transparent and standardised (STS) securitisations, though use has not yet been significant.

What is special about securitisations is that they should not be special.

EIOPA's most recent review of the EU's prudential framework for insurance did not recommend disturbing the current treatment of securitisations nor indeed the treatment of spread risk more generally. Nonetheless, securitisations will benefit from some broader changes being proposed. For example, one recommendation is to simplify the calculation of the risk mitigating impact of a number of techniques including securitisations.

All these measures reflect that securitisations are likely to be a relatively small – 2.4 per cent of overall investments by insurers at end-2019 – but material area for insurers.

Ensuring a well-functioning and stable insurance sector is part of a robust financial services sector in Europe. A risk-based regulatory framework is fundamental to achieving this and to ensuring, both policyholder protection and policyholder trust in the sector.

EIOPA's advice and activity on the areas of securitisation will always follow these considerations so that Europe's insurance sector works for the benefit of people, business and society.

PAULINA DEJMEK HACK

Director for General Affairs,
DG for Financial Stability, Financial Services and Capital Markets Union,
European Commission

What is next for EU securitisation?

When structured in a sound way, securitisation provides a tool for efficient risk and capital management, diversifies funding sources for banks and companies and enables a broader range of investors to fund the economy. However, as the Global Financial Crisis demonstrated, poorly regulated securitisation can be a source of risk for the financial system.

Therefore, regulation and supervision of securitisation need to walk the fine line of ensuring that we continue to draw the lessons from the crisis so that risks do not re-emerge while, at the same time, supporting a beneficial expansion of the market to the benefit of companies and the economy as a whole.

As one of the priorities of the CMU project, the EU aimed to do just that with the securitisation framework that became applicable on 1 January 2019. The new framework is meant to promote the revival of the EU market, in particular through the creation of the STS (Simple-Transparent-Standard) quality label and the prudential benefits attached to it, while also drawing the lessons from the financial crisis by adequately protecting investors and managing potential systemic risks.

Regulation and supervision need to walk the fine line of ensuring that we draw the lessons from the crisis while supporting expansion of the market.

Last December's agreement on the Capital Markets Recovery Package (CMRP) amplifies the potential benefits that securitisation can bring for the economy by extending the STS label to on-balance-sheet (synthetic) securitisations and removing regulatory obstacles to the securitisation of non-performing loans.

The swift conclusion of the political trilogues shows that the legislators share the Commission's ambition to revive this important market, provided that legislative proposals are based on a solid analysis and thorough preparatory work.

As markets and policy makers gain experience with the framework, we also note that the appetite for its reviewis growing. The Council Conclusions on the renewed CMU Action Plan mentioned a review of the securitisation framework as one of the important and urgent deliverables for 2021. This was echoed also by the European Parliament in its own initiative report on the CMU from September 2020.

In any event, the legislation in force requires the Commission to review the functioning of the securitisation framework and deliver a report to the legislators by 1 January 2022. Like the CMRP, the upcoming review – and any legislative proposals that may follow – will have to be based on thorough preparatory work by and input from the European Supervisory Authorities. Further technical work should identify areas where the rules could be improved in order to foster the market, without compromising on investor and consumer protection.

While we are still gaining experience with the framework and its practical effects, the review will be the next important stepping-stone for the market after the CMRP. The review will also look at the important issue of green securitisations, to see what can be done to encourage this market segment to grow further and support the green transition.

The Commission stands ready and is looking forward to the work with the European Supervisory Authorities and all relevant stakeholders to continue to develop EU's securitisation framework in the context of the CMU and beyond.

NATHALIE ESNAULT

Managing Director Securitisation, Crédit Agricole CIB

Securitisation at the service of the European economy

While significant progress has been made to restore the place of securitisation in Europe, securitisation issuance fell under €200bn in 2020, its lowest level since 2013. This is explained by conjectural reasons like the pandemic but there are fundamental reasons at work.

Tremendous effort to restart the market

EU securitisation has been significantly reshaped after the financial crisis and the subsequent adoption of new regulations, providing notably for a new label for "simple transparent and standard" (STS) securitisation. New regulation was also needed to overcome deficiencies, in particular a lack of risk alignment and comparability in structures and reporting. Since its entry into force in 2019, STS has been largely adopted for asset classes by design eligible to STS. Significant effort has been made in reporting for public and private transactions and ABCP.

Public volumes falling short of expectations

In 2020, publicly placed issuance was €81.4bn after €116.8bn in 2019 and €135.8bn in 2018 (record year post crisis). Overall, €194.7bn of public securitisation was issued in 2020, a decrease of 10.4% from 2019. 2019 was a transition year for adapting to the new framework. 2020 has been clearly hit by the pandemic, especially placed issuance.

More fundamentally, bank-led securitisation issuance is impacted by the availability of cheaper alternatives like the TLTRO scheme of the ECB, which has been loosened again and extended until 2024.

Banks need well-functioning securitisation in their toolbox to contribute to recovery and assist in the strategic redeployment of their balance sheet.

Strong latent potential

Public volumes do not reflect the entire market. Banks often use private securitisation for managing their balance sheet. Private securitisation also accommodates diverse non-bank issuers and asset classes (transport assets, trade receivables etc.), with banks providing critical funding to this market, directly or through ABCP.

Finally, securitisation is growingly used in sustainable green finance. Social securitisation is also emerging as a way to support disadvantaged borrowers or projects with social utility.

Which priorities to improve the situation

While securitisation is well equipped to support the CMU, its development is hindered by significant obstacles. In order to make it attractive to banks, it must remain economic and manageable. Therefore, measures should focus on

- Reducing punitive capital charges: measures should focus on reducing the non-neutrality of the capital regime and lowering capital floors for senior tranches. Solvency 2 should also be recalibrated, in particular for STS;
- Facilitating significant risk transfer (SRT): the process for SRT should be improved to ensure consistency and better predictability. Visibility is also needed on key features such as synthetic excess spread;
- Improving liquidity treatment (LCR): securitisation should be treated equally to covered bonds – e.g., senior STS qualified as Level 1 for most liquid assets;
- Revisiting disclosure requirements: full disclosure templates should apply only to public issues in line with the proportionality principle.

Generally, measures should ensure level playing field with other products and sustainability of the operating environment over time. EU banks need well-functioning securitisation in their toolbox to contribute to recovery and assist in the strategic redeployment of their balance sheets.

ALEXANDER BATCHVAROV

Managing Director, Global Research, Bank of America

EU securitisation revival requires CMU level-playing field

Re-launching the securitisation market has been a long-standing objective in the context of the deepening of the EU CMU. Measures adopted in recent years with much fanfare have not delivered the desired results. The market data informs us that 2020 recorded a third-year-in-a-row decline in both placed and retained securitisation volume. STS framework has been in operation for about 2 years now, but we are yet to see a pick-up in its use by new issuers. Over the years total prime Euro area RMBS supply declined to reach €45bn in 2020 (down almost 40% in the last 5 years), while annual mortgage covered bond supply varied between €412bn and €612bn in the last decade. Other ABS volume has been volatile around the €50bn mark from one year to the next. The potential introduction of ESN (e.g. auto loan covered bonds) will likely replicate the negative experience of prime RMBS issuance in auto ABS space.

We must note the increase in direct loan portfolio investments by insurance companies and pensions fund, eschewing the more protected and liquid structured finance bond format. We are also observing a shift away from use of securitisation to use of credit claims pools as general

collateral since the changes that ECB introduced in April 2020. We observe a declining use of prime quality asset cash securitisations with the increase of synthetic balance sheet securitisations, including that of SME loans thanks to the support of EIB/EIF. That contrasts with the pick-up in NPL and in non-conforming (non-prime) mortgage loan securitisations, along with higher-yielding leveraged and commercial real estate loans.

The decline of broadly available securitisation market expertise and its concentration in a small group of investors is underway; a smaller investor base is a challenge to the EU securitisation market revival.

In many EU quarters there is a support for securitisation market re-launch as part of the deepening the CMU, turbo-charging the post-pandemic recovery, transitioning to a sustainable economic model and in response to Basel 3 roll-out. Last year the High Level Forum on CMU prioritised the steps necessary to achieve that goal.

Undeniable need for a level playing field across capital markets instruments on the EU capital markets.

Without enumerating them here, we emphasise that they are only partly addressing the undeniable need for a level playing field across capital market instruments on the EU capital markets in terms of their political, capital, liquidity and monetary treatment. The regulatory treatment of securitisation must reflect the strong credit, price and liquidity performance of EU securitisation bonds without much external support when compared with instruments that were subject to very favourable - in every respect - regulatory treatments. The systemic risk consideration of the use of such other instruments should not be overlooked.

In short, the revival of the securitisation market in the EU requires as a minimum a realignment of its regulatory, political and monetary treatment with that of other fixed income markets. Additional targeted support for certain securitisation market sectors (SME, project finance, green and social finance) is necessary to help EU securitisation achieve its full potential for the benefit of the EU economy and the long-term objectives of EU CMU.

6

DIGITALISATION AND PAYMENTS

ISSUES AT STAKE

Digitalisation, electronic payments and new technologies such as DLT, crypto-assets, AI and cloud services are key drivers of innovation, agility and efficiency in the EU financial sector and may also facilitate its integration. These innovations also bring many changes in the financial ecosystem that raise new questions in terms of level playing field, consumer protection and sharing of responsibilities between regulated financial players and third-parties. They also face regulatory and non-regulatory barriers that may hinder their development at the domestic and cross-border levels.

The Digital Finance Strategy (DFS) proposed by the Commission aims to support this transformation by adapting the financial framework to this increasing digitalisation, identifying measures that may support a further digitalisation of the sector and also addressing possible new risks and level playing field issues related to digitalisation. The DFS is part of a broader Digital Finance Package that includes measures targeting crypto-assets (MiCA), DLT market infrastructures (the DLT pilot regime) and instant retail payments (the retail payments strategy), as well as a framework for digital operational resilience (DORA).

Establishing a common European financial data space that may facilitate an appropriate access to and sharing of financial information among market stakeholders is a further objective for promoting data-driven innovation in the financial sector.

DIGITAL FINANCE STRATEGY

MARCEL HAAG

Director, Horizontal Policies, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Promoting the digital transformation of Europe's financial services sector: harnessing opportunities and managing risks

The European Union is set to fully embrace digitisation in financial services. We are well-positioned to reap the benefits that the digital revolution offers to consumers, service providers and the wider EU economy, while at the same time ensuring that the increasingly digital financial system works safely.

The adoption of financial technologies is a major economic opportunity that stands to boost Europe's competitiveness and growth. With a single market of 27 countries and 450 million customers, along with a single authorisation and passport system and a unified set of rules, the EU is in a unique position to encourage innovation and development in this sector.

Digital finance offers significant benefits to consumers and society. It can promote inclusion, increase digital and financial literacy and empower consumers by increasing choice and maximising control over their data. Financial technology has the potential to turn Europe into a global leader in digital finance, allowing us to shape the values that underpin developing technologies.

The Covid-19 pandemic has emphasised the importance of digital finance. Online identity verification has enabled consumers to open accounts and use multiple financial services at a distance, while growing numbers of consumers use digital in-store payments and make online purchases. The pandemic has demonstrated that consumers and businesses alike are ready to embrace digital financial services.

Europe must seize the benefits of Digital finance for European consumers and companies, while monitoring its risks.

In September 2020 the European Commission published its Digital Finance Strategy. The Strategy takes into account the recommendations of the Expert Group on Regulatory Obstacles to Financial Innovation (a public consultation among 400 stakeholders) and a series of 30 online webinars gathering 6,000 people from across Member States that took place during the course of 2020.

The Strategy sets out four priorities for promoting digital transformation of the financial sector up to 2024:

1. tackling fragmentation in the Digital Single Market for financial services, in order to help European consumers to access cross-border services and help European financial firms' scale up their digital operations;
2. ensuring that the EU regulatory framework facilitates digital innovation in the interest of consumers and market efficiency;
3. creating a European financial data space to promote data-driven innovation, in order to encourage the creation of innovative products for consumers and businesses; and
4. addressing new challenges and risks associated with the digital transformation.

The Digital Finance Strategy is accompanied by legislative proposals on crypto-assets and digital operational resilience, as well as a Retail Payments Strategy.

The Commission's data-driven agenda connects the Digital Finance Strategy with the European Data Strategy. A common financial data space will unlock the opportunities of data sharing in finance. Our priorities are to introduce standard formats for the disclosure of company and financial data, to support the uptake of innovative tools to facilitate supervisory reporting by regulated entities and to boost data sharing in the financial sector and beyond by expanding the Open Finance framework currently limited to the Payment Services Directive.

This will build on the crosscutting data framework to remove barriers across economic sectors, consisting of the 2020 legislative proposals on a Data Governance Act and a Digital Services/Markets Act, and the proposals for a Data Act coming up for 2021.

Across the four priorities of the Digital Finance Strategy, alongside the proposals of the Digital Finance Package, the Commission will promote digital finance and harness its opportunities for consumers and the financial sector alike. At the same time, we will ensure that consumers are protected and that the increasingly digitised financial system functions safely for the European economy as a whole.

HARALD WAIGLEIN

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

DFS – Striking a balance between fostering innovation and a level playing field

"The future of finance is digital" are the introductory remarks of the Digital Finance Strategy put forward by the Commission in September 2020. The Covid-19 pandemic has shown that this is a matter of fact, nowadays more than ever. Digital financial services played a key role to avoid even more social and economic damage across the globe in the current crisis. There is no doubt that fostering digital finance will support Europe's economic resilience and recovery. Therefore, the acceleration of digitalisation across sectors is vital in the upcoming Digital Decade. Strengthening our strategic autonomy in digital financial services will support Europe's position in the worldwide economy and avoid dependencies which in turn contributes to European democracy.

The proposed priorities in the Digital Finance Strategy hit the bullseye. Avoiding fragmentation in the Digital Market and creating a European financial data space in the financial sector is paramount. This will facilitate the upscaling of Europe's vibrant FinTechs and promote data protection which is a prevailing topic due to uprising cloud service providers. Therefore, we welcome the Commission proposals put forward in the Digitial Finance Package. Yet, the future regulatory frameworks need to be technology neutral and future proof as the pace is high in the digital sector and new technologies are emerging on a constant basis. Especially, DORA will contribute to a safe environment for digital services around financial institutions. MiCA on the other hand is already internationally rewarded as a standard setting framework in the sphere of crypto-assets. Another priority addresses artificial intelligence in the financial sector. In this context, we should not forget the strong interconnectedness across sectors that goes hand in hand with artificial intelligence. Thus, the bigger picture of digital services should always be taken into account.

Smart contracts and the ecosystem surrounding these should not be underestimated in the regulatory framework as the field is rapidly evolving and risks are not yet fully assessed. In this context, innovative phenomena such as DeFi should be thoroughly examined in order to understand the concepts and the technology and potentially address them on European or even international level as borders are almost non-existent in this realm while of course preserving the dynamic setting.

The acceleration of digitalisation across sectors is vital in the upcoming Digital Decade.

"Code is law" is a well-known quotation ascribed to Lawrence Lessig, US professor of constitutional law. In many fields of digital finance, we see aspects of this doctrine. Think of Bitcoin for example. No court, no competent authority is able to enforce a rightful judgement if it is not compatible with the code. If a private key is lost, no judge will move a bitcoin. Decentralisation, in some cases, renders lawmakers and authorities stranded. But if only code is law, then democracy is in danger. It should be the legislator who defines the rules and authorities should have appropriate tools in order to execute them in a proportionate manner treating all market participants equally. A level playing field should also be provided in an ever more digital world of financial services.

A good example is Open Banking. As Big Data was already in the past and will in future be the driver of many digital finance developments, PSD II was a major step taken by the EU legislator in order to explore the concepts, address the right issues and unleash the potential of financial data. Now it lies with the customers to make use of it. Technical interfaces will facilitate the exchange of this data. This might help preparing the ground for new business models – hopefully many European companies and Citizens will benefit. On the other hand, we shall not overlook that also other big players, especially Big Tech firms possess extensively valuable data that should mutually be readily available, at the request of the customer.

Summing up, legislators and regulators need to closely follow technical developments in digital finance and draw the appropriate and proportionate conclusions at the right moment. We know it best, it's a balancing act.

ISABEL GUERREIRO

Head of Digital Europe,
Banco Santander

Digital at the core of Santander's ONE Europe strategy

European banks are facing many simultaneous challenges – the prolonged pandemic, lower-for-longer interest rates, the need to accelerate innovation with new players competing for the customer attention and existing profit pools, and finally the potential cyber-security and data protection risks.

The Digital transformation is one of the critical enablers that will allow banks to face those challenges, but to be successful we also need new rules to allow Europe to be truly competitive and lead this transformation.

At Santander we aim to be the world's best open financial services platform with three strategic pillars: the development of a digital native consumer lending business; the launch of a disruptive payments company, PagoNxt; and Santander One Europe, creating scale to leverage the substantial investments made in recent years to automate and digitalize our processes.

We welcome the Digital Finance Strategy launched by the European Commission last year and share its objective to "embrace digital finance for the good of consumers and businesses". From my point of view, the Commission is rightly pointing at some of the fundamental changes to enable the digital European economy: data, facilitate de migration towards a modular IT architecture and the implementation of the "same activity, same risk, same rules" principle.

Data is a core asset in the digital economy. It enables companies to improve their products, better serving customer needs and expanding their reach to enter new sectors/markets. Our financial ecosystem is diverse, with a wide range of participants. These now include non-financial companies like tech platforms, who can leverage users' financial and non-financial data to innovate and enrich their financial products and services. We believe access to the data that users generate and agree to share should be made available across sectors, in a symmetrical fashion, to drive innovation and ensure a level playing field.

Digital transformation continues to be the key to success for European banks.

We have seen the benefits of sharing of data on payments as part of the revised Payment Services Directive, and there is no reason why non-financial data from other sectors should not follow the same example and be made widely available, to further benefit consumers and businesses. We need to work towards enhancing data sharing and openness across and within sectors, of course in compliance with data protection and competition rules.

To accelerate the digital transformation, we must move quickly towards modular IT architecture, which will allow for closer collaboration with other players. Our regulators could support this by creating an oversight framework for critical third-party Cloud services and their providers that meets the supervisory expectations.

Santander continues to make strides on improving our Digital offering, innovating to surpass customers' expectations and meet their evolving needs. We operate with customer's interest in mind, following a robust risk framework and always observing regulatory requirements. In the market we see non-financial service players specialising in a particular leg of the value chain and becoming intrinsic part of the Financial Services ecosystem. With that in mind, I believe it is important for the European Supervisory Agencies to assess whether to apply a more proportional approach over those activities to safeguard financial stability, consumer protection, market integrity, fair competition, and security. I believe on the use of the "same activity, same risk, same rules" principle to take us closer to the level playing field we seek.

The Digital Finance strategy also includes measures to promote digital innovation and facilitate the adoption of key technologies for the financial sector such Artificial Intelligence, block-chain and digital identification. This coincides with other related initiatives such as the Data Strategy and the Digital Services package. We expect the Commission to work horizontally to address the new dynamics at work in our economy, which are so important to the future of the European Union and its citizens.

I welcome and support the European Commission proposals and hope that they can be agreed quickly. In our digital world, time is of essence.

BJØRN SIBBERN

President European Markets, Nasdaq

Digitalisation for sustainable and inclusive growth

I appreciate and support the European ambitions to continuously develop the regulatory framework, enable innovation and leveraging opportunities with technology to create more inclusive, efficient and secure markets.

There is tremendous potential to leverage data sharing technologies in the fight against financial crime – including money laundering, fraud and terrorist financing. Over the past year, Nasdaq launched its Automated Investigator for AML for banks, as well as recently acquiring AML solutions provider Verafin, one of the world's largest players that offers cloud-based, artificial intelligence and machine learning tools for cross-institutional, multi-channel analysis to combated financial crime.

Verafin sends alerts to its bank customers when unusual transactions occur, and then facilitates data sharing and joint data investigations to fully scrutinize the behavior. In addition, Verafin performs data analytics across all clients' data to deliver insights offering a tool that significantly improves the detection of money laundering cases. There needs to be a regulatory framework for sharing data, or financial institutions are unlikely to take full advantage of data analytics.

I welcome exploratory regulatory projects that allow to test innovative initiatives. In order to find the right balance between innovation and investor protection, these initiatives should be limited in scope as well as time, should strictly justify exemptions to current regulations, should be conducted in a transparent way – towards supervisors as well as the wider industry – and should also be evaluated after the specified time. These principles should be applied for instance to the digital ledger technology (DLT) pilot project.

On the private investor side, digitalization is everything. Sustainable and inclusive growth will only happen if private investors can be digitally connected to capital markets. One reason that Nasdaq's Nordic growth markets, First North, have been so successful is a relatively high proportion of retail participation. Smaller investors have been able to be part of the growth journeys of the companies coming to market. The online retail brokers offering services in the Nordics play a vital part in the financial ecosystem. It is crucial that the European market structure allows for efficient and safe participation of both larger and smaller investors.

Leveraging opportunities with technology to create more inclusive, efficient and secure markets.

The plans for a European Single Access Point (ESAP), has the potential of facilitating cross-border investments by allowing any investor to access any issuer's information in a one-stop-shop. For this, it is crucial that the ESAP will truly provide hassle free access for investors, at no added cost for issuers. If on the contrary the access point becomes complicated to use for investors, and if new costs are added to issuers, the ESAP project risks unfortunately deterring issuers from using the public capital markets, contrary to the policy intentions of strengthening the European capital markets. We therefore have to be quite careful on the way the ESAP is framed.

The global pandemic has tested the whole industry. In addition to coping with huge volumes and volatility on our exchanges, we have all been challenged to manage a remote workforce and engage with clients across the globe facing their own struggles. Technology has been a tremendous support as we have worked to remain resilient. Policymaking needs to continue to allow the next steps. Not only will innovation equip technology companies like Nasdaq to deliver top quality products and services to our customers, but they will position the whole industry to adapt to changing business environments.

MÄRTEN ROSS

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Opportunities and challenges of the European Digital Finance Strategy

Does the European Digital Finance Strategy (DFS) identify the main drivers for accelerating the digitalisation of the EU financial sector?

In many respects the DFS is indeed directed towards right priorities in enhancing competitiveness, facilitating innovation and addressing risks of European financial services. The focus on interoperability and broader infrastructure seems clearly heading to right direction. Ongoing digitalisation itself and improving the efficiency of using its opportunities by reducing costs and using digital transformation as for example artificial intelligence is simply a must.

Moreover, the pandemic (as one catalyst for change) has clearly shown more than ever the importance of secure, stable and efficient digital financial services that meet customer needs. For example, instant payments are new reality even without regulatory action and outdated services lose naturally their place in the market. Digital transformation and open data enforce also European Green agenda and therefore strengthen synergy of both efforts and promote recovery of Europe.

Are there any missing points and do the DFS proposals have any downsides or limitations that need considering?

Obviously, it is worth stressing that any digital finance strategy and underlying regulatory initiatives are meaningful only if they target not just new tech and infrastructures, but as well the traditional banking, capital markets and their infrastructures to promote their competitiveness. Europe would benefit even more if introducing new and innovation friendly rules would be at least one step ahead of private sector initiatives and forward-looking compared to actions of other global public players.

The focus on interoperability and broader infrastructure seems clearly heading to right direction.

In that sense DFS itself is only a part of the real digital strategy. True, it is in many respects already broader than most of its predecessors and this is welcome. For example, it is only logical that there is more focus on wider infrastructure issues including cross-border problems of distant on-boarding and related improvement needs on customer due diligence requirements or potential "IBAN-discrimination" issues.

However, "digitalization" of more traditional financial market areas like securities market functioning or registry keeping frameworks are as important for digital agenda as narrower questions. Therefore, forthcoming reviews of MIFID and CSDR are as important elements of the strategy.

Digital transmission goes of course hand in hand with some challenges, which in the long run might turn out to be positive for both the real sector, the private customers and businesses, but also the financial sector stakeholders if the readiness to transform and to change the business models is sufficiently there. Nowadays, the traditional banking sector is not only competing with traditional competitors, i.e. other banks, but also for example with start-ups and global Fintech companies. This is one element that in turn pushes towards more efficient and reliable cross-border solutions. In addition, refinement of risk management and preparedness to incorporate more profound interconnectedness and interdependencies in financial markets and emerging cyber risks into the framework is simply essential. Substantially risen cyberattacks on financial sector institutions across the EU during the pandemic is only one source and example.

What are the priorities in terms of impact and feasibility?

The more widely used and secure the (new) innovative solutions are, the better. This would serve the real needs of our economies and increase the customer confidence and satisfaction in financial services, which has to be the ultimate goal of the DFS. Furthermore, progress in single digital identification, i.e. a single solution across Europe is critical in order to advance global competitiveness of Europe and promote the functioning of the internal market. The challenges and concerns about privacy and security need to be addressed to alleviate the resistance in some Member States.

As regards to the EU's digital finance initiatives, one should support novel business models and instruments that have emerged in this digital era and the joint efforts undertaken at the EU level to address the field of cryptography and digital euro.

SEBASTIEN RASPILLER

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

The European Union should offer new digital opportunities in financial services and payments

At the end of September 2020, the European Commission presented a new strategy for digital finance, which includes a set of measures for the next four years in order to grasp all the potential of digital age across the economy, by fostering competitiveness and innovation of our financial services.

The strategy comprises several legislative proposals, on retail payments, crypto-assets and digital operational resilience, articulated around four main priorities: removing fragmentation in the Digital Single Market, adapting the EU regulatory framework to facilitate digital innovation, promoting a data-driven finance and addressing the challenges and risks with digital transformation.

After the entry into force of this ambitious package, the European Union will offer new opportunities in financial services and digital payments, while ensuring the protection of data and the resilience of the entire system. France, of course, is fully committed in this ambitious program.

On the issue of crypto-assets, which will be addressed through the MiCA regulation, we hope to develop a harmonized Europe-wide framework to secure the digitization of financial services. The Commission's proposal, currently under discussion, already contains positive elements regarding provisions on crypto-asset service providers, and an experimental approach proposed by the Commission to allow the development of the use of Blockchain for financial instruments.

We believe more discussion are however necessary with regard to stablecoins (EMT and ART in the Commission's proposal), for which we support a very ambitious response from the EU. Two priorities seem essential to us: preserving our sovereignty by prohibiting all monetary creation and protecting consumers, with strong requirements on the reserve.

The retail payment strategy is also a step in the right direction. It will make it possible to implement numerous measures in a coordinated and phased manner, such as the improvement of cross-border payments or pan-European instant payment solutions, and thus meet strong expectations on these topics.

Cyber-attacks could lead to systemic financial instability or general disruption of economic activity.

The pandemic, with the development of remote working, has highlighted the importance of taking the cyber threat into account in the coming years, and this is why we much welcome the draft DORA regulation. Cyber-attacks against highly interconnected international financial entities could lead to systemic financial instability or general disruption of economic activity. Recent attacks have illustrated the ability of attackers to intervene by using highly sophisticated methods, on an unprecedented scale.

Some service payments can pose cyberrisks, as recent Target-2 incident made it clear. France is fully committed to this fight, which will be essential to foster sound digitization and competitiveness and has also announced a national strategy for cybersecurity mobilizing 1 billion euros.

Beyond this broad European strategy, it will be important to go further and pursue our reflections in complementary areas, such as open data, artificial intelligence, or quantum technologies. On this last topic, it appears indeed that the financial sector is the area that will be the most rapidly affected by these technologies, with estimated benefits within 10 years.

The exponential increase in the computing power of quantum computers could make it possible to envisage several use cases such as predictive analysis for the detection and prevention of fraud, optimization in portfolio management, risk analysis for liquidity management, etc. In France, a national strategy in this area has been announced recently in order to improve our expertise on this technology, foster innovation and develop solutions in a multitude of areas, including financial services.

FINANCIAL DATA SPACE AND CLOUD INFRASTRUCTURE

JOACHIM WUERMELING

Member of the Executive Board, Deutsche Bundesbank

Combining innovation and stability: a supervisor's perspective on digital finance

We are all experiencing a boost to digitalisation, particularly in the financial sector, due to the Covid-19 crisis. However, innovation goes far beyond this: I believe that we are just at the beginning, not the end, of the digital transformation in the financial system. Artificial intelligence, machine learning, the cloud, distributed ledger technology, quantum computing, big data – all of these buzzwords have the potential to disrupt each and every business model.

New technologies may not only make finance more digital, they could also make it more stable and more resilient. Digital innovation can enhance the stability of both individual institutions and of the entire financial system. For instance, financial institutions could use AI to better detect and ward off cyberattacks. Another example is an early warning system for loan defaults that is based on automatically evaluated economic news and which could improve risk management.

Banking supervision seems to be particularly suited to the use of digital technologies, because the first step in banking supervision always involves analysing data. Our goal is to collect and process supervisory data more quickly and easily via more flexible digital channels.

While digital innovation can certainly promote stability, it also brings with it new risks. That is why we as supervisors have to play a dual role here. On the one hand, we want to enable digital innovation in the financial sector, harnessing its potential for financial stability. On the other hand, we have to keep an eye on potential risks arising from the digital transformation. It is our job to monitor all risks to financial stability.

New technologies may not only make finance more digital, they could also make it more stable.

Therefore, we want to clarify our supervisory approach to the use of AI and machine learning technologies. Given the "black box problem", for instance, we have to assess the extent to which the individual bank and the supervisor can really understand the results of AI/ML procedures. To this end, we published a discussion paper on our website.[1] Our goal as supervisors is to provide banks with balanced, differentiated and practicable requirements so that they can exploit the potential benefits of AI/ML processes in a legally secure manner.

The same goes for the use of cloud technologies. For banks, outsourcing parts of the value chain can be an important lever to increase their competitiveness and to focus on their core business. At the same time, every bank remains responsible for its outsourced processes and activities and has a duty to monitor and control the risks arising from an outsourcing relationship. At present, the approach of joint reviews of cloud service providers (pooled audits) seems to be the most efficient and effective way for banks to gain insights into cloud service providers' risk management and their internal controls. That is why we will further support the advancement of such pooled audits.

But supervisors are not the only players working to provide a clear framework for digital finance. With its Digital Operational Resilience Act (DORA) initiative, the EU is – inter alia – taking steps to forge an effective European oversight framework for critical ICT third-party providers. We welcome stricter regulation of ICT service providers, including cloud providers, as this aims to create a level playing field for all financial services providers. It is important, however, that DORA rules are consistent with existing rules in banking regulation. Otherwise, this would lead to a further fragmentation of regulatory standards and overburden banks that engage in outsourcing arrangements.

DORA is part of the European Commission's Digital Finance Package, published last year. The Digital Finance Package addresses important regulatory issues relating to the use of innovative technologies in the financial sector, also looking at the new risks arising through the digital transformation. With this ambitious plan, Europe intends to pave the way for a competitive digital financial ecosystem whilst ensuring an up-to-date regulatory framework.

1. https://www.bundesbank.de/de/aufgaben/bankenaufsicht/einzelaspekte/risikomanagement/maschinelle-lernverfahren/maschinelle-lernverfahren-598692

TSVETELINA PENKOVA

MEP, Committee on the Internal Market and Consumer Protection, European Parliament

The path towards building up a sound, resilient and harmonised financial ecosystem - DORA and NIS 2.0 - are we moving in the right direction?

The role of cloud infrastructures for financial institutions is vital. Currently, we have seen important developments in the regulatory area with the European Commission's proposals for a Regulation on digital operational resilience for financial services (DORA) and a revision of the Network and Information Systems Security Directive (NIS 2.0). The digitalisation of the financial sector clearly showed that all actors in the chain are interrelated and we have to look into the financial ecosystem as whole. This is what we have already tried to achieve with the GDPR, PSD2, e-IDAS and number of other initiatives that deem, among other things, to guarantee the resilience of the financial system.

While cybersecurity is essential and there is no discussion, whether we need more or less cybersecurity, we need to ensure that we put in place a framework that is harmonised and in line with already existing rules at both EU and global level.

A framework that is harmonised and in line with already existing rules at both EU and global level.

As an example, we observe that even though the DORA proposal builds on the NIS Directive and the lex specialis rule apply, number of intersections between DORA and NIS 2.0 occur. According to the NIS 2.0 proposal cloud service providers should be from now on classified as "essential entities" and should thus be subject to both the requirements of DORA and NIS 2.0. We see no clear hierarchy between DORA and NIS 2.0 for that matter. This brings a clear issue of taxonomy in the incident reporting and overlaps in the requirements for the cloud service providers. The question here is whether this redundancy is intentional, and the regulator sees the need for increased oversight on cloud providers or does it consist of unnecessary duplication? Would there be a coordination between the Lead Overseer introduced in DORA and the competent national authorities defined by NIS 2.0?

The Covid pandemic had imposed a different social behavior framework. The social distancing and the transition to a completely "virtual" life have changed consumers behavior and business strategies. Given the new circumstance, we acknowledge the merit of the introduction of sector specific regulations or a proper "update" of the existing regulatory framework. The importance of preserving the resilience of the financial sector is undoubtful but how can we argue that it is more critical (for instance than health or energy) to require more or complementary regulation?

Finally, the questions that come to mind in the current pandemic situation, and given the prioritisation of digitalisation in the recovery of our economy, is whether an additional regulatory burden is what the industry really needs? Would that bring an added value or support to start ups or small and medium enterprises? We look forward to provide the right solutions to those and many other concerns in the forthcoming months. True, it has been evident that the technological developments are more reactive and often move much faster than the regulators.

Therefore, our goal must be to find the right balance in building up a sound and resilient financial ecosystem in a sound and timely manner.

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Regulation of Digital Finance in the EU: challenges and opportunities

Digital innovation is key in today's world. The financial services sector is no exception, with various commentators highlighting an ongoing digital 'revolution' in this field. Whilst this inevitably creates a number of opportunities for stakeholders, it also brings a number of challenges to the fore – these *inter alia* include cyber security, privacy, and data protection issues.

The European Commission (EC) has been proactive, putting forward a number of key initiatives including:

[i] the Digital Finance Strategy (DFS) – one of the pillars identified in the Digital Finance Package published by the EC on the 24 September 2020. Building on the FinTech Action plan, the DFS acknowledges the impact of digital innovation on the economy and embraces digital finance solutions, such as cloud computing and data sharing. It seeks to ensure sound practices, and to enhance consumer protection and market competition;

Digital innovation is key in today's world.

[ii] the Digital Markets Act (DMA) and Digital Services Act (DSA) - described by the EC as "an ambitious reform of the digital space, a comprehensive set of new rules for all digital services, including social media, online marketplaces and other online platforms operating in the EU",[1] these proposals appear to acknowledge the widespread benefits brought about by digital solutions and set the tone for further digitisation across the EU; and

[iii] the Digital Operational Resilience Act (DORA) – a proposal seeking to harmonise ICT risk management requirements across the financial services industry. It is *inter alia* aimed at strengthening the confidentiality, integrity and availability of data and complements this by establishing an oversight framework on Critical ICT Third Party Service Providers, including Cloud Service Providers.

The strategy and the proposed legislative instruments seek to address fragmentation in the existing framework and will eventually provide stakeholders with regulatory certainty. These proposals embrace digital innovation and should provide more opportunities for FinTechs to establish themselves in the European market. This should increase consumer choice vis-à-vis the range of financial services offered, strengthening competition, and also enhancing resilience and cybersecurity. Of course, regulation will also bring about compliance costs; however, the pros of regulation outweigh the cons.

The success of the EC's strategy and proposals are reliant on a number of factors, namely: [i] legal certainty being achieved; [ii] NCAs embracing digital finance in their work and initiatives; [iii] the uptake of market participants; [iv] education and awareness; and [v] the enforcement of any legislative instruments promulgated. It is in this manner that Europe can become a standard setter in the digital world.

1. European Commission, Press Release, Europe fit for the Digital Age: Commission proposes new rules for digital platforms, 15 December 2020, <https://ec.europa.eu/commission/presscorner/detail/en/ip_20_2347>

KSENIA DUXFIELD-KARYAKINA

Government Affairs and Public Policy, Google Cloud

Cloud in financial services: how effective regulation can support innovation

Cloud presents important opportunities for the financial sector to accelerate innovation and improve security and operational resilience at scale.

Innovative banks are using this technology to understand risk, segment customers, track market movements, develop new instruments and ultimately gain a competitive advantage in an increasingly volatile market. They need to process large volumes of data fast and break organisational silos. The time saved processing this information allows firms to offer products at a much lower cost to their customers.

Cloud has also become an enabler for AI and machine learning (ML) technology. Banks can, for example, utilise cloud-based ML models to combat fraud and money laundering in a more effective way by combining transactional and behavioural data and avoiding costly false positives. Similarly, cloud technology is leveraged for banks' risk-management processes to determine liquidity and exposure quicker, to carry out mark-to-market adjustments and for better accounting in general.

Finally, firms are tapping the cloud to develop entirely new services. Innovative firms can create experiences that closely resemble the best digital ones in other industries. Cloud is transforming the technology ecosystem well beyond the core infrastructure, and European consumers stand to gain the most from this innovation. COVID-19 accelerated many of the digital trends, and resilience of cloud infrastructure came into full view: we continued to support all our customers across the globe without shortfalls.

Understanding the benefits of this technology and with an objective of strengthening risk mitigation and digital operational resilience of the financial ecosystem, European policymakers have been leading global regulatory agenda. The proposal for the Digital Operational Resilience Act (DORA) is an important step in achieving these strategic goals by introducing a direct regulatory oversight over critical third-party providers by financial services regulators.

Looking at key trends of cloud adoption in finance in Europe and sharing a view on DORA.

We welcome these efforts of the EU policymakers: resilience and security are at the core of our technology and operations. We believe DORA could create a genuine opportunity to enhance understanding, transparency and trust between ICT service providers, financial entities and regulators and ultimately stimulate innovation in the European finance sector.

To ensure its effectiveness, the oversight needs to:

- Harmonise and deduplicate requirements, including between DORA and existing frameworks like the European Supervisory Authorities' Outsourcing Guidelines and the NIS Directive - in particular in the view of the new NISD2 proposal;
- Be proportionate and fit-for-purpose, especially through the requirements that recognize the technological realities of evolving ICT services in the public cloud context - that are provided in a multitenant, one-to-many environment;
- Maintain technology neutrality and boost innovation, which is encouraged by open market and the free flow of data;
- Protect the availability and integrity of digital services and cloud customers privacy, whether they are subject to DORA or not.

We will continue to engage with the policymakers as this important legislation progresses and are committed to being a constructive voice in the discussion.

DANIEL KAPFFER

Chief Financial Officer
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DekaBank

Cloud-competence determines the global competition – let's face the challenges ahead

Only a couple of years ago cloud technology has been a promising technology with only a few applications in the financial world. Since then cloud technology has developed to the main enabler of digitalization. It has become one of the most important levers to decrease IT cost (30% to 40%).

The picture is even broader when moving up the technology stack from infrastructure to applications. Cloud native applications are required to provide frequent innovations to clients and ultimately to stay competitive not only with regard to traditional players but also FinTechs or BigTechs.

The two challenges with regard to the application of cloud technology are as well Data security and privacy rules as Management of ICT (Information and Communication Technology) and cyber security risks.

Especially through GDPR the EU has established a common standard with regard to data security and privacy. Most cloud providers provide services from locations within the EU. However, most contracts would still allow a data transfer to locations outside the EU, so that equivalent rules there are needed.

But, the major part of the EU data strategy is mostly about sharing data between different entities. The goal is an aggregated pool of data that can be used for AI and other purposes. However, clients are only willing to give away their data as part of a service that they value and that they otherwise cannot get access to. Therefore, it is questionable whether the data strategy will be able to provide significant value. So the European market place for cloud services and the EU cloud rulebook both intended for 2022 are helpful.

Management of ICT have gained more and more attention by regulators in the last years, especially in terms of breach of confidentiality, failure of integrity of systems and data and inability to change information technology. It also includes security risks resulting from cyber-attacks or inadequate physical security.

The current approach with regard to managing ICT relies too heavily on principles established for outsourcing arrangements. What is adequate for a long term and stable part of a value chain, does not fit to cloud services that can be used short term and their usage can also be discontinued very easily. In addition, large cloud service providers will bring a high and consistent level of standards with regard to ICT risks. Given their heritage, they are more used to providing reliable, secure and extremely scalable IT solutions.

As an important step, the EU's digital resilience framework ("DORA") will assign third party service providers deemed critical to an EU-supervisor (EBA, ESMA or EIOPA). However, European policy makers should consider going one-step further and reduce the burden imposed on the financial services firm when managing ICT risks through cloud services.

In sum, the large US firms (Amazon, Google and Microsoft) already dominate the cloud market. We need to make sure that European financial services firms can at least use cloud services in an adequate framework to ensure their competitiveness in the global landscape.

ADAPTING THE FINANCIAL FRAMEWORK TO DIGITALISATION

FERNANDO RESTOY

Chairman,
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Fintech regulation: how to achieve a level playing field

The emergence of fintechs and big techs constitutes a major source of disruption in the market for financial services. There is already some consensus that we need a comprehensive policy approach, particularly for big tech platforms that offer a large variety of financial and non-financial services – and that this comprehensive framework should aim at minimising competitive distortions.

A slogan which has gained much traction and has often been presented as the basis for the regulatory reform is "same activity, same regulation". This suggests moving from a framework of designing requirements for entities with a specific licence or charter – what we call entity-based (EB) regulation – to rules that address specific activities, ensuring that they apply homogenously to all types of entities performing each activity – what we call activity-based (AB) regulation.

However, achieving a level playing field in a particular market is not a highest-priority objective for policymakers, although it is a relevant one. In some policy areas, like consumer protection or anti-money laundering and combating the financing of terrorism (AML/CFT), there does not seem to be a rationale (based on primary policy objectives) to discriminate across providers of a particular financial service. By contrast, in other areas, like prudential policies or competition, specific EB rules are required. In general, this is the case when risks emerge not only from the performance of a particular activity, but also from the combination of activities that entities perform.

Therefore, regulatory discrepancies across entities performing a specific activity may sometimes, although not always, be justified on superior policy grounds. The current regulatory framework offers mixed signals on the extent to which unwarranted regulatory discrepancies remain.

In AB policy areas, like AML/CFT or consumer protection, it is hard to find discrepancies in the requirements imposed on commercial banks as opposed to other providers of financial services. However, in areas where an EB approach is adequate, there may not be sufficient rules that address the specific risks generated by big techs. This is the case in the area of operational resilience, where a comprehensive approach for big tech groups may be warranted, as is currently the case for banks. Moreover, there are strong arguments for imposing ex ante constraints on big techs' practices concerning data use and different sources of discrimination across actual or potential participants in the platform.

There are indeed some initiatives in different parts of the world (notably in the US, the EU and China) which seem consistent with the need to develop new EB rules for large, big tech platforms. In particular, in the EU the European Commission proposals for a Digital Markets Act and a Digital Services Act contain far-reaching regulatory requirements for big techs.

Reference: F Restoy, "Fintech regulation: how to achieve a level playing field", FSI Occasional Papers, no 17, February 2021.

RUI PERES JORGE

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Regulatory crossroads in digital finance

The EU needs vibrant and sustainable capital markets. Achieving this goal depends crucially on the ability of its financial sector to continuously adapt to faster innovation cycles and evolving business models, to new technological infrastructures and instruments and to fair and responsible use of digital data.

This challenge is recognised both by the new CMU action plan and the Digital Finance Strategy and will only be met if the regulatory and supervisory frameworks strike a balance between ensuring a level playing field that promotes innovation and safeguarding other objectives such as protection of consumers or competition. This, in practice, means we will need pragmatic approaches to the "same activity, same risk, same rules" principle.

In fact, mixing "activity-based" and "entity-based" rules will be necessary both to promote and control innovation in the digital era.

Take BigTechs for instance - although their footprint is still limited in EU's asset management and non-banking financial intermediation (but already relevant in the payments sector), it is wise to consider "entity-based" rules that might deal with possible impacts of their huge market power on financial stability, operational resilience, data protection or competition, together with "activity-based" rules.

On the other hand, and although "activity-based" rules are essential for a proper level playing field between incumbents and newcomers, we should simultaneously ensure that we clearly understand the true nature and implications of new proposals before we classify them and tie them to specific activity rules. This is especially relevant when we deal with completely new realities emerging from the confluence of Artificial Intelligence, Big Data, Cloud Services and DLT.

To face these challenges, regulatory sandboxes and innovation hubs might prove to be useful tools both for regulators and innovators, by helping to reduce information asymmetries and regulatory costs, as several studies have shown. EU-wide initiatives, such as the DLT pilot regime for market infrastructures are, therefore, welcome. This said, possible risks and the relevant differences between these two types of innovation facilitators should be considered.

We will need to keep a pragmatic approach to financial innovation regulation and supervision.

From the experience and information gathered in Portugal FinLab, the innovation hub of the three Portuguese financial regulators (CMVM, Bank of Portugal and ASF), innovations hubs seem to be particularly adequate for projects in seed or pre-seed phases that tend to have few resources allocated to the regulatory framework; while regulatory sandboxes might be better suited for more mature firms with innovation proposals.

As regards risks, at least three should be highlighted: given the level of regulators' resources required by innovation facilitators, regulators' focus might be diverted (and even biased) towards the selected projects, hindering a more comprehensive approach and strategy for innovation.

Additionally, regulators might also end up prioritising innovation over other objectives such as consumer protection. Finally, there is a "race to the bottom" risk in what regards this regulatory framework. A clearer single regulatory rulebook and stronger supervisory convergence within the EU for innovation facilitators might help.

STEPHANE JANIN

Head of Global Regulatory Development, AXA Investment Managers

Digital age in European asset management: a revolution to come?

The Asset Management industry has always taken technological innovations on board. However, for the last decade, the acceleration of FinTech has required to adapt very quickly to this phenomenon to stay ahead of the curve, in order to reduce costs, improve efficiency and possibly explore new fields of investments.

In which areas does the financial framework need adapting to make it fit for leveraging the new opportunities offered by digitalisation in the asset management sector?

What is critical is to avoid keeping an existing set of regulations regarding a fully new area. In particular, the organisation of the Pilot Regime for market infrastructures based on DLT clearly requires the adaptation of the current rules applicable to CSDs and MTFs to facilitate decentralization, competition and lower costs for new infrastructure players.

On the other hand, some high-level principles should remain the same, for instance ensuring the digital operational resilience of those new players to preserve the safety of the whole value chain. The Pilot Regime should also allow for a wider range of eligible assets to make that regime develop sufficiently fast and widely, thus facilitating the amortization of entry costs by new market infrastructures - to the ultimate benefit of end-users.

What are the main regulatory obstacles to the further digitalisation of asset management activities?

For AXA IM, digitalization has already started, e.g. making use of Artificial Intelligence and Machine Learning. But to go further, regulatory obstacles remain and currently relate to DLT – while with DLT, we aim to reduce our costs and therefore those of our clients, as well as increase our efficiency, both in the settlement of assets and distribution of funds.

Does the DFS put forward the main regulatory and supervisory changes that are needed for reaping the benefits of digitalisation in the fund management and distribution area?

The DFS is indeed an excellent initiative proposed by the Commission to ensure the EU remains competitive within an adapted regulatory framework and to set a minimum harmonization among Member States in such a fast-developing area. For instance, regarding DORA, we support the minimum regulatory framework set around critical ICT service providers, in order for users like us to benefit from a higher safety on behalf of our end clients.

However, regarding supervision, on DORA we have some concern about the leading authorities which might be the recipients of incident reports: while our natural competent authorities are securities regulators, considering the risks of hacking which currently exist and which recently hit financial regulators such as the US SEC, we would favor giving that role to the dedicated information security agencies, such as ENISA – which would then share reports with securities regulators as a second step.

In terms of EU legislative process, one key challenge remains ahead of us: how to conciliate the usual pace of negotiation, adoption, implementation and review of EU legislation with such a fast developing area? We know that 20 years ago the Lamfalussy process aimed at speeding up that pace to adapt legislation quickly, but will it be sufficient for topics such as DLT and MiCA? It is difficult to say at this stage.

FRANCESCO CECCATO

Chief Executive Officer,
Barclays Europe

Thoughts regarding the delivery of European financial products in the Digital Era

The pace of technological change continues to rise and as a result the impact of technology on people's lives is getting greater. The pandemic has clearly brought technology further to the forefront of our minds and is accelerating changes in consumer behaviour.

As new operators and business models emerge, it is essential to consider all of the new and different players in the financial ecosystem from the end user's perspective. For instance, as a broader range of firms from a diverse range of sectors seek to offer retail and potentially wholesale financial products, there is a need to ensure that consumers are provided with the same level of protections, and that all those participants who offer the same service, undertake the same activity, or expose consumers to the same risk are subject to equivalent regulatory requirements on a proportionate basis.

Without this, consumers will face an inconsistent experience, with the potential customer detriment counteracting the benefits of greater competition and creating potential risks for market integrity and potentially also financial stability.

Despite the rapid technological changes and the emergence of new digital players, large and small, regulation has developed to respond to the traditional 20th century business model, which regulates based upon product, manufacturer and issuing or distributing entity. This creates a narrow regulatory perimeter applicable to these industries. However, a 21st century "platform company" does not need to create the underlying financial product or service to become a leading digital aggregator and distributor of those products and services. This can – in the case of financial services - create a substantial financial marketplace to complement a non-financial services marketplace. In other words, in the connected economy, a position of strength in one market, led by data, can readily be used to access another very different product market.

Looking forward, as the number and type of business able to access consumer spend data increases due to Open Banking and PSD2 this is likely to have further transformational effects on the composition of the new financial ecosystem and therefore critical components of financial markets infrastructure. The increase in competition for consumers is to be welcome, but there is a need to address how we collectively provide for the protection of consumers and clients and also to ensure a fair playing field for all market participants.

Looking at the ecosystem from a consumer perspective, it will be increasingly difficult for consumers to understand the risk profiles of products attached to different entities and the associated protection they may or may not enjoy without further assistance from regulators. Understandably, a consumer sees products that are interchangeable for their needs, rather than considering in detail their regulatory regimes. There is a significant risk that an industry defined approach to regulation will fail to recognize emerging risks posed by the market changes noted above, and result in customer detriment.

In addition, a key barrier to innovation for firms is the lack of regulatory clarity regarding how 'new' and 'emerging' technologies, such as distributed ledger technology (DLT) and artificial intelligence (AI) may apply to financial sector use-cases. The current regulatory frameworks across the globe were not written with these technologies and the wider ecosystem in mind, and therefore they may not be fit for purpose. Whilst the principle of technology neutrality is important it is also essential that regulations consider the technologies where relevant. In addition, with global regulatory and supervisory direction constantly evolving, one of the main barriers results from some of the inconsistencies from one jurisdiction to another and resulting fragmentation.

Quite apart from this, there is a lack of consistent regulation of underlying products, with some at a more advanced stage unified regulation at the European level (e.g. the UCITS directive, which creates a harmonised framework for investment funds that can be sold to retail investors throughout the EU using a passporting mechanism), and other, substantial areas such as mortgages remain mostly regulated at the national level.

Similarly, investments and trading have been tackled effectively at the European level, with the creation of ESMA; but while such "asset-side" regulation has been advancing, the "liability-side" (borrowing and lending) has yet to achieve the same level of harmonisation. This creates a further gap in safeguarding customers' interests at the European level and in completing the single market.

These issues are recognised by the regulatory community. Steps such as the European Commission's Digital Finance Strategy, which aims to amend the regulatory framework to make it fit for the digital era and achieve a level playing field across entity types, will be crucial in helping solve these challenges. Further, given the cross-border nature of innovation, collaboration by policymakers in different jurisdictions is essential. Regarding underlying product areas, the European Commission recognises the continuing fragmentation of credit markets, and while the Mortgage Credit Directive was a good first step towards an EU-wide mortgage credit market with a high level of consumer protection, it needs to act as a foundation and not an end-point.

This is all the more important in an age of digital delivery of financial services.

FOLLOWING EUROFI EVENT

THE EUROFI HIGH LEVEL SEMINAR 2022

PARIS – FRANCE
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CRYPTO-ASSETS AND STABLECOINS

BENOÎT CŒURÉ

Head of BIS Innovation Hub, Bank for International Settlements (BIS)

Central banks and trends in digital innovation

One of the pandemic's most long-lasting consequences has been a change in the way we work. We are experiencing, first-hand, global collaboration through technology and platforms. Covid-19 has also accelerated trends in digital innovation that were already well under way.

The pandemic has also shown that it is technology that enables our globally connected world, and the provision of money, to go round. Technology has been indispensable in helping to mitigate the economic and social impact of the Covid-19 crisis by enabling economic activity to continue at arm's length and partially overcome social distancing protocols. Consumers in many countries have stepped up their use of contactless payments, and as bricks-and-mortar stores temporarily closed, e-commerce activity surged. With the rise of "decentralised finance" (DeFi), financial services more broadly are experiencing a quieter but momentous revolution.

International collaboration is essential to underpin technological capabilities, ensure interoperability between national systems, enhance cross-border payments and remittances, support financial inclusion, and prevent geographical and social fragmentation. This is the essence of the roadmap from the Financial Stability Board and the Committee on Payments and Market Infrastructures for enhancing cross-border payments, as endorsed by G20 Finance Ministers and Central Bank Governors in October 2020 and actively supported by the Bank for International Settlements (BIS).

> Central banks need to be at the cutting edge of technology.

In the past few years, we have witnessed the rise of cryptoassets and a global regulatory discussion around stablecoins. Moreover, some big techs have entered credit markets, either directly or in partnership with financial institutions. The expanded use of digital payments brought about by Covid-19 could fuel a rise in digital lending as companies accumulate consumer data and enhance credit analytics. This, in turn, presents new and complex trade-offs between financial stability, competition and data protection.

Central banks will continue to safeguard essential trust in money in this rapidly changing environment. To identify these trade-offs, design sound regulatory responses and continue to fulfil effectively their mission to deliver monetary and financial stability, central banks need to be at the cutting edge of technology.

It is for these reasons that the BIS has established its Innovation Hub (www.bisih.org) to spearhead the central bank response to digital innovation. Reflecting the global nature of innovation and technology, the BIS Innovation Hub already has centres across Europe and Asia. It has formed a strategic partnership with the Federal Reserve System in New York, and in the next few months it will open new centres in Toronto with the Bank of Canada, London with the Bank of England, Frankfurt/Paris with the Eurosystem, and Stockholm with a group of Nordic central banks. The Hub catalyses collaborative efforts among central banks and cooperates with academia, financial service providers and the broader private sector.

Our work programme is built around six key themes of critical importance to the central banking community: (i) suptech and regtech; (ii) next-generation financial market infrastructures (encompassing capital markets projects, foundational digital infrastructures, tokenisation of assets, cross-border payments and payment infrastructures); (iii) central bank digital currencies; (iv) open finance (encompassing application programming interfaces in the open banking context and related dataissues); (v) cyber security; and (vi) green finance.

This work is directed towards practical solutions rather than conceptual research. We are building a portfolio of projects across these six themes – typically as proofs of concept to be delivered to central banks. In doing so, we are helping them to harness the benefits of technology while understanding its limits – and to make global financial markets safer as catalysts, overseers, operators and regulators.

Multilateral collaboration and practical thinking will be essential for building a financial architecture that is future-proof against a large range of shocks.

BURKHARD BALZ

Member of the Executive Board, Deutsche Bundesbank

Are crypto-tokens the future of money?

For more than a decade now, distributed ledger technology (DLT) has facilitated the transfer of crypto-tokens across decentralised digital networks using cryptographic methods. DLT transfers take place in a clear and transparent manner without the need for intermediaries, so the technology promises to be disruptive. This could potentially speed up confirmations and reconciliation processes in the financial sector and even eliminate some steps in the process chain altogether.

As a result, DLT may be of value in particular complex labour-sharing processes like securities settlement, though cross-border payments may benefit as well. Given that DLT can also be used to programme payment flows and incorporate payment processing into delivery processes, it is mainly regarded as a promising basis for many applications in what has been dubbed the Fourth Industrial Revolution.

While DLT offers a wealth of potential, the crypto-tokens currently available in the market are a niche phenomenon in the payment space. Indeed, the chief purpose they serve is as a means of speculation, largely because of their huge swings in value against official currencies like the euro. One key reason for this instability is the lack of a credible stability anchor. Crypto-tokens have no intrinsic value, and there is usually no reliable issuer that is legally obligated to ensure that tokens will remain stable in value or to guarantee that tokens can be exchanged back into cash or book money. In addition, many crypto-tokens involve comparably low processing capacities, relatively costly money transfers, and consume huge amounts of energy in the most prominent examples, making them an economically and environmentally inefficient proposition as a means of payment so far.

For crypto-tokens to maximise their potential as a payment instrument, they will need to be stable in value and safe to use. Stablecoins may fit the bill, given that they stabilise their value for example by pegging it to, and backing it by, a currency issued by a central bank. There are several conceivable ways in which stablecoins can be legally structured, and the European Union's Markets in Crypto-Assets Regulation (MiCA) is a new piece of legislation designed to regulate their issuance in the EU. MiCA aims to provide clarity and certainty for crypto-asset issuers and providers, while establishing sufficient safeguards for the buyers of such coins, for example in the form of capital requirements for issuers, well-defined investor rights and stringent supervision.

While DLT offers a wealth of potential, current crypto-tokens are still a niche phenomenon in the payment space.

I believe that in a market economy, offering innovative payment solutions to the general public should be a primary task of the private sector. Nowadays, the vast majority of payment transactions between non-banks are settled in commercial bank money. Stablecoins issued by a private commercial bank could therefore be one way forward to satisfy the demand for crypto-tokens as a programmable payment medium in the financial sector and real economy. However, central bank money will continue to play an important role in payments in the future, just as it does today. Recipients of large payments are likely to prefer settlement in central bank money, while money in the form of cash enjoys enduring popularity as a means of payment for the public.

For this reason, Bundesbank experts are exploring ways to technically bridge the space between DLT networks and existing payment systems in a way that would allow DLT-based trade to be settled in central bank money. Moreover, the Eurosystem is currently examining the risks and rewards of central banks issuing their own digital currencies, or CBDCs. There needs to be a clear understanding of the potential implications of launching a digital euro for matters including financial stability and monetary policy effectiveness before any such decision can be made.

The potential downsides of CBDC, such as structural disintermediation of the banking system, have to be manageable and outweighed by positive effects such as efficiency gains or the facilitation of new business applications. Therefore, we will have to pay close attention to how any digital euro is designed.

MARCEL HAAG

Director, Horizontal Policies,
DG for Financial Stability,
Financial Services and Capital Markets Union, European Commission

Crypto assets – reaping the benefits while addressing the risks

The ongoing digital transformation of the financial system brings along with it innovative classes of assets or products relying on new technologies. One of these are crypto assets built on distributed ledger technologies (DLT).

The market for crypto-assets is very small compared to the market for traditional financial assets. It has historically been prone to leverage, operational risks and high volatility. While stressing the potential of DLT, many authorities have therefore issued warnings about the risks related to certain crypto-assets.[1]

Even so, crypto assets could deliver many benefits. They could increase efficiency, as DLT offers a way to record key information in a safe, immutable format and can make that information widely accessible.It could also increase the efficiency of payments, by reducing cost, increasing speed, security and user-friendliness.It could enhance competition in payment markets, also by encouraging incumbents to improve.

However, there are also challenges. Price volatility undermines their utility as a means of payment, exchange or store of value. However, some crypto assets – so-called "stablecoins" – address this by stabilising their value against an underlying pool of assets. If this is credible and effective, they are more likely to be used for payments.This could be particularly promising for cross-border payments, notably remittances, where there is indeed margin for improvement.

MiCA will allow markets and related private initiatives to develop on a safe and sound foundation.

Beyond price volatility, there are also important operational challenges related to e.g. the ability to scale up DLT.A key challenge, however, relates to the lack of certainty about the rules that apply, as many crypto assets are likely to fall outside existing financial services legislation.

While for all these reasons, the market for crypto assets has remained small, the market is developing rapidly notably in the stablecoin area. This heralds the possibility of such instruments becoming more widely used, notably as a means of payment.This would come with additional challenges and risks that need to be addressed.

The European Commission in September 2020 adopted a proposal for a regulation on markets in crypto assets (MiCA). It creates a new bespoke framework for crypto assets that currently fall outside EU financial services legislation. MiCA also sets more stringent regulation and supervision of stablecoins. This will allow crypto asset markets and related private sector initiatives to develop on a safe and sound foundation.

As these markets will grow, it remains to be seen how they contribute to more efficient payment arrangements. Stablecoins could potentially become a widespread digital means of payment. As set out in MICA, they should therefore be subject to the same rules as other digital means of payment, so as to ensure a high level of consumer protection and a sound retail payments market. In parallel, the Retail payments strategy will foster the development of instant payment solutions, in a pan-European fashion, which will further improve the efficiency of cross-border payments in the EU and beyond.

1. See e.g. the 2018 joint warning of the European Supervisory authorities on the risks for consumers of buying virtual currencies. https://www.eba.europa.eu/esas-warn-consumers-of-risks-in-buying-virtual-currencies

ROELAND VAN DER STAPPEN

Head of Regulatory Affairs,
VISA Europe

Delivering on consumers' payment needs in the digital age

Central Bank Digital Currencies (CBDCs) and stablecoins backed 1:1 by fiat currencies, are an evolution of money brought about by changes in commerce and technology. Both of these financial instruments have the potential to be used for global commerce, much like other fiat currencies, and can help minimize the inefficiencies in dealing with cash and cross-border retail payments. They can also foster financial inclusion for people that do not have bank accounts, or are underbanked, or access to a currency that is stable.

For new forms of digital money such as stablecoins to be widely used for retail payments, convertibility into fiat currency and maintain a stable value is essential to ensure consumer trust. Conversely, crypto-assets like Bitcoin are predominantly held as assets, and given their volatility are not used for retail payments in a significant way.

While stablecoins and CBDCs raise questions about future forms and underlying technology of digital money, we know that the future of payments is digital and mobile. However, we should not only think about the future

of money, but we should equally remain focused on what consumers want and need when they pay in a digital age.

Above all consumers have come to expect trust and security with payments. That requires advanced risk management capabilities and investments in fraud prevention and anti-money laundering control mechanisms by any issuer of digital currencies. In case of a CBDC, consumer expectations will be no different, and the solution should be to work with private intermediaries that have expertise in this area and can help manage security of transactions.

Security also means that consumers know what happens when something goes wrong with a retail payment. Stablecoins and CBDCs should have an equivalent consumer protection standard as e-money if used for retail payment purposes, following the principle of same service, same rules. This will also ensure consumers can use them with confidence.

When considering the potential benefits of new technologies in a retail payment context, it is important to consider what resilience looks like in a digital age.

We should not only think about the future of money, but we should equally remain focused on what consumers want and need when they pay in a digital age.

For retail payment transactions it means the ability to securely process and authorise tens of thousands transactions in milli-seconds. It also means payment network uptime, and that is why we continue to make significant investments in resilience of our network to achieve 6 9s or higher availability, or differently put no more than 32 seconds of downtime per year.

Regulators must continue to promote the use of international standards to enable technical interoperability, whereas international alignment around regulatory principles for stablecoins or CBDCs will allow systems to connect across different jurisdictions. More broadly, we believe that open and interoperable payment networks can enhance both innovation and resilience across payment flows.

Finally, stablecoins and CBDCs will form part of a broader digital retail payment mix with multiple payment networks and payment service providers continuously looking to address consumer needs. We believe that making good use digital currencies can contribute to the development of new forms of commerce and popularize digital payments.

Above all, it has a chance to create greater consumer choice for paying and accepting payments.

CROSS-BORDER PAYMENTS GLOBAL ROADMAP

DENIS BEAU
First Deputy Governor,
Banque de France

Taking the cross-border payments roadmap forward

Cross-border payments, which sit at the heart of international trade and economic activity, have been for long facing a number of shortcomings that hamper their efficiency, in terms of cost, delay, transparency and accessibility. These frictions encompass a wider array of aspects, from fragmented data standards, lack of interoperability, complexities in meeting compliance requirements, data protection purposes or outdated legacy technology platforms. This multi-dimensional set of issues is by far not new but have recently been given a strong political impetus in view of materializing significant progress.

The work done last year under the aegis of the G20 is the first global and comprehensive initiative to firmly improving cross-border payments. The ambitious roadmap agreed in October 2020 indeed aims at addressing all the various pain points mentioned above, from all the perspectives at stake, within a delimited time-frame, under the close scrutiny of the FSB and, ultimately, of the G20. This decisive policy step in the landscape of payments, which implies not only public authorities but also and foremost the private sector, is highly promising. However much will depend on our collective willingness and ability to deliver.

> However much will depend on our collective willingness and ability to deliver.

It is in this regard pivotal that the implementation of this roadmap remains overtime tied to the initial ambition. This stress the critical importance of targets, mostly quantitative, that will be set - in terms of price, delay, transparency and accessibility – as part of the roadmap. Indeed, this will help ensure that the various "building blocks" of a response, whatever their nature and features, be operationalized in a way that will eventually fix the frictions. The endorsement of targets by the G20, in the last quarter of 2021, will be hence essential, as will be the ongoing monitoring of their implementation over the following years.

Central banks have to play an important role in this setting. As overseers of payments infrastructures, they will have to contribute to the design and implementation of the revised frameworks that will result from the need to increase the convergence of regulatory and supervisory approaches between jurisdictions. As operators, their support to solutions designed to inter-connect payments system, wherever needed and possible, will be essential, as will be a number of targeted measures including for instance the extension of operating hours; some more forward-looking initiatives, such as the potential issuance of central bank digital currency in the context of cross-border payments could also be considered. And as catalyst, they will have to stimulate and create a conducive environment for innovative solutions, which may encompass new platforms or some forms of appropriately designed digital payments.

All in all, the G20 roadmap offers a unique collective opportunity to prepare and improve the future of cross-border payments. Its success relies on the steady commitment of all stakeholders.

TARA RICE
Head, Secretariat of CPMI,
Bank for International
Settlements (BIS)

Building the cross-border payments ecosystem for the 21st century

The payments landscape has changed dramatically in recent years. Domestic payment systems have improved, and the use of cash has declined in many jurisdictions, but cross-border payments are still largely perceived to be slow, expensive, opaque and for certain user segments unavailable.

As a result, in late 2020, the G20 endorsed a roadmap to enhance cross-border payments. It lays out a comprehensive set of actions by public authorities and private actors in a broad range of areas to remove the frictions that have held back the development of better cross border payments.

The Committee on Payments and Market Infrastructures (CPMI), chaired by Sir Jon Cunliffe (Deputy Governor, Bank of England), led the development of the 19 building blocks, arranged into five focus areas, which form the basis of the roadmap. Four of these focus areas seek to enhance the existing payments ecosystem, while the fifth is more exploratory in nature and covers emerging payment infrastructures and arrangements.

The focus areas are as follows:

a. *Commit to a joint public and private sector vision to enhance cross-border*

payments: Focus on driving meaningful, coordinated change at the global level over a sustained period of time among stakeholders from the public and private sector.

b. *Coordinate on regulatory, supervisory and oversight frameworks:* Focus on advancing consistent international rules and standards without compromising individual jurisdictional discretion or lowering standards.

b. *Improve existing payment infrastructures and arrangements to support the requirements of the cross-border payments market:* Focus on technical and operational improvements to existing domestic and international payment infrastructures that cross-border payments depend upon.

d. *Increase data quality and straight through processing by enhancing data and market practices:* Focus on promoting the adoption of common message formats, including conversion and mapping from legacy formats to ISO 20022 and common protocols for data exchange. This could mitigate the friction around fragmented and truncated data.

e. *Explore the potential role of new payment infrastructures and arrangements:* Explore the potential that new multilateral cross-border payment platforms, central bank digital currencies (CBDCs) and so called global "stablecoins" could offer for enhancing cross-border payments.

Each of the building blocks individually has the ability to bring notable benefits to cross-border payments. However, due to their interdependencies, the most significant enhancements are likely to arise if over time they are advanced and implemented in a coordinated manner.

Achieving change in all of these areas is a challenging objective. While all of these building blocks feature concrete actions and key milestones, the problem needs to be tackled comprehensively.

Absent a coordinated and sustained initiative, supported by both the public and the private sector, we will not see the improvements we seek.

Only a cross-border payments ecosystem that can keep pace with the way we live and transact is fit for the 21st century. The CPMI is taking a leading role in shaping the future of cross-border payments.

GIUSEPPE GRANDE

Deputy Head of Market and Payment Systems Oversight, Banca d'Italia

Cross-border payments: more access, less compliance costs

The G20 Roadmap on cross-border payments can greatly benefit the public and the world economy. Cross-border payments are the cornerstone of the international mobility of goods, services, capital and people. Yet, for too many individuals and businesses they are still costly, slow and less secure, if they are even available. This has been well documented by the FSB, in coordination with the CPMI. The Roadmap is a high-level and flexible plan to enhance the global payments ecosystem.

Key to the Roadmap's success is the involvement of market forces, enabling a long-term, joint private and public sector commitment. Moreover, to the extent possible, we need to leverage existing infrastructures and arrangements so as to reduce the sunk costs of innovation. Enhancing private-public cooperation and existing systems are two of the focus areas of the Roadmap.

Turning to possible actions, the responsibility to meet end users' needs and requirements lies primarily in the hands of payment system providers (PSPs) rather than those of public authorities. Services could be developed to enable individuals and businesses to make payments through smartphones and PCs, for example, or better track them along the transaction chain, combine them with other services and settle disputes easily.

Enhance access to back end, deepen interlinking, simplify practices and compliance, manage new risks.

The PSPs' ability to improve services also depends on the availability of 'back' end processes. Criteria to extend such processes to non-bank PSPs are being considered in several jurisdictions in order to promote innovation and competition, reduce the risk of single points of failure and ultimately strengthen financial stability. Payments across borders can also be boosted by adopting new structural approaches, such as establishing links between domestic systems or setting up multilateral systems with cross-currency settlement, which would be especially useful for countries that have strong economic ties with one another. In Europe, the instant payment system TIPS is experimenting in these areas.

Industry-led initiatives targeting operational frameworks (e.g., message format) may help to streamline transaction chains.

Changes in the payments industry are giving rise to new risks that must be managed in order to safeguard financial stability and the public's trust in money. The greater dependence on technical service providers and the high concentration of the supply of such services are matters of concern. Companies have to recognize third-party risk and the different responsibilities of the outsourcer and the outsourcee. Competitive distortions due to the presence of a few large players have to be countered and data privacy and cyber security must be ensured.

These policy efforts do not equate to an increase in regulation. There is room for lowering compliance costs by tackling disparities resulting from inconsistent regimes or from duplicative compliance checks. This is also one of the focus areas of the Roadmap. More importantly, an open and inclusive payment ecosystem, with a level playing field, strengthens market discipline and is conducive to growth, thereby reducing the need for public intervention.

Nonetheless, central banks and other authorities will continue to monitor old and emerging risks, to improve oversight criteria and tools and to be ready to act.

MARC BAYLE DE JESSÉ

Chief Executive Officer,
CLS Group

No quick fix – Addressing frictions in cross-border payments

The Financial Stability Board's (FSB) Cross-Border Payments Roadmap rightly focuses on improvements to existing payment infrastructures and arrangements. Such improvements are needed to address current frictions that limit access, increase costs, and leave risks unmitigated.

Removing these frictions involves careful consideration of the regulatory, legal, and operational changes required – many of which cannot be readily addressed by simply adopting a new technology or shifting to a new type of infrastructure.

Core to CLS's purpose is to mitigate foreign exchange (FX) settlement risk, the risk that one party to an FX transaction will pay the currency it sold but not receive the currency it bought. CLS continually seeks to add currencies to its settlement system (CLSSettlement), and is in the process of onboarding the Chilean peso as its 19th currency.

Despite recent reports suggesting FX settlement risk is on the rise[1], CLS's ability to expand its payment-versus-payment (PvP) protection to new currencies and improve direct access to CLSSettlement will remain limited unless there are changes to the regulatory regimes applied to systemically important infrastructures like CLS.

> "Technology is only one part of the complicated equation"

Few remaining currencies can meet CLS's currency onboarding standards, which derive from the Committee on Payments and Market Infrastructures' and the International Organization of Securities Commissions' *Principles for Financial Market Infrastructures*, other applicable regulations, and CLS's own standards for CLSSettlement. Principle 1, legal basis, and Principle 8, settlement finality, have presented the largest obstacles to onboarding new currencies to CLSSettlement.

As a result, CLS has started to formalize its views around a new, separate solution for non-CLS currencies (in support of Building Block 9 of the FSB Roadmap – facilitating increased adoption of PvP). Key questions on operating model, account type, settlement finality, and applicable standards remain, and a flexible and agile way of thinking will be required to answer those questions. New technology on its own will not be able to address them.

Specific to access, as a general rule CLS believes it is important to assess the trade-off between participant accessibility and the potential changes to the risk profile of the ecosystem. However, CLS believes there is merit in ensuring that, from a legal perspective, the following categories of low risk non-bank participants will have the ability to directly participate in systemically important FMIs:

1) supranational institutions and multilateral development banks;
2) foreign systemically important FMIs and their operators;
3) sovereign wealth funds. Depending on the jurisdiction, changes to existing regulations and legislation, including the EU's Settlement Finality Directive, may be required to accomplish this goal.

While the use of new technology may help address current frictions, technology is only one part of the complicated equation to achieve a faster, cheaper, more transparent, and more inclusive global payment system.

1. BIS: "BIS Quarterly Review – International banking and financial market developments", specifically Bech and Holden: "FX Settlement Risk Remains Significant" (December 2019).

PETER BUCHER

Chief Executive Officer,
Western Union International
Bank GmbH

Cross-border payments: welcoming the new political impetus

Under the Saudi Arabian leadership of the G20, the FSB and CPMI embarked on an ambitious work programme to improve the efficiency of cross-border payments. Last month, EU finance ministers adopted important Conclusions to improve the retail payments market in the EU. Western Union is one of the world's leading provider offering efficient cross-border payments to its customers across the globe. It might therefore surprise some to hear that we are big supporters of the recent policy initiatives.

The payment industry has always been at the forefront of technological and societal changes. It has had to adapt to new consumer behaviours and needs. The industry is continuously innovating to make the payment process as seamless, efficient and secure as possible. Today, we are seeing a lot of collaboration across the industry. One good example is the Western Union platform. More and more FinTech companies come to us to use our payment platform to access our global network and agents to be present in all parts of the world.

The regulatory and supervisory community needs to be part of this collaborative approach. This is where we believe the CPMI work is of critical importance. The CPMI sets out a number of important building blocks that, if implemented, would make a big difference: aligning regulatory and supervisory approaches, promoting the interoperability of payment infrastructures and contributing to standard setting on data exchange. While local rules, regulations and consumer protection requirements need to ensure that payments remain safe and secure, they should not unduly fragment the ability of the industry to deliver cross-border payments or stifle innovation in the industry, nor should it favour one payment solution over another.

If we look at our business today, customers are increasingly opting for digital payment solutions. This brings efficiency and helps to reduce costs. Nonetheless, digital payments are not in themselves the solution for making cross-border payments more efficient.

Many customers, not least in remote and rural communities that require the necessary investment in digital infrastructure or banking network, still rely heavily on cash.

How can the EU contribute to the international agenda? We welcome the Retail Payments Roadmap as a constructive way forward. It rightly identifies a number of important actions:

- The move to a harmonized KYC and e-onboarding framework will contribute to cost-efficient and more effective compliance. Such initiative should importantly find ways to incorporate offline customers so that these too profit from the new rules.
- The commitment to encourage, not hamper the appetite of industry to invest and innovate in the safety, security and efficiency of payments. Differences in national implementation of AML, data privacy and consumer protection are creating barriers to scaling up business solutions across the EU and internationally.
- The commitment by the ECB, European Commission and the National Central Banks to have clarity on the real-world applications of the CBDCs including Digital Euro and the options for public-private collaboration when embarking on those new projects.

ULRICH BINDSEIL

Director General, DG Market Infrastructure & Payments, European Central Bank (ECB)

The G20 cross-border roadmap – The foundations of a future-proof global payments ecosystem

The G20 cross-border payments roadmap encompasses a variety of actions through 19 building blocks in an attempt to address the various challenges related to cross-border payments. The diversity of measures under consideration is also a result of the different types of end users of cross-border payments, who face different challenges and have broadly different experiences and expectations. The 19 diverse building blocks lay a strong foundation for progress in the global payments ecosystem.

Despite the heterogeneity of the building blocks, one overarching objective is a desire to reduce the high costs associated with cross-border payments. This challenge is multi-facetted, although one clear outstanding issue is the cost of compliance and associated risks. Providers of cross border payment services need to comply with several sets of rules and regulations while, at the same time, mitigating legal risk resulting from a lack of awareness or a misunderstanding of the way laws and regulations are applied. Compliance costs are, eventually, charged to end users while de-risking (i.e. the withdrawal of providers from the cross-border payments market) means less competition, which in turn translates into more market power for the remaining providers, increasing further fees charged to end users. The G20's work acknowledges the importance of improving the efficiency of compliance and reducing its associated risks, which is why five out of the 19 building blocks are in this area. This is where making improvements will be important for both existing and new arrangements and providers.

The G20's work also recognises the importance of competition. It supports the use of a variety of approaches to address the technical issues involved in processing cross-border payments, such as improving traditional payment rails and correspondent banking. In addition, if new players enter the cross-border payments market under the same set of rules which create a level playing field, this has the potential to enhance cooperation and change the competitive dynamics of the market. New approaches will benefit from more efficient compliance frameworks while from a competition perspective both old and new solutions should obviously be subject to the same rules.

Beyond their roles as regulator or overseer, central banks also have a critical role to play as providers of liquidity and operators of payment systems. With regard to the latter, it should be mentioned that the ECB, in collaboration with Sveriges Riksbank and the Banca d'Italia, has started to analyse how TARGET Instant Payment Settlement (TIPS, the Eurosystem pan-European service that settles payments in central bank money around the clock in real time) could support efficient payment transactions across different currencies. Ideally, payments would have an efficient and competitive FX conversion layer and minimise costs for participants and ultimately end users. The usage of TIPS by both Sveriges Riksbank and the Eurosystem provides a great opportunity to explore this. It will also foster our understanding of all the practical challenges we face when aiming to implement concrete innovative solutions.

International cooperation will also be key to shaping the future ecosystem for central bank digital currencies, which may offer consumers and firms a further option for making cross-border payments, thus strengthening further competition and efficiency.

EU RETAIL PAYMENT INITIATIVES

BURKHARD BALZ

Member of the Executive Board, Deutsche Bundesbank

Securing the future of European payments

Payments are the backbone of our economies. This backbone is undergoing a dramatic transformation, driven by the digital revolution and its impact on the demand for new forms of payment and the provision of innovative payment services. Consumers want quick, convenient, secure and cheap payment methods – around the clock and with solutions covering cross-border payments, too. We can see that the use of cash is waning. The COVID 19 pandemic has boosted the use of contactless credit and debit cards. In a recently conducted survey on payment behaviour in Germany, the Bundesbank found that the share of transactions settled in cash has fallen from 74% to 60% compared to the last survey as of 2017. This shift is unlikely to be reversed once the pandemic is over.

In light of these developments, we need to ask ourselves whether the means of payment currently available adequately meet the needs of consumers in the digital age. Unfortunately, the instruments offered by EU payment service providers are in danger of falling short of the needs of payers and payees alike. The EU payment system is still highly fragmented. Most payment solutions are still developed around domestic ecosystems, with little or no acceptance beyond national borders.

Unsurprisingly, none of the many national solutions available are big enough in terms of reach or user numbers to compete on an equal footing with global players like major card networks or bigtech platforms from China and the United States. This increases the risk that these firms evolve into increasingly dominant market players in domestic markets as well, raising questions about competition, privacy, financial stability and even monetary sovereignty.

The European Union cannot afford to be a bystander to these trends. It is high time to advance European initiatives and develop innovative payment solutions that are fit for global competition. In a market economy, offering such payment solutions to the public should be one of the private sector's primary tasks. Consequently, the European Payments Initiative was launched by a group of 20 major euro area banks as well as two large European acquirers. The initiative is seeking to develop a unified card and digital wallet that can be used across Europe, and potentially beyond. It offers a real opportunity to reshape the payments landscape, providing a pan-European payment solution that is fast, secure, cheap and widely accepted.

That said, the private sector is not alone. European authorities are pulling together, too, so that they can provide the environment and conditions for the private sector to innovate and thrive. Legislators, central banks, financial regulators and competition authorities are setting up the appropriate framework for a resilient, innovative, diverse and competitive payments landscape to serve the evolving needs of European people and businesses.

The Eurosystem has a particular part to play in this, such that payment systems can rely on its infrastructure. The Eurosystem needs to act as a catalyst, being at the cutting edge of technology and providing state-of-the-art payment infrastructure that reflect our changing economies. This includes exploring the potential benefits, risks and operational challenges of issuing a digital euro.

JUAN AYUSO

Director General Operations, Markets and Payment Systems, Banco de España

A European strategy for retail payments

The global covid pandemic has generated an unprecedented economic shock that has impacted the global economy, in general, and the European economy, in particular. Against this backdrop, speeding up the process towards the Capital Market Union (CMU) is a useful tool to foster economic recovery. One of the main initiatives of the CMU Action Plan is the pan-European integration of the financial market infrastructures (FMIs), including securities market infrastructures and payment systems.

In the wholesale segment, the advances in FMI integration in the last years have been significant. The Eurosystem has played a prominent role by developing and operating Target2, the real-time gross settlement (RTGS) system for large value payments in euros, and TARGET2-Securities (T2S), the securities settlement platform which allows the adhered CSDs to settle securities and cash in central bank money.

In the retail segment however, the results are mixed. The Single Euro Payment Area (SEPA) initiative has successfully increased the harmonization of, in particular, credit transfers and direct debits, allowing European citizens to make cross border payments as easily and efficiently as they can do within their

home countries. There is however still work to do regarding the point-of-sale (be it physical or virtual for e-commerce transactions), where the user experience is still fragmented. The domestic card based and e-commerce solutions that exist in a few countries might show a good degree of efficiency but lack pan-European reach, whereas those solutions that work across Europe are usually managed by global companies whose strategies may not always be aligned with the European users' needs.

The Eurosystem is actively working towards the improvement of retail payments in euro, but its role is necessarily different from that played in wholesale payments. While some operational role can still be played (e.g. the deployment of TIPS to promote the pan-European reach of instant payments), an active engagement as a catalyst of private efforts that fit with the overall vision of the Eurosystem seems more appropiate.

The Eurosystem is actively working towards the improvement of retail payments in euro.

The first and main goal of the strategy defined by the Eurosystem for retail payments, fully aligned with the European Commission, is to support payment solutions that fulfil five key objectives: pan-European reach and seamless customer experience, convenience and low cost, safety and security, European brand and governance, and global acceptance, with a focus on a full deployment of instant payments, where Europe is a global reference, and the enhancement of cross-border payments.

Among the private initiatives well aligned whit these objectives, it is worth highlighting the European Payment Initiative (EPI), led by major European banks, perhaps the most promising initiative to achieve these objectives, even though other potential solutions seeking to meet them are of course welcome.

Advancing on these objectives in cooperation with the private sector is of the essence at the current juncture, to the benefit of European citizens and the European economic recovery.

MARIA VELENTZA

Director Financial Services,
DG Competition,
European Commission

Towards a competitive and innovative European payments market

Digital innovation is radically reshaping the provision of financial services. The retail payments sector is at the forefront of this trend; the pace and scale of technological change requires specific and targeted policy measures.

Over the last years, the act of paying has become less visible, increasingly dematerialised and disintermediated. In addition, large tech companies ("BigTechs") have become active in the payments sector. Benefitting from significant network economies, they challenge established financial services providers. Moreover, with the emergence of crypto-assets (including stablecoins) they may soon be offering payment solutions based on encryption and blockchain technology.

Innovation and digitalisation will continue to change the way payment services are provided: old channels and traditional payment instruments are increasingly abandoned; this will lead to new ways of initiating payments, such as via "wearables" (watches, glasses, etc.). The Covid-19 pandemic has reinforced the shift to digital payments and confirmed the importance of safe and convenient (including contactless) payments for remote and face-to-face transactions. However, cash remains the means used for a majority of retail payments in the EU; the principle that euro banknotes and coins are a legal tender is enshrined in the EU Treaty.

Public and private players will shape jointly the future payments landscape – and support a cohesive recovery.

Public and private sectors have complementary roles to play in the future payments landscape. More and more central banks around the world, including the European Central Bank, are looking into the possibility of issuing central bank digital currencies and there are tangible prospects of further significant changes in the retail payments market. Wide acceptance of a means of payment not denominated in euro could impair the transmission of monetary policy in the euro area. Hence, the issuance of a digital euro could support European economic sovereignty and financial stability.

In 2020, a group of 16 European banks launched the European Payment Initiative project with a view to offering a pan-European payment solution by 2022. The Commission welcomes this initiative aimed at completing a single European payments market. Other promising market-driven initiatives have emerged recently, aimed at designing common infrastructures, increasing cooperation and interoperability between domestic payment solutions. Synergies between private and public initiatives will be key in supporting the recovery from the current crisis in a balanced and cohesive way across the EU.

Citizens and businesses in Europe should benefit from a broad range of high-quality payment solutions, supported by a competitive, innovative payments market and based on safe, efficient and accessible infrastructures. The Commission, beyond its specific policy agenda in the payments sector follows those initiatives, which are supporting the objectives of creating an economy that works for people and a Europe fit for the digital age.

Most importantly, competition enforcement complements policy initiatives, hence supporting the digital transformation of finance and promoting a level playing field.

STÉPHANIE YON-COURTIN

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

Retail payment strategy: three pillars for the future

One year after the world went to lockdown following the emerging spread of COVID-19, all domains of our lives have been shaken to the core. The payment landscape is no exception, as the pandemic accelerated existing consumer trends, such as contactless payments, digital consumer-to-consumer and consumer-to-business payments, and indeed the increased use of digital apps for all kind of payments. While fundamental needs related to payments have not changed – it is still and always will be about transferring money in an easy and secure manner – the solutions for retail consumers are more and more diverse and creative.

Private stakeholders continue to compete to provide better solutions for businesses and consumers. As Vice-Chair of the ECON committee in the European Parliament, my role is to ensure this productive competition does not lead to a race to the bottom and respects the core principles of our European regulatory values.

Fair competition, increased trust through increased transparency, protection of our EU autonomy.

The recent European Commission Retail Payments Strategy provides a strong basis for the crucial discussions in the coming years on adapting our EU rulebook on payments, including the wider policy landscape related to distribution of financial products, financial reporting, financial innovation, audit, post-trading, Anti-Money Laundering and Countering Terrorism Financing.

We should anchor our actions going forward in three pillars: fair competition on the open finance field; increased trust through increased transparency; protection of our EU autonomy.

Firstly, we should be proud of the pioneering role that the EU has played in opening competition in the retail payment space with the second Payment Services Directive (PSD2). This approach can be an inspiration for further open finance initiatives related to payments, and even beyond in the broader financial services space. The 'same business, same risk, same rules' principle and reciprocal access to relevant data will ensure a level playing field across providers, and that entities outside of the traditional remit of financial services, including BigTechs, are not unduly getting the lion's share.

Secondly, consumers should be empowered to challenge their payment providers on the quality of their services and associated charges, thanks to clear disclosure on how much and for what they pay. This will build trust overtime. Only a coherent EU approach on the payments rulebook and on its enforcement, involving all relevant supervisors and stakeholders, will rebuild the trust severely eroded by the Wirecard scandal.

Thirdly, our eyes should remain wide open to the challenges to our European autonomy linked to payments, alongside the opportunities they bring. The EU is leading the way in creating the first Digital Operational Resilience framework, also applicable to payment infrastructures. Similarly, the European Payments Initiative (EPI) is a key milestone to preserve the independence of our foreign policy decisions.

FIONA VAN ECHELPOEL

Deputy Director General, DG Market Infrastructure & Payments, European Central Bank (ECB)

The retail payments strategy in Europe

Digitalisation and increasing global competition in the payments area could put sovereignty of the European retail payments market at risk. The digitalisation trend has accelerated with the COVID-19 pandemic where the use of cashless payment methods has risen. Cards continue to be the most used electronic means to pay in Europe, however, a significant share of card transactions are covered under international brands. Additionally, BigTechs with a large customer base that can be leveraged for retail payment services are entering the market. The dependency on non-European payment solutions could thus shape the European payments market in a way that does not serve the interests of European stakeholders.

To overcome the challenges of digitalisation in the payments market, the Eurosystem has re-launched a retail payments strategy. Three of the goals are: 1) the development of pan-European payment solutions at the point-of-interaction, 2) the full roll-out of instant payments in Europe, and 3) the improvement of cross-border payments beyond the euro area and the EU.

Firstly, it is essential that pan-European payment solutions for retail payments at the point-of-interaction (POI), including the physical point-of-sale and in the mobile and e-commerce space, are developed under European governance. In 2019, the Eurosystem

called for collaboration between European stakeholders and devised five objectives that any private initiative needs to meet: pan-European reach and customer experience, convenience and cost efficiency, safety and security, European identity and governance, and, in the long-run, global reach. Currently, a few market initiatives seek to end the fragmentation in the European payments' ecosystem with pan-European solutions.

Secondly, instant payments should be deployed fully in Europe so European citizens can send or receive money in real time, as easily as text messages or emails. The first steps have been successfully deployed. The SEPA instant credit transfer (SCT Inst) scheme was launched in 2017 and the TARGET Instant Payment Settlement (TIPS) service went live in 2018. However, for instant payments to become the "new normal", interconnection between market participants is needed. To tackle this issue, the European Central Bank has put in place a set of measures to be implemented in TIPS by the end of 2021.

To overcome the challenges of digitalisation in the payments market, the Eurosystem has re-launched a retail payments strategy.

By then, all payment service providers in TARGET2 that adhere to the SCT Inst scheme will become reachable in TIPS, either as participant or as reachable party. Moreover, the settlement of instant payments in automated clearing houses (ACHs) will move from TARGET2 to TIPS.

Thirdly, cross-border payments beyond the euro area and the EU should be improved. In this vein, the ECB and Sveriges Riksbank are exploring if cross-currency payments between euro and the Swedish krona can be settled in TIPS. In parallel to the retail strategy, the Eurosystem is exploring the issuance of a digital euro to respond to the evolving needs of European consumers.

A digital euro could be an option to ensure that citizens have access to a safe form of digital money, alongside cash. To avoid any negative impact in the financial sector, the design of a digital euro would need to be further assessed.

MARCEL HAAG

Director, Horizontal Policies,
DG for Financial Stability,
Financial Services and Capital Markets Union,
European Commission

Shaping the payments landscape of the future: the Commission's Retail Payments Strategy

The European payments industry is facing dynamic innovation and continued disruption of its traditional value chain and service propositions. Payments are a constantly evolving business. Over the last decade, payments have benefitted from unprecedented technological innovation. Consumer expectations are also changing, making speed, convenience and ubiquity the new expected normal. Increasingly, the speed of retail payments can be measured in seconds, and households and companies expect to be able to make payments at any time of any day.

EU legislation has promoted innovation and competition in retail payments. In this regard, the second Payments services Directive (PSD2) was a game changer. It has been instrumental in opening up the banking ecosystem and fuelling the development of innovative payment services by FinTech firms.

As digitalisation progresses, the payments ecosystem becomes increasingly complex, with many actors - regulated or non-regulated - intervening in the payments chain. It is important to ensure that regulation remains well-calibrated and that it adequately covers all actors and services that might carry risks to the financial system. All relevant players should be subject to adequate supervision and oversight.

EU regulators are faced with two important challenges: The first is that a significant share of payments in Europe effectively depends on international players, such as international card schemes and, increasingly, of large technology companies. It is crucial, for the EU's open strategic autonomy, to reduce this dependency and to support the emergence of European champions in the payments sector. This will increase competition and choice for end-users.

The second challenge is that despite recent progress, the retail payments market in Europe is still very fragmented along national borders, with many payments solutions being purely national.

The Commission's recently adopted Retail Payments Strategy seeks to address these challenges by supporting the roll-out of instant payments in the EU and the emergence of European payment solutions, ensuring a sound, competitive and innovative retail payments market and a high level of consumer protection. The Commission's Strategy is a long-term policy framework to support the future development of retail payments in the EU and to exploit the opportunities that digitalisation offers.

With its Strategy, the European Commission is showing the way towards the achievement of a customer-centric, modern, competitive and innovative payments ecosystem. Europe is, and must remain a role model in payments integration.

The Strategy requires extensive work and collaboration between all stakeholders, public and private. The Commission is already in the process of implementing its strategy, with work being underway on several of the initiatives announced in the strategy, such as instant payments, cash, digital euro, SEPA enforcement etc.

A public consultation on instant payments will, for example, be soon launched. Some ambitious initiatives announced in the strategy, like the review of PSD2, will be presented at a later stage.

JOACHIM SCHMALZL

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

The way forward: the role of European Banks and acquirers in the future of digital payments

Around the globe, the COVID-19 pandemic has effected significant shifts in the payments industry as a whole. Irregular - but foreseeable - increases in E-/M- commerce transactions, increased use of contactless payment methods at the Point of Sale (PoS), and an accelerated shift to acceptance and use of digital payments methods coupled with a decrease in the use of physical central bank notes can all be attributed to the changing consumer needs resulting from the ongoing pandemic.

In my home country of Germany, we have experienced shifts in consumer behavior and expectations even more acutely than many of our European neighbors. As an example, our national card scheme Girocard (already one of the largest in Europe), has seen an annual increase of over 20% in the number of transactions in 2020 alone and of those, the share of contactless transactions rose from 39% to over 60% during the same period.

Of course, dominant international payment solutions such as the ICS, GAFA, and BATX have also benefited from these shifts in consumer habits. As a result, the overall equation and the fundamental need for a competitive European payments champion has been further reinforced.

We must recognize that the goal of creating a European payments champion cannot be realized by European Banks and Acquirers alone.

In the European Payments Initiative (EPI), we have set ourselves the task of developing a portfolio of retail payment products for consumers and merchants that can compete with international rivals on various fronts such as simplicity and user experience, security, and availability. Best-in-class European payment products, both in physical (card) and digital form, based on state-of-the-art technologies and under a strong common brand will secure the role of banks in the retail payments landscape of the future while ensuring that European interests in sovereignty, standards and data protection regulations are protected.

Long term, the success of EPI will depend on a variety of key factors. Notably, EPI would not be a true European champion if it were not able to compete across Europe. Also critically important is a sustainable business model that allows EPI to innovate and stay competitive long after it has entered the market. Of course, we must also ensure that lessons learned in various national solutions are reflected in EPI and that strong and sensible migration plans are in place where needed.

Lastly, we must recognize that the goal of creating a European payments champion — that is key to the successful implementation of the European Retail Payments Strategy — cannot be realized by European Banks and Acquirers alone. Therefore, support from the European Commission, the European Central Bank, various other EU (and national) regulators, and central banks will be a necessary factor in "leveling the playing field".

The imbalance between global and local models has limited the ability of European players to innovate and reinvest in their solutions. Initiatives (such as EPI) are hence needed in order to effectively compete in a globalized payments industry currently dominated by an oligopoly of international payments service providers.

JUAN ORTI

Country Manager Spain, Head of Consumer Spain and BeNeLux, Europe Board Director, American Express

Building a competitive landscape for payments in Europe

A new and dramatically different era for the European retail payments space has begun. Every choice the EU takes now will help determine Europe's influence and position in the global payments market of tomorrow.

It is vital that we get it right from the start.

Policymakers as well as the industry are working on several solutions to offer European consumers, businesses, and merchants' access to better services and better prices. Fundamentally, this is grounded in the understanding that all market players deserve more choice, and that any forward-looking payments market should have competition at its heart.

The creation of a pan-European scheme is therefore a step on the right direction. Initiatives such as the European Payments Initiative (EPI) are focused on encouraging real competition to the dominant schemes – whether from FinTech's, European-led initiatives or alternative models such as American Express and Diners.

The development of pan-European solutions is no doubt important, but we believe there are also other paths the EU could – and should – consider, to increase competition even further.

At the top of that list must be addressing the shortcomings of PSD2. The changes to the open access rules, for instance, combined with other onerous regulatory requirements, have made it even harder for alternative and innovative fintech players to enter this space and compete with the dominant four-party schemes.

Similarly, the current restrictions in place regarding the passporting of credit services are an obstacle to the single market. PSD2 stipulates that PIs can issue credit on a passported basis only up to 12 months outside their home member state. Such a restriction puts non-bank PSPs at a disadvantage vis-à-vis banks when offering personal loans and credit cards.

Any forward-looking payments market should have competition at its heart.

The much talked about move from Open Banking to Open Finance is another essential part of the puzzle. To make a swift and seamless transition to this broader scope, we first must ensure that Open Banking is fully implemented. Without API standardization, further developments into Open Banking/Finance/Data could lead to inconsistent customer experiences that differ across products and providers, and cause delays to financial institutions updating and enhancing their external APIs. Not least, the definition of "payment account" still needs to be further detailed and clarified, as the overly broad contours of the definition in current EU regulations have led to a divergence in views and implementation across the EU.

Ultimately, if we work on these different workstreams in parallel, together we can empower European consumers, businesses, merchants, and payment service providers with different choices, and we can achieve a truly innovative and competitive payments market.

MARTINA WEIMERT

Chief Executive Officer,
EPI Interim Company SE

Are we able to align in European retail payments?

The pandemic has led to a strong increase for contactless and e-commerce transactions in Europe, including through cross-border e-commerce. Europe seems more than ever ready for digitization. Besides this push, we witness since a couple of years the development of strong international wallet solutions and constantly evolving new technologies as the main market drivers. All these solutions are continuously enriched and numerous value-added services appear including now also financing. But none of these solutions is European or even co-owned by Europeans. At the same time, the European regulator has created the basis for instant payments, but no major development took place in the retail payments space because the alignment of critical mass on one solution necessary for the rapid successful roll out in the market, did not happen.

While this situation clearly offers some potential opportunities, it is important to understand that Europe has to catch up in terms of payments solutions. The reason why many international solutions from different players develop so strongly in Europe is because we have no European reply, but only national or local solutions lost in more or less relevant specificities.

Creating only a level playing field and regulated approaches which we usually deploy in Europe, will very unlikely suffice.

This situation entails consequences: payments innovation is always a long-term investment and will require a substantial shift of parameters known until now, meaning that Europe will have to deliver its our own innovation, investing more into technologies, and achieving efficiency which are in line with our overall European market size.

Ultimately "catching up" with the payment giants will require massive investments and an outstanding persistence in the implementation efforts. In the current economic environment and given the progress of competitor solutions, this looks more than ever challenging and requires a strong concertation between the public and private sector in Europe.

Priorities have to be set out in line with market expectations, so that the private sector can deliver, but the support of the public sector will be needed since the effort will be anyhow immense. A collective effort appears as the only way how to turn around the continuous shift of Europe into increasing dependency in cards, wallets, payment standards and related technologies, while being internationally inexistent.

This support seems not only necessary for the overarching principles or long-lasting objectives but should reflect also in the detailed lay out and set-up of a European solution. In exchange of his support, the European regulator should have control over the realization of these objectives in order to obtain clear benefits for the European consumers, market players and its economy in terms of digitization, innovation and efficiency. Creating only a level playing field and regulated approaches which we usually deploy in Europe, will very unlikely suffice to create the needed conditions for success.

The longer we wait, the more difficult it will become, if not impossible. Lack of support, nationalism, or believing in vain that solutions at the national level could be more efficient and competitive in the long run compared to European-wide innovation and leveraging collectively our scale, are the biggest enemies to this evolution.

DAVID WATSON
Chief Strategy Officer, SWIFT

Cross-border payments evolution: common standards & public/private cooperation

The world of cross-border payments is changing. While there have been developments over many years and through many generations of technology the market continues to evolve. Viewed as an ecosystem, cross-border business involves not only the payer and payee but correspondent banks, domestic market infrastructures, service providers and vendors. It's a complex web of interconnected systems, standards and practices that evolved slowly and often in isolation, and that now work together.

Many small differences across the system in terms of data and data formats lead to automation breaks, loss of data and delay. In many cases, these legacy data formats were optimised to minimise size and processing complexity, constrained by the technology of the day. However, the environment for payments has become much more demanding, with customers expecting real-time experiences, and regulation demanding complex sanctions screening and AML measures.

Finding the right balance will require coordinated action from public and private sectors.

As highlighted in CPMI's recent report, the overall system needs to be modernised to address new needs. But this poses a dilemma: reform too slowly and risk disruption from new technology or models, at least for major corridors; reform too quickly and risk fracturing the existing system, which provides unparalleled access in terms of markets, currencies and accounts. Finding the right balance will require coordinated action from public and private sectors. In the private sector, the SWIFT community has so far taken an evolutionary approach, its gpi initiative building on existing standards and protocols to provide transaction tracking and other modernisations. Another welcome development, already well in hand, is the industry's convergence on a common modern data standard across all the major components of the ecosystem, embracing both public and private sector. ISO 20022, which is already the de facto choice for new or refreshed market infrastructures, from November 2022 will also be adopted for cross-border payments.

Consistent shared data end-to-end, between customers, banks, MIs and service providers, addresses today's fragmentation and its inherent risks, enabling higher automation rates, more effective compliance processing, and richer contextual data benefiting payment system users. For cross-border flows, SWIFT will deploy new technology to ensure banks can move at their own pace to adopt ISO 20022, while maintaining community interoperability and ensuring the integrity of payment data. Public sector implementers can accelerate the realisation of these benefits, by cooperating to harmonise local implementations with their international peers. Regulators can also help by taking advantage of the convergence of transaction data models to harmonize AML/CFT standards.

CHARLOTTE HOGG
Executive Vice President and Chief Executive Officer, VISA Europe

The future of payments is open

The Covid-19 pandemic has brought into sharp relief the importance of digital payments to our markets, as the adoption of contactless payments and e-commerce has increased. The security and resilience of the payments infrastructure has also been critical to maintaining confidence and credibility, and therefore to supporting business and economic recovery.

While European regulation has arguably contributed to the most competitive and innovative retail payments market in the world, it is poised for more change in light of a further uptake of new and efficient digital payment solutions, open banking achieving its full potential, alongside a potential introduction of a digital euro. Looking forward, we believe the future of payments is open. Europe should promote open and interoperable payment systems as this drives both innovation and resilience.

As we move into this next phase, it's important to stay grounded in the fundamentals. Payments have their own "Maslow's hierarchy". At the base of the pyramid is resilience, and security – the food, air, water, and security in the Maslow we know. Without that the foundation is unstable, the risk to credibility and financial stability manifest. The reliability of digital payments over the last year must not be undervalued; the shift to digital of businesses and consumers which in turn has strengthened economic resilience cannot be understated. This base of the pyramid should be a primary focus for all policy makers, setting clear standards and expectations for the digital world we are moving into.

Openness and access comes next – the love and belonging of Maslow. There is a big difference between open and closed-loop payment networks. Open networks are clear and transparent about their rules and all participants who meet those rules can join them. They have governance structures that push towards inclusion, recognizing the

positive externalities for all that come from that.

In our transition from a member association owned by 441 banks to a commercial organization, we have for example become more accessible to EU FinTech players and have supported their growth beyond domestic markets. Thus open networks enable greater consumer choice and competition.

Openness is also about interoperability.0Definitions are important here. Technical interoperability means the ability to facilitate payment transactions between different applications and infrastructure to enable straight through processing. Network interoperability, the ability for multiple parties to connect through a network that facilitates payment transactions. Regulatory interoperability the ability to connect payment systems across different jurisdictions governed by different regulatory requirements. All are important. None imply single platforms or single points of connection. Interoperability avoids creating the single points of failure that are so inherently damaging to the fundamentals.

Europe should promote open and interoperable payment systems as this drives both innovation and resilience.

To give a Visa example; in 2020 our payments push platform Visa Direct completed nearly 3.5 billion transactions involving 16 card-based networks, 65 domestic ACH schemes, 7 faster payment schemes, and 5 payment gateways. This is our "network of networks" strategy in action and a great interoperability story.

So what's at the top – where do payments realise self-esteem? My answer is through serving consumer and business needs, use case by use case. Enabling consumer choice. Ensuring competition and level playing fields. Offering different values for different types of transactions. For example, speed in one case, consumer protection in others, different form factors in yet a third. This is where innovation comes into playing, building off consumer trust and resilience, gaining access to open and interoperable systems.

In a time of rapid change, we must create the environment for innovation, enabling European citizens to benefit from the record levels of entrepreneurship we see. But we must never compromise on the security and resilience that makes this all possible and maintains the trust so vital to our economies.

7

ESG AND SUSTAINABLE FINANCE

ISSUES AT STAKE

The need for more sustainable growth is becoming more evident with the increase of climate-related natural disasters and also the Covid pandemic, which questions globalised economic value chains and demonstrates the impact that the economy may have on biodiversity. The financial sector, the economy and the society as a whole need to mitigate the likely consequences of such emerging risks. In addition the importance of going beyond Environmental challenges by addressing also Social and Governance ones is increasing.

Transitioning the economy towards this new objective however requires unprecedented efforts to develop alternative sources of energy, reduce the consumption of natural resources and develop a fairer economy. One key contribution to drive those necessary changes is redirecting a higher volume of savings and financing from resource intensive processes towards more sustainable ones. Setting clear and common definitions of what is "sustainable" for companies, investors and policymakers is also essential, as well as facilitating the elaboration and distribution of the related information. Defining dedicated risk-assessment and mitigation approaches is also key.

A great number of initiatives are underway at domestic, regional and global levels to address these pressing issues and the EU is in a leading position in this regard. However, reducing the cost of producing the relevant information, facilitating its sharing and achieving a sufficient level of coordination and harmonisation of the related ESG standards globally is necessary in order to obtain sufficient impact.

ESG GLOBAL AND EU STANDARDS CONVERGENCE

HESTER M. PEIRCE

Commissioner, U.S. Securities and Exchange Commission (SEC)

Rethinking global ESG metrics

Many advocates behind the global environmental, social, and governance movement argue that prosperity alone is not a sufficient measure of society's progress, a position that I believe is unassailable. The challenge we face in addressing the ever-increasing number of issues underlying E, S, and G is daunting. The task before us is to find a way to bring about lasting, positive change to our countries on a range of issues without sacrificing in the process the very means by which so many lives have been enriched and bettered. Accordingly, a shared desire to address these and other societal problems should compel us to rethink our prescriptive approach to ESG and instead find ways to encourage our most precious resource—our people—to devise solutions to the climate-related and other challenges our societies face.

In the United States, the idea of enlisting the securities laws to achieve ESG objectives is gaining traction among activists and policy elites with a particular emphasis on requiring disclosure of specific ESG metrics. Some are urging us to closely align our rules with our European friends who long have been working on devising a comprehensive set of ESG disclosure metrics. Others would like to see us rely on standards developed and governed by an international body, such as the work being contemplated by the International Financial Reporting Standards Foundation. Indeed, there is mounting pressure to embrace a single global set of metrics, which would facilitate international capital flows and issuers' reporting obligations.

The result of global reliance on a centrally determined set of metrics could undermine the very people-centered objectives of the ESG movement.

At first glance, everything sounds good—common metrics demonstrating a joint commitment to a better, cleaner, wellgoverned society. Common disclosure metrics, however, will drive and homogenize capital allocation decisions. A single set of metrics will constrain decisionmaking and impede creative thinking. Unlike financial accounting, which lends itself to a common set of comparable metrics, ESG factors, which continue to evolve, are complex and not readily comparable across issuers and industries. The result of global reliance on a centrally determined set of metrics could undermine the very people-centered objectives of the ESG movement by displacing the insights of the people making and consuming products and services.

Hampering the ability of the markets to collect, process, disseminate, and respond to price signals by boxing them in with preset, government-articulated metrics will stifle the people's innovation that otherwise would address the many challenges of our age. Moreover, converging standards would be antithetical to our existing disclosure framework, which is rooted in investor-oriented financial materiality and principles-based requirements to accommodate the wide variety of issuers.

The European concept of "double materiality" has no analogue in our regulatory scheme and the addition of specific ESG metrics, responsive to the wide-ranging interests of a broad set of "stakeholders," would mark a departure from these fundamental aspects of our disclosure framework. The strength of our capital markets can be traced in part to our investor-focused disclosure rules and I worry about the implications a stakeholder-focused disclosure regime would have. Such a regime would likely expand the jurisdictional reach of the Commission, impose new costs on public companies, decrease the attractiveness of our capital markets, distort the allocation of capital, and undermine the role of shareholders in corporate governance.

Let us rethink the path we are taking before it is too late.

The views represented herein are my own views and not necessarily those of the U.S. Securities and Exchange Commission or my fellow Commissioners.

CARMINE DI NOIA

Commissioner,
Commissione Nazionale per le Società e la Borsa

A sustainable ESG strategy to avoid unsustainable consequences

Financial markets do love heterogeneity. Corporate Governance last decade's debate has been centred on the idea of cultural and gender diversity. Modern finance theory itself is grounded on the principle of diversification: Markowitz's portfolio selection framework is based on the research of uncorrelated assets. In order to valorise heterogeneity (of contents), however, we need homogeneity (of forms).

A single shared language must be spoken within a boardroom; agreed measures of risk/returns must drive every portfolio selection.

The same holds for corporate information: specificity of context must be conveyed through standardized and comparable languages. This is particularly true with regards to the emerging wave of ESG information.

The biggest challenge for our generation, with Covid-19, is climate change and, attached to this, the related social inequality and human rights violations. We decided to tackle these issues requiring companies to be to be sustainable in order to receive funding. This is a strategy that puts a heavy responsibility on us. EU has a very strong commitment and our job is to enforce EU ESG regulations but also to put in place, in my view, a surveillance on any unintended side effect that has to be reported back to EU to fine tune the framework.

Much more is needed. Transparency and standardization must be the core of our strategy, i.e. data. Data published by companies, and lately, as remarked by ESMA, ratings published on companies. Beneath these needs there is also the need of consistency and comparability in sustainability reporting drawn up with different standards. It's so impelling that this is the way on which are working the standard setters of the non–financial information, (CDP), Climate Disclosure Standards Board (CDSB), Global Reporting Initiative (GRI), International Integrated Reporting Council (IIRC) e Sustainability Accounting Standards Board (SASB) and on which both IFRS Foundation and EU, by means of EFRAG and ESMA, are moving.

The priority now must be a clever proportional regime for disclosing non–financial information. Disclosure has a cost; so many companies simply do not disclose their ESG situation. If investors and lenders became more demanding on 'green' and 'sustainability', a side effect could quickly arise: a company that does not disclose ESG information can be cut off by financial market or, at least, by cheap funding. Obviously this is the aim of the strategy in the background, but the size of the company 'matters'; while big companies can afford big investments in transition and in reporting, SMEs have to decide whether to invest in transition in sustainability or in disclosure or in which mix of these, because the cost of disclosure could be not light. This need of proportionality becomes more urgent the more we approach standardization and ratings and reports are issued. Moreover, poor, or lack of, non-financial information could also have an impact on the supply chain entities in case the top-chain company requests all the suppliers to disclose their ESG data. Not providing this could lead a cut off even here.

> The priority must be a clever proportional regime for disclosing non–financial information.

Related to this, if we think about production district, whose typical feature is to be built up on many specialized micro and small companies, then we can have – and in Italy we do have many textile, mechanics, furniture districts – wide regions where the success of the general strategy, if not accompanied by deemed disclosure, can be potentially disruptive due to the effect either on the funding (being cut off by cheap one) and on the revenues (being cut off by supply chain).

We need to manage the possible unintended consequences that ESG strategy may have more negative immediate effects on people and communities than positive future effects on the environment.

KATHARINE BRADDICK

Director General,
Financial Services,
HM Treasury

The case for global corporate sustainability reporting standards

Investors, governments, civil society and citizens are demanding better information from companies about social and environmental performance and impacts, but the reliability and the quality of reporting is often lacking. Today there is significant global variation in the information on sustainability impacts that many stakeholders want corporates to disclose. However, in the case of financial markets – which by their nature are inherently international – there is an acute need for global comparability.

Consistent corporate disclosure of sustainability-related information relevant for enterprise value is foundational to investors managing short, medium and long-term sustainability risks. Voluntary sustainability metrics, frameworks and standards in this area have proliferated in recent years, most notably through the Taskforce on Climate-related Financial Disclosures (TCFD) recommendations. Today, the TCFD has become the pre-eminent framework for climate-related reporting on enterprise value.

Whilst private sector convergence around the TCFD is clear, voluntary action in the private sector has most likely progressed this cause as far as it can, to the point where public sector co-ordination is now needed to ensure consistent, comparable and reliable disclosure. With that in mind, last year the UK became the first country in the world to announce our intention to make TCFD aligned disclosures fully mandatory across the economy by 2025. Of course, the EU's ambition on sustainable finance has also been world-leading, marked by an unrelenting focus on aligning the economy with the Paris Agreement objectives. One foundational element of this is the on-going review of the Non-Financial Reporting Directive (NFRD) which is seeking to significantly strengthen corporate sustainability reporting in the EU.

> Global baseline standards are the only way to deliver truly consistent and comparable sustainability reporting across jurisdictions

Nevertheless, although jurisdictional sustainability disclosure regimes – being developed in the EU, UK and elsewhere - are an important lever for improving the quality and quantity of reporting, so too are common international standards. Such global baseline standards, built from the now established TCFD, are the only way to deliver truly consistent and comparable sustainability reporting across jurisdictions. Whilst a few months ago this might have seemed impossible, today's geopolitical context makes this not just feasible, but increasingly likely to happen at pace.

The IFRS Foundation are rapidly advancing the establishment of a Sustainability Standards Board (SSB) under their remit, in close collaboration with IOSCO, FSB and other international organisations, with preparatory work on the development of standards underway. Ahead of COP 26, the UK government is calling on countries to announce their intention to implement TCFD disclosure obligations across the economy, and to join us in supporting the proposed IFRS SSB, with a view to seeking to adopt future SSB standards when appropriate.

Crucially, standards from the IFRS SSB will be delivered through a building blocks approach, allowing individual jurisdictions and regions to supplement baseline international standards with additional domestic corporate disclosure requirements that capture wider sustainability impacts. This is important given the SSB will develop standards on information relevant to investors on enterprise value creation in the short, medium and long-term.

The UK fully supports this building blocks approach, it promotes international convergence on a global baseline, without constraining the ambition of individual jurisdictions or regions. This will be an important consideration for the EU, as it explores establishment of a European sustainability reporting standard-setting body. With that in mind, IOSCO and the IFRS Foundation are progressing the establishment of an expert multi-stakeholder committee to help the SSB co-ordinate with reporting requirements on wider sustainability impacts.

The EU's long-standing commitment to promoting international standards, and leadership and expertise on sustainability disclosure, places it in a unique position to both inform and integrate common baseline international reporting standards. At the same time, EU leadership – including through the International Platform on Sustainable Finance - is needed to promote cross-jurisdictional convergence on sustainability reporting matters that stretch beyond this baseline.

ANNE FINUCANE

Vice Chairman,
Bank of America and Chairman,
Bank of America Europe

The ESG agenda needs global actionable commitments

For some years now, we have seen an increased focus from the private sector in addressing society's most pressing issues. Now, the ESG agenda has real momentum, and collaboration is key. It is vital that companies across industries work together to achieve the United Nations Sustainable Development Goals (SDGs).

Even before the pandemic, there was an understanding that it would take the creativity, innovation, energy and resources of the private sector to address the major needs of society, as broadly reflected in the SDGs.

Companies have responsibilities to all their stakeholders – shareholders, clients, employees, and partners in the communities where they operate. There is an increasing expectation that companies should integrate ESG considerations and impact into their core purpose, strategy and operations. This is being driven by three big dynamics: 1) widespread understanding and agreement that there are large, systemic global issues that we must address urgently; 2) the growing belief that corporations have a role and responsibility to address these issues (stakeholder capitalism); and 3) an increased understanding – validated by BofA Global Research -- that companies that manage ESG well perform better over time. This, in turn, helps prompt investors to direct capital toward companies with strong ESG characteristics.

However, we need effective principles of governance to ensure companies are really integrating ESG into their operations. Stewardship, accountability, and transparency are the principles companies should follow. Stakeholders are seeking greater transparency around ESG alongside the transparency in financial reporting that companies already provide. However, the current ESG reporting ecosystem is complex, with ratings organizations and standards setters offering different and sometimes contradictory performance metrics and assessments. Companies and their stakeholders may struggle to know which evaluations matter.

To make real progress, especially in addressing climate change, we need global, actionable commitments and true private-public collaboration and cooperation.

Bank of America therefore supports straightforward, global standards for ESG disclosure, so that companies can demonstrate long-term sustainability and update their progress, alongside their financial reporting, in Annual Reports and other filings. We worked with global accounting firms Deloitte, EY, KPMG, and PwC, together with the World Economic Forum, to help develop common metrics drawn from the most prominent and established standard-setters. More than 70 companies have now signed on to this effort, and that number is growing. The work is contributing to a broader movement toward a global, regulator-approved standard for ESG disclosures. The involvement of private sector companies in this movement is critical.

Private sector action should take place alongside the public sector. Government programs, including statutes and regulations, can be important drivers of change. Often, government defaults to "sticks" – regulation or restrictions if economic concerns don't take the desired actions. But the private sector is leading in many instances, and the public sector can encourage accumulation of private sector participants through incentives. Incentives, combined with regulations, have worked very effectively. In the US, for example, renewable tax credits have driven significant scale-up of wind and solar investments, making them cost effective today.

In Europe, the EU has taken the lead on the fight against climate change, sustaining and even increasing the pace throughout the pandemic. Europe is committed to addressing climate change and driving toward a low-carbon, sustainable future. This is what the EU Green Deal demonstrates: a fully-fledged and purpose-driven plan for Europe to reach its climate neutrality goal. But the Green Deal might consider including incentives to further stimulate private sector engagement and allow a green economic recovery as well as a just transition.

The US is once again at the same table as the EU and the rest of the world, increasing the focus on the ESG agenda. To make real progress, especially in addressing climate change, we need global, actionable commitments and true private-public collaboration and cooperation.

NATALIE WESTERBARKEY

Director & Head of EU Public Policy, Fidelity International

Globally consistent ESG policies are indispensable for international finance

Undoubtedly, sustainable finance is accelerating as investor demand is rising. In order to meet the demand, asset managers and financial institutions are increasingly incorporating ESG criteria into the investment and distribution process. In parallel, corporates are working to provide greater transparency through non-financial reporting. Fidelity International developed an in-house proprietary ESG rating tool launched in 2019, evaluating its investee companies on ESG metrics. This approach is a key building block for enhanced corporate engagement on non-financial factors with investee companies, and in response to investor client demand as well as policy expectations. Recent data evidence confirms a correlation between financial and non-financial factors, as companies with robust ESG scores have on average suffered less financial loss and outperformed.

To continue the journey from here, the work of policy makers in the area of sustainable finance is indispensable for the success of the financial sector and corporates to transition towards a greener financial system and economy. ESG policies provide guidance for asset owners, managers and corporates on the definition of sustainable economic activities and their application in practice. It is imperative that ESG standards converge at international level so to prevent regulatory arbitrage across global jurisdictions, as capital flows are international, and corporates operate across global supply chains.

At the heart of the success lies an improved and standardised approach to corporate disclosure. In the EU, corporate transparency is driven by a revised EU Non-Financial Reporting Directive (NFRD), which is expected to result in more comparable and meaningful disclosures. Consequently, investors may have better quality data in future when engaging with the investee companies on sustainable corporate governance. However, investors are already valuing corporates on both their financial and non-financial performance today, since the EU's Sustainable Finance Disclosure Regulation (SFDR) entered into force in March 2021.

> It is imperative that ESG standards converge at international level.

Therefore, it is essential that corporates swiftly disclose non-financial data based on international frameworks existing today, developed already by SASB, the Sustainability Accounting Standards Board, and the FSB's TCFD, the Financial Stability Board's Task Force on Climate-related Financial Disclosures created in December 2015. EU sustainable policy initiatives ideally would build on these frameworks and develop them further as envisaged through the double materiality concept embedded in the future, revised EU NFRD.

Likewise, it is welcomed that EFRAG, the European Financial Reporting Advisory Group, aims to ensure that IFRS - International Financial Reporting Standards - takes into account European needs. Consequently, the investor community is hopeful that globally consistent minimum sustainable reporting standards are developed by policy makers and existing frameworks applied today by the corporate community, responsive to regional needs. IOSCO's urgent call for globally consistent, comparable and reliability disclosure standards in February 2021 and commitment towards working with the IFRS to develop an SSB - Sustainability Standards Board - is highly encouraging to achieve global convergence.

The EU's efforts to establish a dialogue through the International Platform on Sustainable Finance (IPSF) could be the critical path towards achieving global convergence of ESG standards and already includes major countries in the Americas and Asia Pacific. Hence, asset managers welcomed that the United Kingdom joint the IPSF at the beginning of 2021 and encourage also the United States becoming a member, as they are indispensable in successfully achieving the global convergence of ESG standards. COP26 this year will also represent a key opportunity to align international sustainable finance policies.

Most importantly, in the interest of investor protection - both retail and institutional investors - international convergence of ESG standards including eco-labels for financial products will be vital. Ideally these in future will be built on global, not just on regional policy initiatives such as the EU Taxonomy, corporate disclosure and SFDR ESG product classification. Hence, international ESG policy convergence will ultimately benefit the end investor.

JESSICA GROUND

Global Head of ESG,
Capital Group

Why reporting on human capital matters

The events of 2020, including the impact of Covid-19 on social imbalances and the murder of George Floyd have very firmly put the "S" back into ESG. However, apart from media headlines bringing social considerations into the spotlight, little has been said about what this might look like for company reporting.

ESG reporting today

ESG-related disclosures by issuers are largely made on a voluntary basis. In the absence of a mandatory ESG disclosure framework, companies exercise their own discretion in determining which ESG risks and opportunities are material to their business and which to disclose to investors. The result has been a lack of consistency, quality and comparability of ESG data, which is of limited value to investors.

Companies are making progress on environmental and governance reporting. Indeed, they have been providing governance reporting in one form or another since the first corporate came into being. The Financial Stability Board's Taskforce on Climate-related Financial Disclosures (TCFD) has helped make progress on a major aspect of environmental reporting with a focus on climate change-related risks.

What is the state of Human Capital reporting?

In the last year, Capital Group invested over 4,000 hours of analysts' time in building our bottom-up ESG frameworks. These frameworks give us an excellent understanding of which issues matter most to the companies in which we're invested. This in turn builds our understanding of the impact that companies have on their local communities, the broader economy and the market as a whole. This level of detailed analysis reveals just how much an issue of unique importance, human capital is.

Today, there is little or uneven reporting on even the simplest human capital indicators.

More and more of the value of companies, and hence the savings of people, is represented by intangible assets such as software, brands and data, all of which is driven and sustained by human innovation. Yet while an investor can find out exactly how much is invested in research and development or the cost of new equipment, finding out how much has been invested in workforce training is much more difficult.

> It is widely acknowledged that we face a climate emergency...

What is missing from current requirements?

Last year, the Securities Exchange Commission (SEC) acknowledged the importance of human capital but stopped short of providing specific reporting requirements. They called for companies to disclose the number of employees and a description of its human capital resources if material to the business as a whole.

Training, recruitment, safety, engagement and mention of objectives are all voluntary. This coupled with US Generally Accepted Accounting Practices (GAAP) requirements means that even calculating what the average employee earns is difficult.

The EU's Non-Financial Reporting Directive (NFRD) currently has one human capital reporting requirement, on diversity. But the fact that individual member states have added in additional requirements such as board diversity, distribution of employees in terms of age, gender and pay indicates more is needed.

What we'd like to see

Companies are reporting more on a voluntary basis but much more can be done to encourage more disclosure of the following:

1. Total workforce cost
2. Employee turnover
3. Comprehensive workforce demographic data (EEO-1 equivalent in the US)
4. Total cost and hours of employee training provided
5. Gender pay gap reporting
6. Monitoring of internal engagement and workplace culture

What is also crucial is that this information and these disclosures apply globally. Indeed, global consistency is a key factor in allowing investors to make valuable comparisons across regions and can help companies draw financing from a wider range of investors.

We believe these six metrics would put "S" on equal footing as other types of environmental and governance metrics. It is widely acknowledged that we face a climate emergency, let's not wait for the next human emergency before we start reporting on human capital.

KAY SWINBURNE

Chair of KPMG's EMA FS Regulatory Insight Centre (RIC) and Partner, KPMG in the UK

Defining ESG: the journey to convergence

In order for financial firms and institutional investors to measure their ESG exposures, they need data from the companies and projects they fund, insure or invest in, including other financial firms and products. Without mandatory and consistent definitions, metrics and reporting, it is difficult for firms to obtain the data they need, let alone verify their accuracy. Listed corporates are responding by improving their ESG reporting and credentials, but there are still many data gaps, a lack of consistency and differences across asset types.

Individual jurisdictions are taking different approaches to sustainable finance regulation. Some governments have developed over-arching strategies. Some regulators have adopted specific requirements, while others have, to date, tended to leave it to market forces. Given global concerns about the diverse range of sustainability standards, standard setters have joined forces to strive for consistency in corporate reporting, including recent confirmation by the IFRS Foundation Trustees of their intent to establish a global sustainability reporting standards board, building on existing frameworks. So, there is progress, but there is still a long way to go.

A fundamental difference is whether we are talking about climate change, environmental risks more widely or the full set of ESG factors. The UN Sustainable Development Goals, the recommendations of the Taskforce on Climate-related Financial Disclosures, the EU Taxonomy Regulation and Sustainability Accounting Standards Board (SASB) framework focus on different aspects. They are also a mix of definitions, metrics and reporting standards, as are the various industry initiatives. Other jurisdictions are entering the debate but are indicating they intend to write their own detailed requirements, which may make convergence challenging.

Throughout the convergence journey, a balance needs to be struck between detail and flexibility.

Around the globe, the focus is largely on corporate reporting and rules for listed firms. The EU financial services industry is at present alone in also being subject to specific ESG FS regulation. Those rules currently fall on benchmarks providers and the buy-side (asset owners and managers). They require disclosures at both company and product levels. The fact that these FS disclosures are different and additional to corporate reporting can be confused. And more product rules are on their way: the Green Bond Standard and EU Eco-label for retail products.

The EU supervisory authorities have set our clear expectations that banks and insurers should incorporate ESG risks into their overall risk frameworks and stress testing. The UK PRA led the way on this and the US Federal Reserve Bank has recently indicated similar expectations. EU regulation is expected in this area, too. The European Commission's renewed Sustainable Finance Strategy includes proposals that climate and environmental risks should be fully managed and integrated into financial institutions' operations, and that social risks should be considered where relevant.

In order to comply with this rapidly growing body of regulation, firms need data that are not only comprehensive and consistent, but also reliable. It is notable that the Technical Expert Group's recommendations to the Commission on the Green Bond Standard include mandatory verification by an external accredited verifier, of both the bond's framework and its allocation reports – how proceeds have been used. There is no similar requirement yet for external assurance on corporate reporting that sits outside the audited financial statements. A few companies are voluntarily seeking such assurance, but until this becomes commonplace, users have to trust the veracity of the disclosures made.

The journey to convergence will not be easy. The more detailed standards and rules become in one jurisdiction, the more difficult it may be for others to converge with them. This tension is playing out within the EU as regards the detailed Level 2 rules under the Taxonomy Regulation. The 30-page Level 1 Regulation is already supplemented by 500 pages on two of the six environmental objectives with perhaps 1,000 more pages to come. And the debate on defining S – social – has still to come. Throughout the convergence journey, a balance needs to be struck between detail and flexibility.

DANIEL HANNA

Global Head,
Sustainable Finance,
Standard Chartered Bank

Improving sustainability reporting to catalyse private finance

It has been a challenging year. The growth in sustainable finance and the momentum to 'build back better' in response to the Coronavirus pandemic are small positives but are important ones that can set us on the path to a more environmentally and socially sustainable world.

Complementary to this growth, we are seeing the steady and inexorable shift from the consideration of environmental, social and governance (ESG) issues as reputational matters to a reflection of a company's performance. This is an important driver of capital inflows to 'sustainable', 'ESG' or 'climate' activities. It also raises the bar on the volume of information that the financial sector needs from its clients in identifying the underlying economic activity, and that it needs to provide to investors on the extent to which their investment has enabled sustainable outcomes.

The drive for more information is not just coming from the financial sector. Our 'Zeronomics' report (https://www.sc.com/en/insights/zeronomics/) shows 81% of senior managers of companies want standardised, globally consistent measurement and reporting standards and believe these would help accelerate their net-zero journey.

Reporting frameworks are a critical tool in unlocking investment in the fight against climate change and the delivery of sustainable development globally. Yet we know that access to capital remains a key barrier. The financing required to keep global warming to an increase of just 1.5 °C may be as high as USD8 trillion annually, and the UN estimates that the funding gap to reach the Sustainable Development Goals (SDGs) by 2030 is USD2.5 trillion a year. As policymakers consider how best to enable sustainable or climate finance through reporting frameworks, we encourage progress in three areas.

First, greater focus on transition. Many of the frameworks put in place are backward facing, yet we are united in the goal of enabling the transition to low-carbon, which implies we are not where we want to be. Taxonomies, in this context, give a clear view of 'green' or, in the EU's case, 'net-zero aligned' exposures, but that is not the same as understanding a company's direction of travel and progress against those targets. Given the planet's finite resources, we also encourage moving the wider economy to reporting on a 'double materiality' basis to help in investment decision making, though financial materiality will take longer to establish.

> We need to recognise that impact matters as much as volume; indeed 'where' may be more important than 'how much'.

Second, international consistency and the avoidance of fragmentation. More effort is required to increase, improve and harmonise data and disclosures from all sectors of the economy, in particular from emerging markets which are the most at risk from climate change but also represent the biggest investment opportunities. Information is improving thanks to initiatives such as the Task Force on Climate-related Financial Disclosures. However, the quality and consistency of broader sustainability data is often poor, non-comparable and inconsistently disclosed.

Internationally, we are seeing fragmentation undermine progress. The proliferation of taxonomies for example prevents interoperability, increases the compliance burden on companies operating across multiple markets, and ultimately prevents global sustainable capital mobility. The International Platform on Sustainable Finance has great promise in bringing about convergence.

Finally, as we emerge from the Covid crisis with constrained resources, we need to recognise that impact matters as much as volume; indeed 'where' may be more important than 'how much'. A dollar invested can have a significantly different outcome depending on where and how it is deployed. As our first sustainable finance impact report (https://av.sc.com/corp-en/content/docs/Sustainable-Finance-Impact-Report-Sept2020.pdf) highlighted, financing a solar project in India will help avoid more than seven times the CO_2 from a similar-sized project in France given the current sources of power on those countries' grids. This is why we are proud that out of our USD3.9 billion of verified sustainable financing, 91% is in emerging markets and 86 per cent is in some of the world's least developed nations.

With the right frameworks put in place, with the EU leading on this important agenda, we can ensure that we meet the next global crisis – the climate crisis – head on.

EU SUSTAINABLE FINANCE TAXONOMY

PAUL TANG

MEP, Committee on Economic and Monetary Affairs, European Parliament

The EUs sustainable finance agenda, a first step of many

The pace of technological change continues to rise and as a result the impact of technology on people's lives is getting greater. The pandemic has clearly brought technology further to the forefront of our minds and is accelerating changes in consumer behaviour.

As new operators and business models emerge, it is essential to consider all of the new and different players in the financial ecosystem from the end user's perspective. For instance, as a broader range of firms from a diverse range of sectors seek to offer retail and potentially wholesale financial products, there is a need to ensure that consumers are provided with the same level of protections, and that all those participants who offer the same service, undertake the same activity, or expose consumers to the same risk are subject to equivalent regulatory requirements on a proportionate basis. Without this, consumers will face an inconsistent experience, with the potential customer detriment counteracting the benefits of greater competition and creating potential risks for market integrity and potentially also financial stability.

Despite the rapid technological changes and the emergence of new digital players, large and small, regulation has developed to respond to the traditional 20th century business model, which regulates based upon product, manufacturer and issuing or distributing entity. This creates a narrow regulatory perimeter applicable to these industries. However, a 21st century "platform company" does not need to create the underlying financial product or service to become a leading digital aggregator and distributor of those products and services. This can – in the case of financial services - create a substantial financial marketplace to complement a non-financial services marketplace. In other words, in the connected economy, a position of strength in one market, led by data, can readily be used to access another very different product market.

Looking forward, as the number and type of business able to access consumer spend data increases due to Open Banking and PSD2 this is likely to have further transformational effects on the composition of the new financial ecosystem and therefore critical components of financial markets infrastructure. The increase in competition for consumers is to be welcome, but there is a need to address how we collectively provide for the protection of consumers and clients and also to ensure a fair playing field for all market participants. Looking at the ecosystem from a consumer perspective, it will be increasingly difficult for consumers to understand the risk profiles of products attached to different entities and the associated protection they may or may not enjoy without further assistance from regulators. Understandably, a consumer sees products that are interchangeable for their needs, rather than considering in detail their regulatory regimes. There is a significant risk that an industry defined approach to regulation will fail to recognize emerging risks posed by the market changes noted above, and result in customer detriment.

In addition, a key barrier to innovation for firms is the lack of regulatory clarity regarding how 'new' and 'emerging' technologies, such as distributed ledger technology (DLT) and artificial intelligence (AI) may apply to financial sector use-cases. The current regulatory frameworks across the globe were not written with these technologies and the wider ecosystem in mind, and therefore they may not be fit for purpose. Whilst the principle of technology neutrality is important it is also essential that regulations consider the technologies where relevant. In addition, with global regulatory and supervisory direction constantly evolving, one of the main barriers results from some of the inconsistencies from one jurisdiction to another and resulting fragmentation.

Quite apart from this, there is a lack of consistent regulation of underlying products, with some at a more advanced stage unified regulation at the European level (e.g. the UCITS directive, which creates a harmonised framework for investment funds that can be sold to retail investors throughout the EU using a passporting mechanism), and other, substantial areas such as mortgages remain mostly regulated at the national level. Similarly, investments and trading have been tackled effectively at the European level, with the creation of ESMA; but while such "asset-side" regulation has been advancing, the "liability-side" (borrowing and lending) has yet to achieve the same level of harmonisation. This creates a further gap in safeguarding customers' interests at the European level and in completing the single market.

These issues are recognised by the regulatory community. Steps such as the European Commission's Digital Finance Strategy, which aims to amend the regulatory framework to make it fit for the digital era and achieve a level playing field across entity types, will be crucial in helping solve these challenges. Further, given the cross-border nature of innovation, collaboration by policymakers in different jurisdictions is essential. Regarding underlying product areas, the European Commission recognises the continuing fragmentation of credit markets, and while the Mortgage Credit Directive was a good first step towards an EU-wide mortgage credit market with a high level of consumer protection, it needs to act as a foundation and not an end-point. This is all the more important in an age of digital delivery of financial services.

CARLOS
SAN BASILIO

Secretary of the Treasury,
Ministry of Economy
and Digitalization, Spain

EU Taxonomy: the programming language of the European green deal

«The EU Taxonomy as the catalyst for the green economic rebound»

We are still in the fighting phase of the COVID-19 crisis, but fortunately, the end is in sight, thanks to the progress in the roll-out of COVID-19 vaccines across the EU and the selfless sacrifices made by the frontline corona-warriors and by all the companies and workers who have borne such a disproportionate share of the burden.

As we are starting to see the light at the end of the tunnel, it is becoming ever more evident that the economic recovery will be green, or it won´t be at all. This conclusion derives not only from the fact that the European and national public support schemes will be financing to a large extent environmentally and socially sustainable economic activities. Indeed, a fair transition to a green economy is not a mere policy choice nor an experiment designed in a laboratory. We just need to look at the crisis wrought by the coronavirus as an early warner of what could potentially happen should a climate disaster strike. The Covid-19 pandemic will eventually subside, but the climate crisis is here to stay.

The green recovery will not happen just by accident. And showing goodwill when it comes to promoting a transition to a green and sustainable economy won´t be enough either. We need to find the right incentives in order to direct investments to green activities and start thinking more from a long-term perspective. Such a paradigm shift in economics requires not only significant investment from both the EU and the national public sector, but also from the private sector. Even more importantly, it must be based on a new programming language, that maps the way things are and that encourages people to effect change in the world. As we all know, language is action, and the EU Taxonomy will become the new programming language of the green economy that is yet to come.

> We need to find the right incentives in order to direct investments to green activities and start thinking more from a long-term perspective.

From this perspective, it is clear that Taxonomy is not only about organizing and classifying. Which industries should qualify for support? Should investments go exclusively to self-evidently green sectors or also to firms in carbon-intensive sectors trying to clean up? How can stakeholders be brought together to formulate a vision for the future and how can such a vision be implemented? In the public arena, where stakeholders often have very different incentives, this can be particularly challenging. We need therefore to also consider that the key concern for many companies, regions and cities is the 'fairness' portion of the 'fair and green' transition.

As we create this new language, we must work with all stakeholders to ensure a just transition where nobody is left behind and that the EU Taxonomy is workable and dynamic, responding to changes in technology, scientific evidence, new activities and data. The upcoming Delegated Act establishing the screening criteria for economic activities contributing substantially to climate change mitigation or adaptation, is a very important step in this process. Furthermore, a common EU database of Taxonomy reports would ease transparency and comparability, while avoiding duplication of data collection efforts.

In this regard, I think it is fair to acknowledge that the Commission is trying its best to come up with innovative solutions in order to create a single market for data by connecting existing databases through digital means. And, why not, maybe it is also the right time to take advantage of the latest technology, such as Distributed Ledger Technologies, to provide a single point of access to information relevant to investors and companies. Eventually, progress in this area will naturally spill over to the workstreams on taxonomy of "brown" and "social" activities, which would enhance comparability and reliability of ESG data.

Technical discussions on the EU taxonomy and political discussions on the broadness of the transition category that recognizes companies' efforts to invest in becoming carbon neutral, are not only inevitable, but a fundamental aspect of democratic law-making. As long as we have a clear sense of direction and the necessary political goodwill, it is entirely possible for this project to succeed.

JEAN-PAUL SERVAIS

Chairman, Financial Services and Markets Authority, Belgium (FSMA)

The sustainability taxonomy: an additional tool against greenwashing

The Regulation on the establishment of a framework to facilitate sustainable investment (the "Taxonomy Regulation") is an important part of the EU sustainable finance plan drawn up by the European Commission. The Taxonomy Regulation, together with the Regulation on sustainability-related disclosures in the financial services sector, is not only an important enabler for scaling up sustainable investment but also a powerful tool to protect investors from greenwashing. Indeed, by stating what economic activities are sustainable from an environmental perspective and requiring manufacturers to disclose in their pre-contractual documentation the share of the portfolio invested in such activities, the Taxonomy Regulation offers an easily readable and comparable indicator of a product's level of greenness.

The EU cannot achieve the green transition alone, and hence global cooperation is key.

However, it still faces many challenges to ensure its effective implementation. In order to provide accurate information on the products, the information about the sustainability of activities should be easily accessible for all financial market participants, and tools should exist to measure the environmental performance of activities carried out by companies. It will also be essential to take account of proportionality in the implementation, especially in the current economic situation.

The EU cannot achieve the green transition alone, and hence global cooperation is key. Taxonomies, if developed in isolation, might lead to greater fragmentation of practices and could inhibit the growth of global sustainable finance markets. It is therefore important to limit undue fragmentation, e.g. via the International Platform on Sustainable Finance.

For national authorities, the entry in force of disclosure requirements based on the Taxonomy Regulation will entail the evaluation of environmental information published by regulated entities. Moreover, market participants and financial advisers will have to take into account the sustainability preferences of their consumers, and regulators will then have to ascertain that the proposed products adequately reflect investors' ESG concerns. In this respect, it will be of crucial importance for financial market participants to have access to standardised ESG information from investee companies.

It is therefore to be welcomed that the EU is working on a review of the NFRD, in order to enhance the delivery of high-quality sustainability related reporting by corporates. This will facilitate the gathering of information by financial market participants when developing, managing and marketing their products.

In the face of the need for a global response to climate change, the ultimate goal should be to foster coherence and consistency between the EU and global sustainability reporting. In this respect, it is encouraging that the EU is open to working with global initiatives such as the initiative of the IFRS Foundation, which aims, in close cooperation with IOSCO, to develop new global standards for sustainability disclosures by companies.

MARCEL HAAG

Director, Horizontal Policies, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Sustainable finance: a finance agenda for the transition

Sustainable finance is key to mobilising the massive investments needed to meet the objectives of the Paris Agreement and the UN 2030 Agenda on sustainable development goals (SDGs). In the EU, in particular, sustainable finance is vital to reach our targets under the European Green Deal, our strategic growth agenda for a climate-neutral Europe by 2050.The pandemic has not altered this necessity: the recovery needs to support the Green Deal and to catalyse the green transition.

To mobilise private investors,regulators need to set the targets,provide clarity on the direction of travel, and put in place credible and usable tools and frameworks.The EU Taxonomy will play a key role.It provides investors with a robust and evidence-based tool to identify opportunities for green investments in line with our 2050 environmental target.The Taxonomy Regulation adopted in June provides for a general framework that will be further refined through the adoption of delegated acts specifying the technical criteria for an economic activity to be included in the EU Taxonomy. It will be expanded and updated as technology and research evolve.

The first delegated act, defining activities that substantially contribute to the objectives of climate change mitigation and adaptation, will be adopted in April 2021 and enter into force at the beginning of 2022. A second delegated act defining activities that

make a substantial contribution to the other four environmental objectives, namely protection of water resources, biodiversity and ecosystems, circular economy and prevention of pollution, will be elaborated once the Platform submits its technical input in autumn.

Furthermore, a separate delegated act will specify the taxonomy-related disclosures by which companies falling under the scope of the Non-Financial Reporting Directive (NFRD) will have to disclose their key performance indicators, i.e. share of turnover and capital expenditure, in respect of sustainable economic activities. This delegated act is planned to be adopted in Q2 2021 building on the technical advice submitted by the European Supervisory Authorities (ESAs) on 1 March.

The legislative proposal of the revision of the NFRD, to be adopted by the Commission in April 2021, is critical to the success of the sustainable finance agenda.

Sustainable finance is key to mobilise the massive investments needed to meet the objectives of the Paris Agreement and the European Green Deal.

By improving the environmental, social and governance (ESG) information that companies report, it will enable investors and assets managers to better understand the sustainability related risks to the entity (outside-in), and will enable civil society organisations to hold companies accountable for their social and environmental impacts (inside-out).

The Commission is assessing the EFRAG's recently issued recommendations on sustainability reporting standards.Currently,standards represent the best solution to address the lack of relevance and comparability of the non-financial information,as well as to ensure consistency with other pieces of sustainable finance legislation,such as the Sustainable Finance Disclosure Regulation and the EU Taxonomy.However,we recognise the importance of applying proportionate sustainability reporting requirements to SMEs:we are considering a simplified non-financial reporting standard for smaller companies to be applied probably on a voluntary basis.

HIDEAKI TAKASE

President and Chief Executive Officer, MUFG Bank ltd

Taxonomies and the road to decarbonization

The financial sector is making an unprecedented shift to support the transition to a low carbon economy. Environmental and social considerations have been part of financial decision-making for some time now but as a result of geopolitical, societal and market developments, this shift has accelerated at a rapid speed.

Net zero commitments from stakeholders across the public and private sector are becoming more concrete, painting a clearer picture of the shape and speed with which the energy transition will take place.

In October 2020, the new Prime Minister of Japan Mr Suga declared that by 2050, Japan will aim to reduce greenhouse gas emissions to net-zero and to realise a carbon-neutral society. This declaration is a defining moment for Japan's future energy and climate policies, and the government is developing additional policies to achieve this target. Japan wants to cut greenhouse gas emissions by 26% between 2013 and 2030. Other major economies are working towards similar ambitious targets.

We encourage regional policy makers to bring their expertise on taxonomies together, with the aim to design common, globally consistent principles.

These global emissions reduction commitments require a balancing act between energy security, economic efficiency, environmental protection and safety. We need a whole economy transition in which each stakeholder is playing an important part.

In order to understand what the overall transition pathway will look like, we need to rely on consistent and comprehensive data and policy frameworks. Not only will these measure success, they will help financial institutions and central banks assess the risks related to the pathway, while at the same time seize opportunities to enhance and potentially even accelerate the transition.

Taxonomies are essential tools to help put in place a framework for ensuring we all speak the same language about the economic activities which are playing a role in the path to net zero. They assist in driving the economic shift necessary to reach the ambitious goals we set ourselves. We know from various studies that this will require significant investment in renewables, but equally important is the necessity of a significant transition from high-emitting sectors to more sustainable and energy efficient solutions. To reduce financial risk arising, the process of reducing GHG emissions over time needs to be managed in a steady and reliable manner.

Many banks are in the process of developing their own taxonomies with the purpose of supporting clients and facilitating the conversation about transition paths. Multiple taxonomy frameworks complicate for banks active in multi jurisdictions. The market perception of the current EU Taxonomy is that it could give an increased focus on transition and avoid cliff-edges. In this perspective, we welcome the EU's views that taxonomies need to be dynamic and not a static framework, as well as take into consideration transition.

Financial transactions and decision-making, in particular for large banks, are global in nature. Whilst we appreciate the challenges a single, uniform global taxonomy would bring given regional transition paths, we encourage regional policy makers to bring their expertise on taxonomies together, with the aim to design common, globally consistent principles.

ADRIANA PIERELLI

Regional Executive Southern Europe, Managing Director Global Client Management, BNY Mellon

Implementing the taxonomy – challenges and opportunities

"Reforming our financial system in such a way that it not only creates wealth, but that it creates wealth, worth having: that is the challenge we now face" – Bianca Jagger (European Commission Open Hearing on Sustainable Finance, 17 July 2017)

Since Bianca Jagger spoke those words, almost four years have passed.

This is not a complaint. In the intervening four years much serious and substantive work has been done. This remark is rather a reflection of the major challenges inherent in the sustainable finance agenda, and in the creation of a taxonomy of environmentally sustainable economic activities.

A first major challenge is the compatibility with the price system. Prices serve as strong signals guiding investment and economic activity. The data derived from the taxonomy will also serve as a strong signal identifying investments that are sustainable and that will maintain their value in the long term.

It is critical that these two mechanisms complement, and do not counteract, each other. There is in other words a need for public authorities to have a coherent approach across different areas of public policy (including energy, emissions, and transport policy).

It is critical that these two mechanisms complement, and do not counteract, each other.

A second major challenge relates to the design of the taxonomy. A short and simple taxonomy will contain limited information and will give clear and strong signals only for a limited area of economic activity.

A broader and more complex taxonomy will contain more information, covering broader areas of economic activity, but at the cost of clarity and simplicity.

The world is a complex place and managing the transition to a more sustainable economic system is highly complex, with often a need for difficult judgments as to the best transition path.

By its nature – as a piece of European legislation, and as it can be based only on judgments that have a high degree of certainty and of consensus – the taxonomy will be authoritative, foundational, but limited.

In order to meet the challenge identified by Bianca Jagger, we shall need to go beyond the taxonomy.

We shall need other, more diverse, types of data, as well as complementary frameworks that can cater for different and uncertain judgments as to what are the best transitional paths. And we shall need a financial system that uses and creates different types of data, and that facilitates those different paths.

This creates requirements and opportunities.

Key requirements include better access by investors to more, and more reliable, granular source data on companies and securities, as well as more efficient, and more effective, capital markets that can channel savings into diverse forms of innovative investment. We need, in short, progress on the revision to the Non-Financial Reporting Directive, the European Single Access Point, and all other items set out in the Capital Markets Union Action Plan.

Opportunities lie in digital innovation that can help make sense of, and derive insight from, disparate data from diverse sources and allow tracing of proceeds from ESG issuance. They lie in the enormous pent-up demand for green and sustainable investment products. And they lie in public sector actions such as the Next Generation EU issuance which can help create the foundation for liquid and efficient European capital markets.

RAMI FEGHALI

Partner, PricewaterhouseCoopers Audit

Unlocking the European taxonomy potential

The European taxonomy is a granular set of criteria that needs to be met in order to qualify an economic activity as sustainable. It is essentially a tool that will have multiple usages. The most important one will certainly be the requirement for non-financial companies, under the scope of the NFRD, to disclose their share of revenue, capex and opex that is aligned with the taxonomy, starting from January 2022 and based on 2021 information for the two climate related objectives. Financial companies will have similar requirements.

The taxonomy can play a pivotal role in the European environmental transition provided it is properly and swiftly implemented. It can indeed fill two important gaps that are currently preventing a quicker transition of the European economy towards a sustainable economy.

First the extent and the timeline of the industrial transformation that is required at an individual company level is usually still unknown. While the taxonomy does not directly address this issue, which is a matter of regulation

of the real economy, its does address it indirectly by requiring to disclose the alignment with a granular sustainable target, creating the market incentive to converge to this target.

Second, the absence of ESG standardized, reliable and comparable data that can be shared with all users, hinders the ability to measure performance, analyze risk in a consistent way and take informed decisions on the direction of travel. The Non-Financial Reporting Standard will address this; however, the taxonomy disclosure requirements can be considered, de facto, as a first building block of an ESG reporting standard. It will be mandatory, granular, directly linked to underlying industrial activities and its implementation will require significant investments that need to be leveraged.

There are however three important issues to be addressed in order to achieve a proper implementation of the taxonomy. First, public authorities should plan a progressive implementation, the disclosure of a single alignment number can create an illusion of certainty, while most companies will only be able to produce estimates in 2022.

Supervisory bodies and companies need to recognize the underlying uncertainty and be transparent about it, to avoid expectation gaps and what could become a taxonomy washing. Second the taxonomy is currently one sided, it shows what is sustainable today but doesn't say much about the remaining dimensions of the transition: the targets, when these targets will be reached and the other dimensions of sustainability such as the social impact. It must be put in context. The completion of the taxonomy on the remaining dimensions would also help in building a meaningful picture. Lastly, the SME shouldn't not be excluded, they are part of the journey and should be supported on embarking on this journey.

The taxonomy is not a perfect tool, but it is a tool that we can build on. Both public and private sectors should create the conditions of a swift, controlled and large adoption of the taxonomy. It can be the catalyst of the necessary and urgent transformation of our economies and its operational implementation will also secure the consistency between ESG European policy choices and the reporting standards that will prevail.

OLIVER COLLIN

Fund Manager,
European Equities,
Invesco

Climate Change is a generational opportunity for Europe

The Covid health crisis of 2020 created a synchronised economic depression. Europe's response was the creation of a €750bn European Recovery Fund. However, rather than just deploy the capital, Member States chose to focus on a Green Recovery, with a significant proportion of the funds to address the existential threat of climate change and the protection of the environment. In practice, this means EU spending is being guided by the newly developed Sustainable Taxonomy. The EU Recovery Plan is interlocked with the Commissions' 2019-24 priorities that included the realisation that "Europe needs a new growth strategy that will transform the Union into a modern, resource efficient and competitive economy". However, the real prize isn't intra-European, it's global.

European environmental legislation is not new. For years, Europe has been a first mover in safety standards and best practices that have become global standards. However, the European Green Deal marks a more dynamic approach and the Taxonomy has the potential to become the means by which the market will administer the carrot or the stick to companies. Winners will be those seen to solve the environmental crisis and the losers will be those thought to be the cause.

Failure to nurture companies in transition could cause them to wither before sending up new shoots.

Combined these elements create the foundations for success. European companies that exhibit strong alignment with the Taxonomy will see their cost of capital fall compared with those that don't.

The goal of climate neutrality requires significant investment and innovation. However, the proposed technical screening criteria under the Taxonomy fails to reward transition. This risks excluding our existing stock of European companies from being part of the solution. Failure to nurture companies in transition could cause them to wither before sending up new shoots and lead to Europe dependent on imports to achieve its goal. If policy rewards companies through the transition phase we will grant our existing enterprises access to cheaper capital as they change and hence fund more innovation and create the products, services and refreshed jobs to achieve EU prosperity and its climate goals.

This idea of creating a pathway isn't new. Europe has 2030 climate goals as well as the goal of climate neutrality by 2050, which recognises the need for transition plans such as hybrid autos ahead of full electric, coal to gas electricity generation and blue hydrogen ahead of green being viable. We must further embrace this approach and reward companies for becoming less bad, not just those that are good. By focusing on transition, we will incentivise European companies to allocate their existing cashflow towards green innovation as opposed to being forced into ever larger dividend yields.

Europe has grand ambitions and a once in a generational opportunity to steal a march on other continents. Most of the tools in place to achieve success, however failure to promote our existing companies in the transition phase could endanger our goals, including those beyond climate change. With small adjustments to the current agenda Europe has the potential to achieve Net Zero and in doing so become the Silicon Valley of Green Tech including the vibrancy, jobs and innovation that comes with it.

CLIMATE-RISK IMPLICATIONS

SYLVIE GOULARD

Second Deputy Governor,
Banque de France

Climate risks, new risks?

"Climate change is a source of risks that is fundamentally different from the financial risks investors and financial regulators are used to managing" (Bolton et al, 2020) Assessing them calls for new risk models based forward-looking analysis fed with original data. Assessment of physical risks requires very granular geographical analysis of potentially extreme climate events, as well as specific hypotheses regarding how impacts in one place could cascade to downstream activities and locations. Assessment of transition risks calls for developing scenarios of sectorial adjustments at granular level, foreseeing which technologies might prevail in a low-carbon economy, and which countries, regions or firms may win or lose from the diffusion of such technologies.

Accounting for ESG risks also calls for better identifying how specific events that were traditionally not or only poorly assessed by financial agents such as rating agencies could have material financial impact. For instance, firms that do not respect basic social or environmental standards will lose clients and could face costly lawsuits with adverse impacts on market valuation and credit rating. In addition, accounting for climate-related and ESG risks might call for integrating them into macroeconomic and financial models. For instance, the low-carbon transition could have significant impacts not only on GDP, but also on other macroeconomic and financial variables such as the rate of interest or the price of assets. The transition's impacts will also exhibit significant sectorial differences and strong distributional effects. These require that assumptions in models, such as indicating the incidence of a carbon price or the use of proceeds of a carbon tax, be made explicit.

In order to size climate-related financial risks, the Banque de France and the French supervisory authority (ACPR) have run a pioneering stress-testing exercise involving banks and insurers. Launched in July 2020, the objectives are threefold: i) assessing over a long-term horizon the impact on financial stability of disorderly transition pathways as well as a 'hot house world' scenario, relying on NGFS reference scenarios; ii) understanding the strategic and mitigation reactions of financial institutions; iii) and finally, unveiling the main obstacles to a robust assessment of these risks in terms of modelling challenges and data gaps. Significant challenges remain. First, financial institutions need adequate information to differentiate dynamically when assessing counter parties and geographies. They need, for instance, to be able to assess future vulnerability and not only existing vulnerability. Corporate disclosure such as the TCFD at the global level and the revision of non-financial reporting directive in the EU are critical steps.

Second, as climate change has barely started to materialize, climate change-related risks are not historical but modelled events meaning that using traditional methods reliant on historical data is impossible. Accordingly, the stress testing exercise is a starting point for building more appropriate models.

Third, any modelled projection over such long-term horizon needs to be considered carefully. This means questioning the traditional use of supervisory stress-test tools. Quantitative analyses need to be complemented with an assessment of the strategic resilience of supervised entities against climate change.

Finally, the climate challenge is collective and global. Being successful alone is an illusion. Cooperation should prevail, between actors and across borders. The political changes in the US as well as the coming COP 26 represent a great opportunity to make collective progress, improve risk assessment and mitigation, in particular through a better disclosure.

FRANCOIS-LOUIS MICHAUD

Executive Director, European Banking Authority (EBA)

Building a regulatory and supervisory framework enhanced for ESG risks

In recent years, the financial sector and policy-makers have stepped up their efforts to tackle risks stemming from environmental, social and governance factors. These, and climate-related risks in particular – raise considerable challenges: their far-reaching impact, irreversibility, and dependency on short-term actions have the potential to materialize into financial risks at many levels and over multiple, including long-term, time horizons. Financial firms cannot ignore these risks. Neither can they underestimate the role they can play in facilitating a transition towards a more sustainable environment.

Traditional risk assessment tools and metrics were not developed to cater for the specificities of ESG risks in the first place. Challenges related to data and methodologies are many. Nonetheless, financial institutions need to build their long-term risk, strategic and operational decision-making processes to embed ESG considerations. The banking regulatory and supervisory framework is actively adapting to integrate ESG factors and risks into disclosure, prudential rules and supervisory practices, at the global, European, and national levels.

The EBA is actively contributing to this, in Basel discussions, but also by directly supporting the EU Commission work, building on the EU taxonomy. It has started embedding ESG risks into the European regulatory framework by following a sequence whereby key metrics and disclosure[1] are available to support strategy and risk management.[2] Enhanced transparency and disclosures of simple and comparable metrics informing on institutions' strategies, such as a Green Asset Ratio, should allow to gradually get to a better picture of the current situation and on the way forward.

In spring 2021 the EBA will publish the findings of its 2020 pilot exercise on climate risk. The outcome of the pilot exercise represents the starting point for a more comprehensive discussion on how to embed climate risk in the stress test framework in the coming years and will support the EBA in shaping methodological aspects and data requirements. While climate risk stress test and scenario analyses differ from solvency stress test in terms of objectives and framework, they can provide valuable information to financial firms institutions for their own assessments of vulnerabilities and the identification of remediating actions.

The EBA is developing key metrics to support the disclosure and management of ESG risks.

Stabilizing the referential and its metrics is of the essence if financial firms are to integrate ESG considerations into business strategies, risk management and governance. Any adjustments to prudential treatment will come later, based on appropriate evidence.

Addressing ESG risks requires a long-term forward-looking strategic approach. The ambitious EU sustainable finance agenda paves the way for the development of such an approach, bringing together scientific evidence, societal expectations, public policies, and sound and risk-based prudential standards that take into account the impact of ESG factors and facilitate meeting expectations around financing the transition to a carbon neutral economy. Data and methodologies will keep improving. Some first tools have recently been developed and we can now start implementing them.

1. See EBA press release (https://www.eba.europa.eu/eba-launches-public-consultation-draft-technical-standards-pillar-3-disclosures-esg-risks).
2. See EBA Discussion Paper (https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Discussions/2021/Discussion Paper on management and supervision of ESG risks for credit institutions and investment firms/935496/2020-11-02 ESG Discussion Paper.pdf).

WILLEM EVERS

Head of Department,
Supervisory Policy,
De Nederlandsche Bank

Climate-risk implications for the EU financial sector

Climate-risks are high on the agenda of the financial sector and its policymakers. As central bank and prudential supervisor, De Nederlandsche Bank (DNB) is committed to contribute to sustainable prosperity. We are convinced that sustainable economic growth is only possible when we avoid harmful effects on the environment.

DNB's sustainable finance strategy for its supervisory tasks focuses on integrating sustainability-related risks in our supervisory regulations, methodologies and examinations. In a broader context, and leveraging our role as central bank, DNB aims to fuel the public debate by contributing facts and insights about the energy transition and its effects on the economy.

DNB's approach on the integration of climate-related risks in our supervisory practice currently focuses on Data and disclosure, Risk management, and Governance and strategy – which follows the framework of the Taskforce on Climate-related Financial Disclosure. Taking a look at where we are at integrating climate-related risks in the regulatory framework, notable good news is that the need for embedding (financial) risks related to climate change in the prudential regulatory framework is widely recognized.

Encouraged by the expanding Network for Greening the Financial System, there's a growing number of standard setters and regulators taking a serious look at the effects climate change will have on our societies at large and how the risks stemming from these developments should be dealt with within the financial industry. However, amending a prudential framework typically requires quantitative evidence – which is, as of yet, lacking. Collecting such quantitative evidence is hampered by some specific characteristics of climate-related risks, which makes it challenging to adequately reflect their impact in a prudential regulatory framework.

First, whereas a forward-looking approach is key, there is an obvious uncertainty related to the size and timing of climate risks. Second, historical data are of very little use in making climate risk projections. Third, we lack expertise and experience in translating climate risks to financial institutions' financial risks. Furthermore, physical climate risks are subject to sizeable geographical differences, making it hard to generalize the impact of these risks. Fifth, there is a clear interrelation between climate-risks and other environmental risks (eg biodiversity loss), which may amplify their impact on financial risks. This interaction further complicates the design of risk differentials. Finally, the time horizon for climate-related risks tends to be longer than time horizons traditionally applied to prudential standards.

So, what is the way forward? Identifying and mitigating climate risks will require taking a fresh and perhaps non-traditional look at our regulatory toolkit. As the future is not in the data yet, it may be worthwhile exploring tools designed for non-cyclical and long-term events, such as concentration limits and/or targeted risk buffers, along with climate stress testing and scenario analysis.

Having said that, financial market players should not wait for all the regulations, conditions and perfect data sets to be in place before they can have impact. They, too, have a social responsibility to support a sustainable economy.

ÅSA LARSON

Executive director, Finansinspektionen

Climate risks seen from a supervisory perspective

One problem in defining specificities of climate and other ESG related risks is to differentiate and untangle climate risks from other types of risks handled by each financial institute.

So I'd say that the specificities for these types of risks are all about challenges – in the timeframe of the risks, uncertainty of the impact of the risk and also the uncertainty of how this risk can spread to other areas of the financial sector and to society. Not to mention the challenge in determining the size.... This is a fairly new risk area and there is a lot we do not know yet.

There is a lot of published information on sustainability and also the way insurers and other financial companies provide this information to consumers, to investors and to supervisors. In many cases, companies use different types of voluntary standards and frameworks that do specify what and how information should be compiled and published.

This is in itself a challenge since it makes it difficult to assess how companies are financially affected by various sustainability factors. We also still have different disclosure requirements in different regions in the world.

Climate risk - what's in it for a supervisor?

That means that a potential client, an investor or a researcher looking for information will find different data and answers depending on where he or she is situated.

Climate changes and the transition to a low-carbon economy include many and major changes over a long period of time in complex ecological and social systems. It is, as we all know, very difficult to predict the future. Longer time horizons increase the uncertainty and the elements of genuine uncertainty, where risks are particularly difficult to translate into probabilities, are significant.

When uncertain, it is important to work along the lines of scenario analysis. Such analyses can help to illuminate and accept uncertainty. It can also increase the ability to handle unexpected outcomes.

One way to calculate transition risk in financial companies is to analyse how compatible the exposures are with national or global climate goals. A particularly relevant climate scenario is that of the limited global heating.

We see that more and more investors request information on the extent to which companies' operations in a forward-looking perspective are compatible with objectives of the Paris Agreement and how they are affected by the Paris Agreement's commitment to limit the global warming.

My contribution to the panel will be about the importance of data, in order to measure, compare and understand the risks related to sustainability and climate changes. I will also give a few examples of activities and tools in this risk area my authority (the Swedish FSA) has initiated.

EMILIE MAZZACURATI

Global Head of Climate Solutions, Moody's ESG Solutions Group

The true costs of climate change

Climate risk combines the characteristics of a black swan event - hard to predict, highly disruptive - with the inevitability of a systemic shift that we all know will happen. Mark Carney called this tension between the ineluctability of climate change and the limited ability of financial markets to anticipate and integrate long-term factors the "Tragedy of the Horizon."

Climate risk is also defined by dynamic uncertainty: the future will be what we make of it, through our collective policy and economic decisions. Yet some of the changes underway may not be reversible, bringing another layer of uncertainty.

Melting ice sheet and sea level rise, for example, may already be beyond the reach of policy intervention, while scientists are still working to understand the physics of the processes underway. The physical changes, combined with broader environmental pressures – unsustainable natural resources consumption, water stress, biodiversity loss, and their ripple effects -- point to existential threats to human societies that our financial system does not yet know how to fully process.

These characteristics of climate change will mold the shape and features of risk assessment tools. Maps become an essential asset, as climate risk is fundamentally geospatial. To assess their risk, lenders and investors need to understand the spatial distribution of their portfolio – a challenge for many institutions. Climate risk assessments should be forward-looking and as granular as the science will allow; yet that granularity may still not be enough to inform investments and risk mitigation as global climate models perform best at the regional scale.

Pervasive and multifaceted, climate risk should be be mainstreamed and integrated into established risk

management tools and models. To bridge the knowledge gap between disciplines, there will need to be collaboration between economists, financial modelers and climate scientists.

Financial institutions should embrace the complexity of climate impacts on economies and financial systems and be ready to work with a range of models to understand impacts across asset classes, sectors and geographies. They also need to recognize and understand the assumptions, limitations, and uncertainties of the models.

Early efforts to assess climate risks in bank and investment portfolios shed light on the progress and limitations of the exercise. With adequate location and sector data, financial institutions can readily identify core exposure in their portfolios.

The costs of physical risk are grossly underestimated due to data limitations.

While the costs of transition risk are fairly well understood, the costs of physical risk are grossly underestimated due to data limitations, raising the specter of potentially flawed decision making. The discrepancy comes from a lack of historical data on economic and financial weather-related losses, as well as the limitations of climate models in predicting non-linear changes, and the difficulty of modeling second and third order impacts on human and ecological systems.

Addressing these fundamental data and modeling limitations is a critical to incorporating the true costs of climate change in financial and economic decisions.

ALAN SMITH

Senior Advisor
Climate and ESG Risk,
HSBC Holdings plc

The 8Cs of effective climate risk management

Climate Risk is the defining risk management challenge and strategic opportunity for the EU Financial Sector for the generation to come. The Sector has the responsibility to play a leadership role in supporting the transition to the low carbon economy and society by 2050.

This will require that the boards, executives, regulators and investors in financial sector firms are effective at the 8Cs of Climate Risk – Clients; Communities; Culture and Capabilities; Calculations; Controls; Conduct; Contracts; and Communication.

Clients must be central and supported along the entire journey to the Net Zero world, through advice in building credible transition pathway plans and via the provision of financing to enable them to be executed;

Communities of all stakeholders, in particular the vulnerable and marginalised should be engaged, consulted and considered to ensure the Sector plays its role in a just transition so that the Green New Deal works for all;

Culture and capabilities need to be nurtured and enhanced to build financial sector firms with the right climate skills and mind-sets essential to ensuring that economies are built back better for a sustainable future and that green jobs of worth and dignity are created in support of the low carbon economy;

The 8Cs of climate risk management will be essential to EU Financial Sector being effective in supporting the transition to the low carbon economy.

Calculations underpinning climate measurement must be robust. Climate is the ultimate big data area and the calculations for scenarios, climate risk models and warming potential must be developed with rigour to inform data-driven decisions;

Controls need to strong around climate data, disclosures and risk identification. Given all that is at stake, decisions must be evidence based and strong controls must underpin all the processes generating them to ensure that this is the case;

Conduct and treating all customers fairly must be a top priority for EU Financial Sector firms. Climate conduct programmes must be in place from the outset with the overarching goal to protect the climate vulnerable and prevent "green-lining" exclusion in credit decisions;

Contracts need to fully capture and comply with the legal requirements of climate change now enshrined in legislation across the EU. As Nationally Determined Contributions get encoded into laws and regulations, they need to be embedded into contractual relationships.

Finally, Communication must be transparent and ongoing to all stakeholders - the Board, investors, regulators, employees, NGOs, civil society.

As financial sector firms across the EU make real their climate commitments, the context in which they execute them will evolve and it is essential to be communicating transparently and constructively at all stages to all interested parties. The ultimate goal of addressing climate change is to keep average global warming to no more than 1.5 °C by 2050.

To achieve that, many of the necessary foundational actions need to be put in place and commenced over the decade which has just started, through to 2030. To be successful, we must get The 8Cs of Climate Risk right.

JOHN SCOTT
Head of Sustainability Risk,
Zurich Insurance Company Ltd

ESG & climate-risk: implications for the financial sector and EU policy

Despite the pandemic crisis, environmental risks dominate the risk landscape according to the WEF Global Risks Report, for which Zurich is a strategic partner, with 4 out of the 5 top risks being environmental.

The most common perception of climate change risks is the 'physical risks' (melting polar ice caps, sea level rise, retreating glaciers and changes in severe weather patterns). Demands for rapid reductions in greenhouse gas emissions aligned with the Paris Agreement are coming from scientists, climate activists, civil society and increasingly the finance sector. This is driving climate related 'transition risks' as the global economy transforms, moving towards a net zero global economy. New low-carbon technologies are changing investor preferences and consumer sentiment. All of which requires new policy frameworks to influence supply and demand of low carbon products / services and successfully deliver the EU Green Deal.

This transformation comes with risks on a shorter time frame than the physical risks of climate change. The economic and societal impact of the "just" transition will be felt sooner than many might expect. The public and private sectors must act now and focus on developing strategies that build resilience and adapt to climate change. Only then will they be able to take steps that drive the low-carbon transition while managing the risks and opportunities that come with it.

Changes in climate risk assessment and disclosure

The Taskforce for Climate related Financial Disclosure (TCFD) framework for climate risk disclosure is now widely accepted and in some jurisdictions is now mandated for financial services companies.

Discussion and consultation are ongoing to better assess and disclose climate risks. Key issues are about the assumptions inherent in long-term scenario-based analyses, or stress tests and the implications for capital and solvency in the short-term. There are also challenges with standardizing forward-looking metrics and the lack of data on which to base quantitative assessments of climate change risks. This requires using different quantitative and qualitative tools, data and metrics to monitor and assess exposure to physical, transition and liability risks.

Lessons learned

The insurance industry has a long history of analyzing natural catastrophe risks and is addressing the complex task of building long-term climate science simulations into these models. Zurich proposes analytical and risk management tools such as climate risk advisory services to clients to better understand the impacts of climate change on their physical assets and supply chains.

EU policy priorities

Policymakers should enact legislation to continue raising awareness around protection, infrastructure, information gaps for citizens and businesses and to build adaptation and resilience through sustainable investments, sound and adequate risk management tools and metrics. Public-private partnerships will be required to accelerate the delivery of critical policies supporting the transition to a net-zero economy.

The EU Green Deal and Climate Adaptation Strategy is an important first step in this, as will be the ongoing EIOPA work on ESG considerations in pricing and underwriting.

GIANLUCA CANTALUPI
Managing Director and Global Head of Reputational, Sustainability and Climate Risk, Credit Suisse International

Putting ESG front and centre for our business and risk management strategy

Regulations and internal risk management frameworks of banks have often played catch up to cover risks after they manifested themselves, for example, the introduction of liquidity coverage requirements after the 08-09 crisis. It is difficult to set guidelines and internal constraints without a clear historical example of what can go wrong.

This is where ESG themes, and in particular climate risk, are breaking new ground. We cannot afford to witness multiple events with catastrophic environmental, social and financial consequences, before acting. Hence, the need to be forward-looking, proactive and brave.

At CS, we have committed to setting Science Based Targets within the next 24 months for achieving net zero emissions from our operations, supply chain & financing activities no later than 2050. We have developed sector-specific Client Energy Transition Frameworks (CETFs) which identify priority sectors/industries and set out a methodology to categorize clients that operate in these sectors according to their energy transition readiness. In this way, we aim to actively encourage clients to transition along the CETF scale over time and support them through financing and advisory services.

To advance framework developments across the ESG spectrum, we participated

in many industry-wide initiatives, including, the Equator Principles, the PACTA project[1], and the Task Force for Nature-Related Financial Disclosures (TNFD).

Key concepts such as reporting greenhouse gas emissions, disclosing biodiversity-related aspects and reporting D&I statistics, are increasingly becoming standard. However, there is a need for more transparency and standardization on an international level to make approaches more comparable and to minimize greenwashing, while increasing the availability of reliable data. This should not come at the expense of flexibility required to recognise emerging risks.

At CS, we have aligned Reputational, Sustainability, Credit and Compliance processes to develop a more holistic perspective when managing the bank's client risks. ESG factors are currently considered mainly based on qualitative criteria, but we are adding more structured KPIs, leveraging internal & third-party data. Credit decisions should be taken with full consideration of ESG matters, especially for clients in sensitive sectors & countries.

There is a need for more transparency and standardization on an international level to make approaches more comparable and to minimize greenwashing...

Looking ahead, we see merits in exploring mechanisms in the prudential framework to provide a preferential treatment for green investments while ensuring that requirements remain risk-sensitive. Capital needs to be sized based on a forward view, while existing models tend to look back. Forward-looking stress testing is the key tool to obtain insights and explore risks to inform business strategy. Unfortunately, models are still at an early development stage, and data is scarce.

Our ambition is to become a Sustainability leader. However, the financial system can only facilitate the transition - governments must also play their part by charging the cost of pollution at source. Together, we share the responsibility to protect the planet and drive towards sustainable prosperity.

1. Paris Agreement Capital Transition Assessment

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ABOUT EUROFI

The European think tank dedicated to financial services

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

OUR OBJECTIVES

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

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

OUR APPROACH

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

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

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

OUR ORGANISATION AND MEMBERSHIP

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

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

OUR EVENTS AND MEETINGS

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

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

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

OUR RESEARCH ACTIVITIES AND PUBLICATIONS

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

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

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