SESSION SUMMARIES

I

POST-COVID RECOVERY AND STABILITY

EU RECOVERY PACKAGE IMPLEMENTATION

The EU is working to turn its €750 billion Next Generation EU (NGEU) recovery package into action on the ground. In February 2021, the Council adopted a regulation establishing the Recovery and Resilience Facility (RRF) which lies at the heart of this EU's recovery plan. It will make €672.5 billion in grants and loans available for public investment and reforms in the 27 member states to help them address the impact of the COVID-19 pandemic, to foster the green and digital transitions and to build resilient and inclusive societies.

1. NGEU: a potential game changer for economic growth

1.1 Policy-makers acted quickly and comprehensively in Europe to find innovative solutions

A policy-maker summarised that the previous year demonstrated the strongest hits to the European economy since the Second World War, a large risk of divergences and a coordinated economic fiscal response ran through the EU budget. This is the first time the Union has reacted in this way, mobilising the budget on a macroeconomic scale. There was a volume of 5% of gross national income (GNI) here. The analysis of the risk of divergences in the euro economy was made early on and addressed directly.

1.2 A historic breakthrough

An official stated NGEU is the appropriate response to the crisis. This crisis differs from the last one because it has been possible to move much more quickly with new instruments. There has been more innovation. The clear intuition and assessment from Chancellor Merkel and Emmanuel Macron when they announced the idea of a stimulus plan of €1 trillion and €500 billion of grants from 18 May 2020 was that this crisis could have the potential to undermine the foundations of the European Union. This for at least three reasons. First, in the first wave countries were not hit in the same way by the health crisis. Second, there was a different share of sectors affected in different countries. Third, countries up to the crisis had different fiscal spaces and were not able to respond the same way.

The right features were found in order to deal with the crisis. Allocations were calculated on the impact of the crisis, taking into account the economic consequences of the pandemic. Beyond the current allocation, there will be adjustments that are already programmed in order to take into account the impact in 2020 and in 2021. Part of this support includes the grants, which are being financed through covered joint bonds by the European Commission. The Commission will reimburse Next Generation EU borrowing between 2028 and 2058.

NGEU will be reimbursed through new own resources. The notion of net beneficiaries and net contribution to the plan will fade away and the impact on national public finance will be considerably reduced. For the first time, the European Union has agreed to never let a crisis go to waste. Now the issue is implementation.

1.3 Next Generation, a performance-based instrument to face up to growth challenges

A policy-maker noted that the impact assessment last summer shows that, if implemented properly, the plan would lift gross domestic product (GDP) by about two percentage points structurally. Heavy lifting at the national level is also needed, but the effects could be macroeconomically relevant as well.

This is innovative in that it picks up on longstanding weaknesses in economies, both on structural reforms and investment deficits. A forward look is being taken because the investments that are being prioritised are those that will drive economic transformation in digital and in green. By linking this to the European Semester, it will significantly strengthen economic governance at the European level.

This is not a traditional cohesion policy instrument that pays for bills. This is a performance-based instrument. Payments follow only when milestones and targets are met. That is rather new when it comes to the implementation of the budget and it gives some assurances, both when it comes to absorption and results.

1.4 The Recovery and Resilience Facility (RFF) paves the way for supporting investment in the green and digital transition

A public decision maker noted that with the RRF and the multi-annual financial framework there is quite a comprehensive toolkit for facing the crisis ahead. Investment levels declined substantially in Q2 last year, and according to the European Investment Bank's (EIB) investment survey half of the companies in the EU say they are delaying or reducing their investment plans for the future. Here there is an important role for public entities to use these funds in a timely fashion and crowding in private funds too. The additional investment needed to meet the priority agreement targets before 2030 is estimated to be €260 billion per year and public money will not be enough. The climate bank roadmap, which is the definition of the European Green Deal, has the target of mobilising €1 trillion until 2030. That is about half the amount needed. The EIB is also very supportive of the RRF investment priorities: 37% of funds for climate action and 20% for digital transition. The EIB remains committed to a green, sustainable and digital recovery and engaged with the Commission and member states in bringing forward a very good implementation of the RRF.

1.5 Reforms and investment must go hand in hand

An official noted that Italy is not amongst the best performers in Europe in making use of the European funds. However, the new performance-based paradigm behind the RRF represents a strong incentive to perform better and therefore a unique chance to catch up for the country. The funds will indeed be disbursed once the ex ante defined outcome is achieved, but not as long as the expenditure proceeds. This calls for a review of administrative capacity. Reforming public administration is both one of the objectives of the plan and a fundamental means for implementing the plan itself. There will also be a comprehensive package of other structural reforms including those involving the justice system. Competition will also be part of the reforms in the plan. It is an opportunity to complement fiscal capacity, and to do so in a coordinated manner with the other European countries.

1.6 A big leap forward in terms of greater European integration

A public representative stated that this is a big leap forward in terms of greater European integration. What is observed in the markets is actually a signal of how important it is to also have a strong European capital market. The hope is that the Commission can be on the market before the summer because time is of the essence. Member states need to start the investments, so the NGEU package is on the ground as soon as possible. In this respect, it is appropriate that a new freeze of the pre-financing was negotiated, because many countries will need to have strong pre-financing as soon as the grants are approved.

1.6.1 A bold and unprecedented step

A public decision maker stated that the EIB welcomes the NGEU. There is quite a substantial amount of funds that, used properly to implement coherent packages, should lead to structural reforms that deliver and that may contribute to increased potential output. The RRF is the right answer to the problem that was raised by the pandemic, but it has to go hand in hand with a strong focus on delivering quality investment beyond volumes.

1.6.2 The right instrument at the right time

An official added that the right direction is being pursued, and all of the plans are going well. The plan is being integrated and there is toughness in requesting reforms.

1.7 Next steps: NGEU should start in the summer of 2021; the German Karlsruhe legal challenge should not delay the process

A policy-maker stated that a robust machine has been put in place. It is ready to go on 1 June. Two key conditions have to be met. First is the ratification of the Own Resources Decision (ORD). The hope is it is on track for finalising in May. Second, the plans need to be submitted by the end of the month. If all of that happens, the Commission will be in the markets in June.

An official noted that there is a lawsuit in Karlsruhe. It is strongly believed there will be a legal victory in this case. The legal position has also been strengthened by 2/3 majority in the German Parliament. The German Government will do all it can to defend this before the Constitutional Court. It is impossible to guarantee the timings of the case, because that is a matter for the Court, though there is an attempt to have an accelerated procedure.

Additional own resources is where it becomes really exciting if, as a next step in this, there can also be assurance of the repayment of the funds through sensibly designed and structured own resources for the European Union. The fact that all agree on the goal of establishing own resources is already a strong signal. With the recent movements on minimum taxation at the global level, there is optimism for getting a good test case quickly, and that this concept of minimum taxation at the global level will also increase the inspiration for agreeing on own resources in Europe as well.

1.8 This EU package has impressed markets

An industry representative noted that the market has been very impressed by the speed and depth of the decision that Europe as a whole and the single members were able to achieve. While the market looks at many things debt is issue number one. There is the size of debt, and how that is eventually deleveraged, and the quality of debt. This is a real change, now that the Commission and the budget of Europe is out and getting direct funding from a market in size and becoming basically the largest debt issuer. It is already changing the dynamic of debt issuance in Europe.

1.9 This move towards fiscal cohesion and solidarity is reassuring

An official stated that this significant EU fiscal deal has been a crucial reassuring on the perspective of the Union and the monetary union. This has proved the capacity of the European member states to react together and otherwise it would have been very difficult to respond to this crisis, with the different situations there were, with the symmetric shock but very different fiscal spaces available in single member states. It has been effective. Markets have reacted very positively and are continuing to do so. This is benefiting the Union and all member states. It is confirming that the business environment is safer. It is more resilient and able to find solutions to these new and very challenging problems. There can be certainty that Europe will become more attractive to investors and this is going to facilitate the economic convergence process across EU Member States. This is crucial for the monetary union.

2. NGEU: a potential game changer on capital markets

NGEU is a significant added value to EU capital markets. It will turn the EU into a major player on the global capital markets and strengthen the international role of the euro. The European Commission acting on behalf of the member states becomes the legal borrower responsible for the servicing and the repayment of the issued bonds. As the Treaty imposes the balancing of European budgets, the ultimate guarantee on the bonds issued by the Commission will eventually fall on all Member States.

2.1 Given the volumes frequency and complexity of the borrowing, the Commission will have to act like a sovereign borrower

A policy-maker noted that funding on the capital markets against a guarantee given by the budget itself will make the European Union one of the biggest issuers on the capital markets in Europe. That transforms the Commission into one of the biggest debt management offices and requires it to put forward a very different way of financing the plan. The Commission is also putting in place a modern borrowing policy. This will be backed up by a completely overhauled governance framework. The expectation was for anything between €15 billion and €20 billion per month to be raised to finance the machine, bringing over €100 billion this year if the Commission gets into markets in June. Next year and the year after it could be anything between €150 billion and €200 billion of disbursements. The Commission will use multiple funding instruments - medium and long term bonds as well as (short term) EU bills - to maintain flexibility in terms of market access and to manage liquidity needs and the maturity profile.

An official added that the programmes are already in the guarantee and the guarantee structure figured out in the ORD will greatly interest and inspire capital markets.

2.2 NGEU should promote the international role of the euro

A policy-maker noted that a very important side effect of this new funding machine is that it strengthens the role of the euro in the international capital markets. Banks have put this borrowing not at their sovereigns, supranationals and agencies (SSA) desks but at their sovereign desks. Quite a few actors in the system say they want to use this as a reference point: a European yield curve as a pricing reference in the markets. €800 billion will have to be raised between now and 2026, which is a challenge but there is confidence it can be done.

2.3 An opportunity for enhancing the euro as a reserve currency and developing a safe asset

An industry representative remarked that this provides an opportunity to fill some gaps in European financial markets and to provide the right tools for the euro to strengthen as a credible reserve currency. Here there has to be a large quantity of common European AAA state assets. The number before this programme for AAA single countries in Europe was less than 29% of total European debt. With this programme, that will go over 35%. This will make a difference to the ability of the euro to grow into a reserve currency. At the same time, a safe asset will be developed, which will be very useful technically to work the monetary market better. That would be a much better way to run monetary policy. There are many technical issues that will become easier.

2.4 An opportunity for a deepened and more liquid EU green bond market

An IFI representative stressed that, given the objectives of the green transition in the RRF, there is also an opportunity to move forward in terms of looking at the green bond market and to allow this market to be even larger and deeper This is also an opportunity to look at the Capital Markets Union and to try to bring forward a Green Capital Markets Union.

3. The main risks, challenges and key success factors

3.1 The main risks

3.1.1 The risk related to the recovery if new structural effects following the pandemic are not considered

A public representative noted that much attention is placed on how to go through the Next Generation recovery and address the existing structure of problems. It may be that there is not enough thinking about what kind of structural changes there will be as a result of the current crisis. There might be issues that will not come back as they were before. There might be some structural issues that will require a different kind of intervention that is not sufficiently taken into consideration.

3.1.2 The risk related to the long-run sustainability of the recovery

A public representative noted that the idea that the aggregate will be looked at to see how fast to get to pre-crisis level is an objective, but there is also a need to look at how this happens at a more disaggregated level to make the recovery sustainable. If the inequalities and social problems are not narrowed down then this is a huge transformation of the economy and society being observed in terms of ecological transition and digital transition, and consideration must be given to the divergence and inequalities that could lead to the recovery not being socially and politically sustainable.

3.1.3 The main risk is that member states do not implement structural reforms

An official stated that the biggest risk is not achieving the growth targets. If this becomes a pure spending programme with no impact on structural growth opportunities and structural growth rates across Europe, then the programme will end up unsuccessful.

3.1.4 Parliament's powers within NGEU will not allow it to avoid a possible fragmentation of the internal market

A public representative noted that Parliament had to fight its own battles on the RRF regulation and had fought for a stronger role scrutinising the RRF. Parliament has a strong European role on the financing part, but the expenditure part is more decentralised. Parliament would have preferred to see a stronger role for European institutions in the spending part as well. The risk of this decentralised approach is that there may be some fragmentation in the single market. Parliament tried to put in the six pillars to make sure that investments would work and really invest in social cohesion.

3.2 The main challenges and key success factors

3.2.1 Quickly Implementing the NGEU package remains challenging

An official stated that the crucial phase is being entered where everything depends on implementation. A process that really increases productivity has to be started in such a way that the debt load seen in some countries becomes sustainable in the long run. Sustainability depends on the additional growth created with NGEU, and for that implementation is crucial.

An official sees two risks. The first is taking too long to implement NGEU. Then there is the regulation of the facility. The ORD has to be ratified.

3.2.2 Two years for implementing reforms and investments is short

A public representative noted that there will be implementation challenges, especially because of bureaucratic issues within member states, and because many of the plans are linked to addressing structural reforms. The risk is delays in the implementation that could hamper the timing of the recovery.

An IFI representative noted that the crisis has lasted longer than expected. However, in terms of recovery there is a need to be ambitious. It is not just recovering to the previous level; it is recovering to the previous trend such that this is not a missed opportunity for growth. The implementation challenges are mainly related to high-cost rates. The deadline for a project is 2023; the deadline for payments is 2026. The time is so short that it might be a challenge to achieve the outcomes of reforms and the deadlines may have to be reconsidered.

3.3 Key success factors

3.3.1 The need for credible plans being appropriately implemented

A policy-maker stated that there have to be credible plans, which are not yet there but are due in two weeks. Then robust and rigorous implementation is also needed. Ultimately, it is about results and being put on the trajectory of higher growth and productivity. There is execution risk on the funding side, but every possible insurance has been taken out and there is a great deal of support from the European Central Bank (ECB), the European Supervisory Mechanism (ESM) and the member states.

The Chair asked whether delays would also be a risk. A policy-maker confirmed that there are regulatory delays which could hold things back. The ORD needs to be put in place, otherwise borrowing will not be possible and nothing will happen. In principle, though, in two months the Commission could realistically be very active in the capital markets. Then the money will flow very quickly. There is nothing in the Commission that is holding things back.

3.3.2 Spending wisely

An official noted that an inside factor is that the auditing and milestone exercise cannot deteriorate into political mission creep. It has to be a high-quality exercise. In essence it is similar to an ESM or IFM programme where there are targets that need to be reached and there might be a situation where 95% of all targets have been fulfilled but some crucial parts are missing. In that case, the question is whether the money is still spent, or if there will be a wait to look for quality. Speed is important, but quality is even more important.

An official added that there are issues of governance, transparency, accountability and the proper incentives. If it is not possible to deliver on the objectives introduced in the plans, there is a clear threat to credibility in a rather wide sense, including credibility of the capacity to provide solutions for citizens. The risk of failure is backtracking not only on NGEU, but possibly on other dimensions as well when there is a need to proceed on many open matters: Capital Market Union, Banking Union and the safe asset. There is also a need to think of additional resources to strengthen the European capacity for feeding the new tasks and challenges that the EU would be undertaking.

A public decision maker hoped that any support will be based on a rigorous selection of the most productive investment projects and that the RRF funds will enable the deployment of investment projects that would not be possible to deploy otherwise. There has to be additionality, and existing funding sources should not simply be replaced by this cheaper funding source.

One lesson learnt by the EIB from the financial crisis is that investment barriers are quite prevalent, particularly at sectoral and geographical levels. Attention must be paid in the context of the discussion of the reforms so the investments have their impact. On regulation, taxation and the scale of investments, in particular in green technologies, this seems to be quite important. This also holds for the capacity of the public sector to generate bankable projects. Value can be added by advisory, technical terms and financial terms such that the projects are implemented faster in the right manner for reaching the desired objectives.

4. Critical problems unresolved

Fundamental problems of the euro area remain unresolved with NGEU, including extremely high levels of public and private debt in a number of member states. Additionally, very low interest rates favour liquid assets over productive investment in Europe.

4.1 A fundamental problem of the EU remains unresolved: the high level of public and private debt

An industry representative stated that the quality of debt was an opportunity; the major challenge is the quantity of debt. After this crisis, Europe as a whole, both the public sector and the private one, will have a substantial accumulation of debt. It is not a problem right now for the market, but the question is there. Europe has a credible strategy to deleverage and get out of this increased debt. The only credible strategy is growth. The answer has to be how Europe will deliver a substantial change in the pace of growth. Even if there is a good job of implementing and spending €750 billion, that is not going to be enough. It is clearly going to be part of the answer, to fill the gap in productivity and competitiveness compared to other parts of the world in terms of technology, human capital and infrastructure, but it is not enough.

A better strategy is still needed in the case of doing business in Europe. Deepening the single market, especially in the service sector, is key. Without it not enough will be done to improve growth. Some countries have to do more than others, but when thinking about a single market in services there are many things that prevent a truly single market in all services. Financial services are part of how public administrations work nationally and how they interlink with each other. For the justice systems in financial markets, some areas are rudimentary. The answer is to work hard with the resilience and recovery plan, and taking it as an opportunity to introduce reforms that will deepen the single market European-wide, especially in services.

4.2 Achieving a balanced mix after the crisis is not a given

An official stated that the RRF can help maintain a supportive fiscal stance in the coming years and achieve a more balanced policy mix after the crisis. Member states with high debt should take the opportunity of the RRF to begin to carry out structural reforms which will boost resilience and help repay the fiscal space, without reducing public investment. The

Commission should also address differentiated fiscal guidance to member states to encourage those with fiscal leeway to stimulate demand by supporting both public and private investment. This will help achieve a more balanced policy mix in the euro area in favour of sustainable growth.

4.3 Lasting very low interest rates favour liquidity assets or low-risk projects over productive investment

An official noted that at a certain point somebody has to think about how the ECB exits the unconventional measures. That will interlink with the question discussed before on how far has been reached with productivity and whether there has been success. If risk premia remain as compressed as they are, because of the unconventional monetary policy, investment will continue to be crowded out from productive, riskier projects. With the same risk premium in both the low-risk and the high-risk projects, it is the low-risk project that will be invested in. There may need to be investments in high-risk projects. It sounds counterintuitive, but this is exactly what is happening the longer these unconventional measures continue. This will, of course, interlink with the investments in NGEU and that is also something that needs to be done correctly. There also needs to be very good brinkmanship or very good steering at the top of the ECB.

The Chair emphasised that member states, the Parliament and the Commission should summon the political energy to drive the Capital Markets Union and Banking Union. Things are happening with the conclusion of the German presidency in December, but there is a need to go further. Fixing deadlines, as seen with the recovery plan, really focuses minds. That could be done for that triptych of issues, and then some spectacular changes in Europe might be seen, which would reinforce the impressive programmes proposed.

PRIORITIES FOR FOSTERING INVESTMENT IN THE EU

Over the last few decades, real gross domestic product (GDP) growth and productivity gains in the European Union have failed to catch up with the US, China, and Japan. If Europe wants to recover the ground it has lost due to COVID 19, it is important to change course and encourage higher levels of productive investment. While the end goal is clear, it is less clear how best to achieve this. The panel examined this question by analysing the root cause of structurally low investment and discussed possible solutions. Speakers expressed views on key monetary and fiscal priorities and assessed the main structural reforms and regulatory priorities for overcoming the current impediments and fostering investment in a post Covid context.

1. The level of productive investment in Europe has been more affected by the Covid crisis and is recovering more slowly than other regions of the world

The decline in activity due to the Covid crisis has been much greater in Europe than in the US and investment has recovered more slowly than in other regions of the world. A policy maker described how there was a collapse in fixed investments in Europe over the last year. This drop of around 10% was almost entirely in private investment. This is understandable, given the liquidity constraints, the restrictions on working capital and the measures introduced to contain the pandemic.

1.1 Productive investment has fallen most in the EU countries that need investment the most

An industry representative noted that productive investments suffered a smaller decline following the Covid crisis compared to the Global Financial Crisis. This resilience is a result of the prompt fiscal support provided by member states and the EU, but it is also the result of continuous action by the European Central Bank (ECB) on quantitative easing (QE) and negative interest rates since 2014. This is encouraging, but it will not be sufficient to close the investment gap between the European economies and the US or Asia. Productive investment has fallen most in the EU countries where uncertainty about the virus was at its highest and where social distancing measures severely hindered the economy. This was exacerbated by factors such as uneven fiscal space, uneven reliance on tourism and uneven access to finance. Productive investment has fallen the most in the countries that most need investment such as Greece, the south of Italy and the east of Poland. In other words, Covid has increased the economic divide between EU countries and contributed to the western eastern divide.

1.2 Europe will be slower to recover than the United States

A Central Bank official explained that since 2014 15 private investment in Europe has broadly followed the dynamics in the US. However, there has been a falling back in terms of public investment in Europe. Relative to the US, Europe's economy is oriented towards areas such as construction rather than intellectual property. Due to its support policies, the US will close its output gap by the end of 2021 or early 2022. Europe, however, will not close its output gap in the current or next year. To some extent, this is an issue of ambition. While the Recovery and Resilience Facility (RRF) is a step in the right direction, the process has stalled due to problems concerning the establishment of effective packages of projects. Ultimately, this is a problem of the architecture of the EU. With common monetary policy, there is a need for a much larger common fiscal facility and a larger and more operational common investment facility. A genuine European Banking Union and deep, well functioning capital markets are not luxuries; Europe needs these achievements in order to go forward.

1.3 GDP in Europe is projected to recover by mid to end 2022

A policy maker outlined the prospects for recovery in the immediate term. Based on the Commission's most recent forecast, GDP in Euro area is planned to recover its pre-COVID real GDP level by the first quarter of 2022, though this projection is predicated on a recovery in private investment. Whether or not this materialises will depend on the successful rollout of vaccinations, and therefore the lifting of restrictions, and the gradual adjustment or tapering of support measures to avoid cliff edge effects.

2. Diverse structural impediments to investment

There are diverse structural impediments which are hindering sustainable investment across member states, including high levels of public and corporate debt, the absence of a single market for services, the predominant role of bank finance and an inappropriate business environment.

2.1 The business friendly environment is a key structural determinant of investment

A Central Bank official highlighted the importance of having a business friendly environment. There is work to be done on the business environment in Europe both in terms of differences between countries and in comparison with the US or Asia. This should have been done 10 or 20 years ago. Without addressing this, Europe's macroeconomic management tools will not foster more investment in the future.

2.2 Structural impediments to investment in Europe

2.2.1 Business demography

An official explained the role of business demography. Europe's production output is heavily skewed towards small and medium sized enterprises (SMEs) compared to many other advanced regions. This is a structural impediment, because SMEs are less productive than large corporates. Many studies show that larger companies tend to be more nimble in their response to similar increases in demand.

2.2.2 The absence of a single market for services

A public decision maker described how Europe has not managed to successfully create a single market for services despite a very good intention to do so. The lack of a single market for services constrains the growth of some enterprises because they do not benefit from the advantages of a single market to supply. In areas like professional services, there are barriers created by a lack of national implementation of the directive on this subject. A Central Bank official agreed that there has been positive progress on the single market for goods, but there are unresolved problems in services, including digital services. A public representative noted that in the US some sectors such as aeronautics have been brought together with a rigid approach from the federal government in Washington.

2.2.3 The high level of corporate debt

A policy maker described how SMEs' prominence, production and contribution to growth is a structural impediment. SMEs are typically characterised by higher corporate debt and higher leverage, which constrain investments.

2.2.4 Banks are too dominant and capital markets are underdeveloped and fragmented in Europe

An official noted Europe's heavy reliance on bank finance. The reliance on banks is a structural impediment to growth and investment, because banks do not invest very dynamically, i.e. they are not very good at investing in intangibles. Typically, banks lend against collateral. Europe has much lower investment in intangibles than the US. Considering the example of start ups, Europe is very rich with innovative ideas and new initiatives, but at some stage of growth these start ups lack finance and resort to a more global capital market, especially the US, which limits corporate expansion. A Central Bank official agreed that banks are too dominant as a funding source. They only value certain types of risk and certain business models. Underdeveloped capital markets, especially in smaller jurisdictions, offer fewer sources of financing for investment, less diverse risk taking and a limited set of business strategies.

An IFI representative considered the issue of fragmentation to be very important. The complex patchwork of different markets is a key obstacle to developing better equity markets, notably in CEE countries. Encouraging smaller stock exchanges to consolidate will improve efficiency and performance. There is a clear correlation between a market's size and depth and the level of initial public offering (IPO) activity and liquidity, which illustrates why the European Bank for Reconstruction and Development (EBRD) has been involved in attempting to create a pan Baltic capital market.

2.3 The negative consequences of high public debt on investment in Europe

An official suggested that high public debt explains some of the fragmentation in Europe. The countries in Europe with high public debt have a high risk premium in their capital markets. High debt countries' banks have higher funding costs, and this translates into higher implicit or actual borrowing costs for the corporate sector, particularly SMEs. Large corporates in Europe have generally been able to access other sources of finance. In the current crisis, the part of the European corporate sector that accesses the capital markets rather than the banks has performed well compared with the US. Corporate yields in both the investment grade and high yield sector have not suffered substantially. In this low rate environment, corporate sector yields are on par with the US. The bank funding cost for SMEs is the source of the problem. High public debt also explains the disparity and fragmentation in bank funding costs.

2.4 Slow progress on corporate balance sheet restructuring after the global financial crisis

A policy maker noted that one additional structural factor in Europe is the relatively slow pace of corporate balance sheet restructuring in Europe following the global financial crisis, which was due to issues on the financial market side and issues related to insolvency. Unusually, public investment held up well during the Covid crisis. Last year, public investment showed slight growth of about 3% of GDP.

2.5 There are both cyclical and structural factors at play

A Central Bank official suggested that there are both cyclical and structural factors causing the lack of investment in Europe. On one hand, both foreign and domestic demand play a role as cyclical factors, particularly during the pandemic, along with uncertainty. On the other hand, there are factors which are partly cyclical and partly structural, such as the financial conditions. There was a huge monetary expansion during both the Covid crisis and the Global Financial Crisis, but this has not created more productive investments. This is partly due to structural financial problems caused by cyclical factors in the structure of the banking system, such as the tightening of financial conditions in banks and the tightening of lending standards. Much of the monetary policy space has been used up; there is now a need to use a large amount of fiscal policy space without creating a substantial number of investments. The high levels of public and private debt make the usual macroeconomic management tools less effective at boosting investment.

3. Regulatory and tax barriers

It is unfortunately likely that the revision of Solvency II will further disincentivise insurers from making equity investments, because the set of capital charges will reduce the overall solvency ratios in the insurance sector. In any case, the accounting environment and the Basel framework also discourage financial players from financing long term investment.

3.1 Solvency II: a major impediment to equity investment for insurers

An industry representative described how the insurance sector is disincentivised from investing in equity. The risk free rate dropped by 50 basis points in both 2019 and 2020. Insurers normally invest in equity when fixed income is low, but the fact that the solvency ratio drops when the risk free rate drops means that there is no space for institutions to take risk. The French insurance sector has €2 trillion which cannot be invested in equities, because of this drop in the solvency ratio. Through the design of Solvency II's solvency ratio, the EU is actively preventing European insurance companies from providing equity financing. An official agreed with this, noting that the IMF has highlighted this as a constraining factor on investment for some time.

3.2 On taxation, there has always been a preference for debt

An industry representative suggested that there has always been a preferential tax treatment for debt, which is based on the deductibility of loan interest. If there is no tax to pay on loan interest, it incentivises companies to take on debt. An IFI representative agreed that regulatory and taxation barriers hinder the equity market and disincentivise its development. With very low interest rates, debt financing is an easy option, especially for collateral rich companies. The problems with Solvency II and taxation, however, are not the sole reasons for comparably low equity financing in the EU.

3.3 Accounting standards also hinder investment

An industry representative outlined how accounting standards hinder investment. The use of fair value in IFRS 9 and IFRS 11 incentivises institutions not to invest in equity; rather, there is incentive to invest in debt. Second, there are issues with Solvency II and the Basel framework. The European prudential standards privilege debt versus equity. When there are difficulties in the market, debt might ensure an institution's survival, but equity will not.

4. The way forward: a recipe for relaunching productive investment across member states

Unfortunately, monetary policy cannot solve structural problems. Ensuring adequate remuneration for savings and risk is a prerequisite for relaunching productive investment. Increasing investment will also require structural reforms across member states, including improvements to the labour market, education and training, increasing the efficiency of public administration and judicial systems, and a reduction of excessive expenditure to the benefit of public investment. It is also critical to create the right regulatory incentives. Long term investment should not be discouraged, particularly by the review of Solvency II. The Next Generation EU (NGEU) package could be a game changer for resolving these investment challenges, provided that the funding is spent wisely and that credible structural reforms are implemented effectively.

4.1 Normalizing monetary policy

4.1.1 Monetary policy can help but cannot solve structural issues

A Central Bank official stated that monetary policy has 'brought the horse to water but cannot make it drink', describing how monetary policy has provided ample support for investments. There are many new instruments to support lending and investment, but the weak investment in Europe is fundamentally a structural problem. The low and negative rates are the consequence of the double dip recession 10 years ago and insufficient fiscal and structural policy responses. This has led to a situation where monetary policy has been given too much to do. Ultimately, the debate around investment is about structural issues. For example, R star has been sliding down over the last 20 or 25 years from 2% to 0%; some estimates show that it is now negative. This slide must be arrested. Rates will not be at such low levels forever. The change will be cautious rather than abrupt, but countries cannot rely to an excessive degree on monetary policy. It is time to address the structural issues in a much more resolute way than in the past. Fiscal policy and monetary policy are complementary and should function together. An official (Mahmood Pradhan) agreed with these remarks, stressing that this perspective aligns with the IMF's view that monetary policy is not a problem here.

4.1.2 Escaping the monetary deadlock: the need for adequate remuneration for savings and risks

An expert emphasised how interesting it is to hear the panellists' explanations for the insufficiency of investment in Europe. The debate has focused on three key areas which could be used to draw comparisons between Europe and the US. First, in Europe there is more debt; in the United States there is more equity. Second, in Europe banks are responsible for the financing of the economy; in the United States, it is the financial markets. Third, Europe has many structural problems; the United States is a very flexible economy.

An expert considered that there will be no investment if savings are not sufficiently remunerated. Negative interest rates in Europe are one explanation of the poor investment behaviour; thus, if the remuneration on complex productive projects is zero or negative, economic agents have a natural propensity to move towards more liquid ways of holding their money, which is a behaviour that was well described by Keynes. This is one explanation of the very fast increase in the share of household savings in the most liquid forms, i.e. banknotes and bank accounts. The expert suggested that there is a very simple way to view this. If monetary policy means that the cost of capital is zero or negative – i.e. it carries a tax – there will be no long term investment. People will wait for better days and put their money in highly liquid forms, which is what is happening currently.

The expert described how there has never been a period in history with healthy investment accompanied by zero or negative rates; it has simply never existed. If economic agents want to invest in a long term project that carries risk, it is normal for them to expect positive remuneration. It is very unusual for monetary policy to be depressing interest rates in the way it has. The natural interest rate in Europe is low, given the demography and the importance of savings, but it is further reduced by monetary policy, which is reducing interest rates to zero or less than zero. This is a mistake because it means there will never be any investment. It is absolutely clear that people are motivated by remuneration. When people believe that interest rates will remain at zero or negative for the next 10 years, what Keynes called the 'animal spirits' of investors will be depressed. Discouraged by the prospects for growth, entrepreneurs move towards share buybacks and speculative opportunities. This is the main negative effect of the non remuneration of capital. It is somewhat tautological, but 'anyone in the street' would agree with it.

The expert stated that what is needed is a change of gears and to abandon the sacrosanct idea that zero interest rates will foster investment. This sentence makes grammatical sense, but it does not make sense, because people expect remuneration. In the United States, the situation is much better. When bonds are not renumerated, as is the case in the US, there is a shift of savings towards equity and stocks. Europe lacks this fungibility of savings. People hold bonds without remuneration. They do not shift towards equity naturally, because they are risk averse. This must be factored in with changes to monetary policy. Ultimately, it is monetary policy that depresses the 'animal spirits' of Europe to a degree that is incomparable with the United States.

Lastly the expert stressed that it is necessary to have a more realistic view on price developments. Indeed, having a positive cost performance index (CPI) that is slightly less than 2% is not a sign of instability. If yields move higher, central bankers should not entirely repress that tendency by providing member states with the unconditional "benefit" of a zero rate guarantee.

4.2 A larger common fiscal capacity would yield a more effective policy mix

A Central Bank official suggested that frontloaded investment geared fiscal support is needed not only at a national level but also at EU level, indicating that there is a need for a larger common fiscal capacity. It would also be more beneficial to have a more effective policy mix along with monetary policy, including structural reforms and bolder fiscal policy. Countries with excessive debts will need to reduce their debt levels; current expenditures should be substituted significantly by public investment. The lack of investment in Europe has structural causes. If these structural problems are fixed, it will be possible to move forward sustainably.

4.3 Implementing structural reforms in all parts of the EU

4.3.1 Improving the labour market, education and training and increasing the efficiency of public administration and judicial systems

An official highlighted the importance of structural reforms to the labour market and education and training. First, the high share of temporary workers in quite a number of countries discourages firms from investing in human capital. Second, in terms of education and training, a high proportion of the labour force in some countries in Europe is unskilled, which constrains dynamism and growth. In the public sector, the key priorities are the efficiency of public administration and the judicial system. It is encouraging that some countries' efforts on digitalisation within the Recovery and Resilience facility (RRF) and the Next Generation EU (NGEU) package will focus on digitalising the public sector to make the delivery of public services and the administration of the public sector more efficient.

4.3.2 Supporting viable SMEs

An IFI representative outlined several positive trends, including the development of the venture capital market and state equity. The important question, however, concerns what action to take on SMEs. It is important to ensure that small businesses are not ignored in the recovery. It is crucial for SMEs to have access to equity capital markets through products like redeemable equity, convertible loans and alternative financing channels. The EBRD believes that measures such as the Baltic states' commercial paper framework, for example, can enable the sustainable financing of European economies in the future. The idea of building back better and sustainable recovery is very important here.

4.3.3 The issue of urgent structural reforms: the example of Croatia

A Central Bank official explained the situation in Croatia, noting however that many of these structural issues also apply to other European countries. For years, the Croatian National Bank's survey of businesses suggested that the main problems in Croatia were overregulation, ever changing regulation and slow administration. Before the pandemic, the lack of a qualified labour force became the number one issue. This problem is not seen as urgent during the pandemic, but when the pandemic is over the lack of a qualified labour force will again be a significant problem. Next Generation EU funding could speed up the work of administration through digitalisation and support education and training, which would help with the lack of a qualified labour force. The two public sector areas where structural reforms have been needed are the judiciary and healthcare. A faster and more predictable judiciary would reduce risk and make banks more willing to finance projects. The healthcare sector has a very inefficient structure. The world is experiencing a pandemic, but the sector has needed reform for many years.

4.4 Setting the right incentives for private investments

A reduction in capital requirements would allow European insurers to provide capital for the economy. However, it is likely that the revision of Solvency II will further disincentivise insurers from making equity investments. Remunerating savings is a prerequisite for escaping the monetary deadlock and encouraging entrepreneurs to relaunch productive investment.

4.4.1 Disregarding EIOPA's advice regarding Solvency II

An industry representative stressed that the key priority would be for the European Commission to disregard EIOPA's advice on Solvency II. EIOPA has advised that the interest rate shock in the formula should be increased because the risk free rate has dropped by 100 basis points, which would magnify the constraining effect on financial institutions. EIOPA wants insurers to hold even more capita given the interest rate risk, which means even less capital for equities. There is a belief in some governments that this can be compensated for by adjustments to the risk weight of equities, but this is not true. As the risk weight for government bonds is zero, which is impossible for equities to achieve, financial institutions will put their money into risky bonds. If the Commission and Parliament follow EIOPA's advice, they could 'kiss goodbye' to the equity financing on insurers' balance sheets.

4.4.2 Lengthening the duration of banks' corporate loan portfolios

An industry representative explained that prudential regulations do not prevent banks from holding equity; banks are simply not a good place to house equity. Regulatory progress is being made on banks' loan portfolios, however. The last revision of the Capital Requirements Regulation (CRR) increased the capital discount for SME financing and introduced a new discount for infrastructure financing. This infrastructure supporting factor has been fast tracked in the Spring 2020 'Quick Fix'. In terms of priority areas for progress, there should be further effort to lengthen the duration of banks' corporate loan portfolios. This means there will be a need to improve the synthetic risk transfer from banks' portfolios, although this is more to do with the revamp of securitisation than the regulation of capital.

4.5 NGEU: an ambitious answer to EU investment needs

4.5.1 NGEU is a bold and unprecedented step for addressing investments and structural reform needs

A policy maker explained that the Commission is now in the closing stages of negotiations with member states on the designs of their recovery and resilience plans. In many, but not all, cases, the Commission hopes to be able to complete and approve these processes by the end of June. The funding will hopefully start flowing around then or shortly after the summer break. The funding will support demand and investments directly through spending. The grants part of the funding is deficit neutral and it will contribute to the productive capacity of European economies by ensuring that money is channelled to the right investments. The RRF is not only about investment, however; it is also about reforms. In terms of potential impact, the Commission's models suggest that every additional percentage point of GDP on public investment could translate into near term GDP growth of 0.7%. However, this impact could reach 1.5% GDP growth over the longer term. This is extremely significant for countries like Croatia, where the grant transfer is 10% or 11% of GDP, or Italy, where it is 4%. It is important to ensure that the investments are high quality and the reforms are ambitious. The regulation requires targeting spending on the digital (20%) and green (37%) transitions, but some member states have shown a slight tendency to favour older or more traditional types of investment. It is essential to ensure that this funding helps create transformational change in the public and private sectors.

The policy maker agreed with the remarks made by previous speakers on the areas for structural reform but stressed that it is also important to be realistic. RRF will not solve all of Europe's underlying structural problems, but it is an opportunity to make a decisive step forward. The Commission will focus on reforms that will create the essential framework conditions for investment and growth, which means focusing on the unnecessary impediments to doing business and investment and the modernisation of public administration and the judicial system. Digitalisation can catalyse this process. These reforms are extremely important. RRF is not merely about investing more money on digital projects. Unless those investments lead to interconnected systems across government, there is a risk that countries will spend large amounts of money but not realise the potential benefits. It is vital to find reforms which can support the sustainability of public finances. Pensions is also an important topic, but it is a very difficult issue.

The policy maker suggested that the critical issue for public investment will be the quick implementation and rollout of NGEU. This will ensure that public investment can be supported and even increase in the years to come, in sharp contrast to the curtailment of public investment after the global financial crisis caused by the need for fiscal consolidation. An official (Mahmood Pradhan) praised the fact that much of the RRP is deficit neutral, which is positive for the move towards public investment and increased growth prospects. For example, it is encouraging to see that Italy's National Recovery and Resilience Plan (NRRP) will enable Italy to reach an investment to GDP ratio of 3.5%, which is 1% higher than it has been for the last 10 or 20 years. An industry representative (Sylvain Broyer) considered that continued fiscal support, fiscal solidarity and financial integration are critical to foster investment in Europe. The EU economy is in dire need of Next Generation EU, capital markets union and the banking union.

4.5.2 Public finance is part of the solution

An industry representative described how not all businesses suffered from the crisis in the same way. Some businesses have experienced a 'double blade' effect, in which they experienced the Covid crisis and then a second structural crisis. This demonstrates the double need here: there is a need to overcome the current crisis and a second need to adapt to the new world. For many years, it was considered that public financing is less efficient than the private sector, but these times are over. During the crisis, market participants in every country came to the public finances and said, 'We need you'. Public finance creates positive externalities by attracting and spending money on social infrastructure and public infrastructure. Second, the leverage effect of public finance is much more important than for other types of investment. In order to redevelop public investment, there should be tailor made prudential rules for public finance. There must be a clear definition of the assets that should have a specific accounting treatment. This is where national banks and financial institutions can play a dedicated role. This has been seen during the crisis of last 18 months, in the Juncker plan in the past and in InvestEU in the future.

MAJOR FINANCIAL RISKS IN THE CURENT MONETARY AND MACRO-ECONOMIC CONTEXT

Major financial risks include public and private levels of indebtedness, financial system profitability, credit risks leading to non-performing loans (NPLs), and overstretched asset prices. The Chair reminded the audience that this goes back to the financial crisis of 2008-2009, when financial sector excesses could have led to a great depression, which was avoided by monetary and fiscal policy. Fiscal policy withdrew in 2010, when monetary policy faced a phase of circular stagnation in advanced economies, with low growth, inflation, and real equilibrium interest rates.

Monetary policy tried to lower market rates across the spectrum of the yield curve using different instruments but was not enough to spur private expenditures sufficiently to normalise robust growth and inflation, which are low everywhere. The Covid crisis has implicated the support of households' and firm's incomes, leading to the reactivation of fiscal policy and a new consensus on policy mix. All policies have trade-offs and challenging spill-overs that have to be analysed, faced, then mitigated or overcome.

This session discussed to what degree corporate indebtedness can lead to increasing default rates and pose financial stability issues or if the post-pandemic recovery will offset those effects. Speakers also examined the policy challenges raised by the current monetary and macroeconomic context and expressed their views on the appropriate regulatory, monetary and fiscal policies for addressing the EU's major financial risks.

1. The risks raised by the corporate-sovereign-bank nexus

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 sovereigns. This nexus is vital at the moment for supporting the economy. But it also means sovereigns are increasingly exposed to corporate risk, and vice-versa. This might be a financial stability issue if many businesses suddenly were to go bankrupt. Rising credit losses for banks may require governments to provide more support and pay out on guarantees. This would further increase pressure on public finances. Conversely, rising risk premia could also affect banks through their domestic bond holdings.

The present situation entails the risk of NPLs increasing after the temporary measures of public guarantees to loans and moratoria end when the pandemic is under control. The scale of the impact of the pandemic on NPLs is difficult to predict.

1.1 Strong EU and national policy responses have contained the impact of the pandemic

An official considered the nexus between the corporate, the bank and the sovereign balance sheet. The pandemic and lockdowns caused a revenue collapse for the corporate sector, which implied a liquidity crunch. In the first wave it was general; in the second and third, it is now impacting specific sectors. A liquidity crisis was avoided by substantive support from central banks, regulators and governments at national and European level, which successfully provided the corporate sector with means.

1.2 Policy responses resulted in a growing dependence on public policy support

An official noted the strong reliance by companies and banks on public support, as much European bank lending was done against a backdrop of significant government guarantees. This interconnectedness carries risks when the temporary policy support is phased out. On the corporate side, a wave of bankruptcies was largely avoided due to those measures and the moratoria that are in place. As these are phased out, this will change. In the corporate sector, what was initially a liquidity issue will increasingly become a solvency issue. Even viable companies that can sustain business face the challenge of the leverage they received during the crisis. This may lead to underinvestment during the recovery.

The bank side provided credit and is well-endowed with capital. The European Banking Authority (EBA) and the European Central Bank (ECB) stated that the banking sector should be in a good position to weather an increase in NPLs, even under a relatively severe scenario, with two provisos: first, what is true for the sector overall may not hold for each bank, so problems may still arise; and an increase in NPLs also implies a drag on profitability, having implications for the ability and willingness of banks to lend and finance the recovery.

Governments face the challenge of phasing out and withdrawing public sector support measures to support viable and new companies. This is a challenge as it is not the predominant task of governments and so a suitable instrument must be considered. Comprehensive, gradual and well-sequenced promotion of post-pandemic bank and capital market financing is critical for a strong and sustained recovery. This includes narrowing support schemes to viable firms, restoring transparency, removing forbearance in bank operations and accounting, and remedying capital shortfalls.

Debt levels also increased due to the broader fiscal support given to the economy. Further government aid during the recovery may increase the contingent liabilities of that. It looks manageable but must be considered in the future. The task is to make the best use of the European measures – and particularly Next Generation EU (NGEU) – to make that work.

1.3 The banks have not been tested hard by Covid so far

A Central Bank official stated that exiting the EU during a pandemic has not been completely straightforward. However, the broad lessons and the approach being taken on financial services Covid measures are similar to the EU. The UK is determined to maintain standards of resilience at least as high as those existing before Brexit and Covid. Banks have not been tested by Covid, due to the fiscal and monetary support provided. Nonetheless, if they had gone into Covid with bank balance sheets as in 2007, there would now be a financial crisis as well as a health and economic crisis, and there is a lesson to draw from that.

An industry representative agreed that banks have not been tested. The sector gets credit for having been part of the solution, but it is really due to fiscal and monetary policy. The guarantees were there, and banks went to central banks for liquidity, as they are still, unfortunately, not profitable enough to raise money competitively in the market. Fiscal and monetary policy is crucial, and the key risk is withdrawing too early.

1.4 The scale of the impact of the pandemic on NPLs is difficult to predict

An official noted that there will be an increase in insolvencies and NPLs when budgetary and regulatory support is phased out. The question is how big the impact will be. That is hard to assess at this stage and many measures have been put in place to address it. It will not be such an 'easy ride' as it has been so far, and more will be seen, but there is no reason to be excessively alarmed about that perspective.

A regulator stated that government support will have to become more targeted so it might be a step-by-step finish. The focus must be on supporting viable corporations, particularly those at risk or unable to invest. Selection is difficult for public authorities. Dialogue is needed between governments and banks as the banks know their clients, such as considering situations where, for stronger corporates, governments could finance partial debt relief with the condition that banks would refinance the loans on better terms, so as to have a partnership between the state and banks. Repayable instruments could be converted into grants, up to a ceiling, to support corporates. The banking sector has the task of identifying them. That implies additional spending but would defend the economy and reduce long-term indebtedness problems.

The Chair noted that supporting the banking sector and financial institutions requires an awareness of the Solvency II review for the insurance sector and the long-term financing perspective that the sector can provide. A different public sector may be needed when the pandemic is over as temporary measures' consequences come to the fore. A degree of different types of public support will be necessary.

An industry representative noted that a surprise silver lining is the success of the crisis response from monetary, regulatory and fiscal policymakers in muting the expected impact on the corporate sector. The confidence that policymakers will be as successful when withdrawing the stimulus is an article of faith, as these are uncharted waters, and so future uncertainty is the greatest theme.

2. Policy challenges: exit strategies to consider corporate revenues and debt dynamics

The scale of potential solvency problems depends on the evolution of the pandemic the performance of sectors and appropriate policy responses. The temporary regulatory relief given to industries should be phased out firmly as economies recover. Policy challenges are significant but there are reasons to be positive.

2.1 Authorities must manage trade-offs related to the duration of support measures

A regulator stated that Europe is ahead in some respects. Insolvencies have not materialised. There is an opportunity for states, banks and corporates to take combined action to reduce or prevent this wave. Negotiations between the Dutch government and banks on supporting corporates are ongoing. Parties must consider existing options to facilitate debt restructuring.

Potential solvency problems depend on the evolution of the pandemic, the performance of sectors and appropriate policy responses. Withdrawing fiscal support too soon could exacerbate the effects of the economic crisis and risk instability. Maintaining it for too long increases budgetary pressures and delays structural change and recovery. Managing this requires access to timely, reliable economic information.

Timing is key, and a European Systemic Risk Board (ESRB) report will be published soon. Action is needed before resigning to the fact of a large set of NPLs, and there is time to identify schemes where governments, banks and corporates might help to reduce the problem. There are concrete possibilities that are feasible and await implementation.

2.2 Temporary relief given to industries should be phased out as economies recover

A Central Bank official agreed that temporary regulatory relief for industries should be phased out as economies recover. The Fed's decision to put Treasuries back into the denominator or the leverage ratio is important. Although the rationale for it was understandable, if left in place it could have set a concerning precedent as it could be a path back to the banks' sovereign doom loop which has caused trouble before. It is right to reverse that, and that is the right spirit for the transition out of Covid.

That does not mean that there are no lessons from Covid. While short-term pressures to weaken regulation with the supposed aim of boosting the recovery should be resisted, it is important to learn from the crisis. Buffer usability is key. Although buffers were not tested, regulators and investors have created a system where, if possible, banks will avoid using buffers to support the economy. That must be looked at.

The Chair underlined the importance of the Fed's decision on Treasuries. The measure was temporary but was against the Basel III agreement. Other regulatory relief measures during this period will have to end.

2.3 Four reasons to be positive

An industry representative noted four reasons to be positive concerning the global financial crisis (GFC). First, this was not a cyclical event. It did not result from unsustainable imbalances, particularly in property. While some imbalances present in the GFC still exist, corporate debt has not risen by as much as it did then. This crisis is expected to unwind more quickly than the GFC. Second, it was not accompanied by a credit and a real estate boom, which would magnify the downturn impact on the banks.

Third, the European banking sector is better able to weather a shock now, with higher capital levels, more forward-looking provisioning policies and strong liquidity, partly due to the actions of regulators and the ECB. Fourth, government support has been rapid and strong, aiming to cushion the impact while addressing its cause through the development of vaccines, allowing the crisis to unwind. That is what is broadly expected to happen. Support has been effective in limiting defaults and NPLs. While these are expected to increase in the coming years, particularly in economies where the small and medium-sized enterprise (SME) sector plays a significant role, the level of defaults will not be anywhere near those of the GFC.

These are uncharted waters and there is uncertainty and risk. Much rests on policymakers' ability to find and afford withdrawal mechanisms to avoid the cliff risk. There are concerns given the straitened circumstances of many sovereigns in Europe. In Europe, the nexus between weaker banking systems and sovereigns means that much rests on the willingness and ability of the euro area to stand collectively in support. There has been a willingness to do that with Support to mitigate Unemployment Risks in an Emergency (SURE) and NGEU, and the ECB stepping up again. It is assumed that that will continue, but the confidence of investors, banks and others that that will continue will be crucial in how the crisis unfolds.

An industry representative considered this is a peculiar recession from the banking industry's point of view, affecting a subset of industries. When the economy rebounds, the expectation is that NPLs will be under control. They have been so far, thanks to the support measures implemented. If measures contain equity components for the affected sectors, a huge increase in NPLs is not anticipated.

3. Cautiously normalising monetary policy

The low-rate environment exacerbates the structurally weak profitability of the EU banking and insurance sectors. Lasting ultra-low interest rates also encourage the growth of public and private indebtedness and holding cash without promoting productive investment. Low interest rates risk may increase with the 2020 review of Solvency II. It is time to exit, cautiously and gradually, from accommodative monetary policy.

3.1 Normalising monetary policy is challenging

A Central Bank official stated that it is awkward to talk about normalisation when it seems that things are not getting better. The vaccine brings hope that Covid will be under control soon. A year ago, the discussion was on how to get out of unconventional monetary policies, before Covid came, and it all changed. It was not an easy discussion, and it has become more difficult as monetary policy has become expansionary and balance sheets and debt have grown. Exiting these policies is unchartered territory.

Quantitative easing (QE) was always said to be easier to get into than to get out of. Central bankers and markets saw the consequences of the taper tantrum in 2013 and will carefully judge how to normalise monetary policy. That means getting out of the zero lower bound and back to normal monetary policy, which might be far from the position now, so unconventional QE-type policies must be considered first. That requires assessment of the trade-offs involved and the changing conditions. There are risks if monetary stimulus is removed prematurely or abruptly or if this policy goes on too long, creating excessive reliance on monetary policy and potentially working in the opposite direction on the necessary economic policies. Governments could be disincentivised to make the necessary structural reforms, or the corporate sector to restructure, thereby creating zombie firms. Risks must be balanced as monetary policy begins to normalise.

There are two questions: one that is key for central banks is the reason for the disconnection between monetary policies and inflation. If monetary policy wants to stay goal-oriented – and colleagues will agree that it should – then the goal is inflation. If the mechanism between monetary policy and reaching the goal is not understood, it will be difficult to assess if the right thing is being done. Central banks must understand the reasons for the disconnect between monetary policy and inflation. The interest rate level is less important than understanding the mechanics of what is being done and how it translates into the stated main goal.

The Chair noted that there is great awareness of the pressure that monetary policy has been subject to. Monetary policy is asymmetric in its effects; it is more effective to counter high inflation than to push inflation up in periods of low growth in advanced economies due to circular stagnation. It needs the help of other policies to reach its objectives. It cannot do it alone.

3.2 The risk of low interest rates could increase with the 2020 review of Solvency II

3.2.1 Ultra-low or even negative interest rates weaken insurers

An industry representative noted that the impact of the policy dilemma on insurers is different to other sectors. Balance sheets must be managed over the very long term, all the more so as the population's needs, linked to ageing and pensions, increase. Insurers are used to tackling events like the pandemic, even with the death toll, whereas the pressure on balance sheets from the persistent very low or negative interest rates is a shaping component of medium-to-long-term management.

This is not apparent in terms of profitability, even if it is not as high as it should be but is visible on solvency positions. The sector is solid, but the very long-term effects must be foreseen, and the pressure from very low rates is diminishing solvency. It also impedes offering clients long-term products combining yield, security and liquidity; and investing as freely as possible, as the regulatory environment requires caution.

3.2.2 The EU economy needs a balanced Solvency II review

An industry representative noted that the conjuncture of this very-low-rate situation and stringent regulation may be greater when the Solvency II Directive reform considers the situation. This limits the capacity to take more risks on the asset side and investing, or to pay back to clients a good yield or warranty for their investments. An appropriate solution for the sector would be a slight rise in interest rates, getting them back into positive territory, without harsh movements.

3.3 If the US overheats, global and European financial conditions could worsen

An industry representative stated that the US position is worrying. It implemented an aggressive stimulus package at the end of 2020 and in March 2021, which is already leading to an increase in long-term interest rates, due to the expectation of increased activity and increased inflation in the US. Europe is behind that trend. The brisk recovery in the US implies for Europe – and Europe is behind in terms of monetary policy reaction – a weaker euro and comparatively lower rates and better financial conditions. At some point, European monetary policy should change and tighten as the eurozone's recovery progresses.

The challenge for the ECB will be to administer an increase in long-term rates while considering the differential effect on member states, which are suffering to different degrees from the pandemic and the deterioration of their fiscal positions. The US is likely to change monetary policy earlier than Europe, but, since monetary union has not been completed, the ECB's challenge will be in accommodating rate increases and ensuring that a fully integrated European market is maintained.

3.4 Time to start gradually exiting very accommodative monetary policy

The Chair noted that it should not be problematic to normalise monetary policy. The increase in 10-year Treasuries yields was mild and is still at 1.67%. By the end of 2019, it was at risk of going above 3%.

An industry representative hoped that a policy normalisation phase would follow. It must be cautious, but he sympathises with Jacques de Larosière's view that the market should be allowed to work. If markets anticipate higher rates, it is counterproductive to go against that trend. The ECB is forced to do that to maintain an integrated eurozone. Interest rates should be allowed to rise as the recovery takes hold.

The Chair stressed that a distinction should be made between developments in nominal terms and in real terms of market yields. One is nominal accompanying developments and the other is real rates, in a situation which needs a robust post-pandemic recovery. That is partly why ECB policy has differed from the Fed.

An industry representative advised that there is room to go into more positive ground for interest rates, be they nominal or real. Long-term market rates used to be higher. Throughout the crisis, other than at the beginning, there was not a huge widening of spreads within the eurozone, which is a sensitive indicator. There is room for an orderly and moderate return to a more normal level of interest rates. This would be appropriate for private investment and savings and would alleviate the public finance burden. This is not pleading for a burst in the level of interest rates; on the contrary, that would be a tremendous risk.

4. More fiscal stimulus would be welcome but is not realistic

The Chair stated that in 2021, the US will attain a gross domestic product (GDP) level that returns to the growth trend before Covid. Europe will reach the 2019 level by the end of 2022, and several European countries will reach it in 2023.

An industry representative noted that there is confusion between gap fillers and investment. This is an unusual recession, and it is seen as natural, economically and morally, for fiscal policy to step in after the private sector raised savings ratios, trying to find and fill this gap to reduce scarring. Talk of zombie firms theoretically makes sense, but creative destruction is done by market forces, not the pandemic, so it is difficult to identify now. The argument is around filling the gap in the short term, until the economy is on its feet again. Europe is conservative on this. Europe seems to be focusing on returning GDP to 2019 levels, whereas other countries – the US in particular – are trying to reach the trendline. That is appropriate. On monetary policy, the paper only runs to March before GDP is predicted to get to even the end-2019 level.

The other important part is investment, but there is no realistic way for fiscal policy to fill a hole within a year through investment, because of appropriate procurement rules. It is crucial to separate gap fillers supporting firms and people who have been hit by the lockdowns, but also to use the opportunity to put in place longer-term investment, which is where NGEU is important. In Europe, there is no question that gap fillers can be done only by national budgets. Longer-term things can be done by the budget and by Europe. NGEU is key. It is hoped that it will happen, but the US investment programme as a share of GDP is three times the size of NGEU. NGEU is good, but interest rates are low, and it is easy to get a return from the public sector to make it profitable. More would be welcome. It is not realistic, but Europe is on the stingy side, and that is a risk.

The Chair stated that the US infrastructure programme presented recently is to be implemented over 10 years. When discussed and analysed, this aspect is not underlined: it is not comparable with previous fiscal stimuli that the US ran in order to direct immediate support to households, firms and the economy.

LESSONS FROM COVID ON NON-BANK FINANCIAL INTERMEDIATION

1. Opportunities and challenges associated with the growth of the investment fund sector

A regulator stated that funds are an essential part of capital markets. They provide an efficient vehicle through which to pool investment capital to the real economy and diversify risk, via a wide universe of fund types and investment strategies. That diversity is a strength and must be supported. Funds also undertake important roles in the functioning of the financial system itself, so it is critical that they should be able to operate appropriately in periods of stress and not become sources of systemic risk.

An industry representative explained that Money Market Funds (MMFs) for example play an important role in the financial ecosystem by providing low-cost funding for the economy and high-quality, diversified options for liquidity management.

The Chair noted that since the 2008 financial crisis and the tightening of the banking regulatory framework, non-bank financial intermediation has grown rapidly, especially the fund industry. In Europe, the net assets of investment funds amounted to €8.6 trillion at the end of 2010. After 10 years, this amount has grown by €10 trillion, half by valuation effect and half by investment flows, while the total assets of the banking system are broadly stagnant. This rapid development came with an increase in stability risks - some from a liquidity mismatch between assets and liability, others from highly leveraged funds - exacerbated by very low interest rates.

An official added that instability is inherent in financial markets and can never entirely be removed, but it is important to avoid unnecessary instability. The fast growth and the concentration of the asset management industry can be viewed as an inherent problem for the stability of the financial system, but on the other hand having a growing role of capital markets and of asset management in particular, is positive for Europe as a source of diversification of its financing. That however does not mean ignoring potential risks, but identifying and addressing them.

2. Lessons from the Covid crisis regarding Money Market Funds (MMFs)

2.1 Outflows experienced by different MMF structures in March-April 2020

An industry representative noted that stability in markets results from adequate regulation and confidence in the system. In March and April 2020, investors' worlds turned upside down and no one knew what to expect. Investors wanted cash in order to be prepared for the unknown, thus equity and bond assets were sold, money market investments were redeemed, and companies drew down their lines of credit.

The experience of European MMFs in the Covid crisis showed no discrimination based on fund structures and outflows were similar from all types. Shareholders of variable net asset value (VNAV), public debt constant net asset value (CNAV) and low volatility net asset value (LVNAV) MMFs all sought to obtain liquidity due to similar fears of the unknown. If central banks had established a methodology to ensure liquidity when announcing the closing of economies that would have limited the increase of financial stability risks. As soon as they announced facilities for supporting investor confidence in the markets, liquidity returned, and the pressures disappeared. These measures were not put in place to help MMFs specifically, but to stabilise the financial system, so MMFs should not be blamed for this market stress.

The Chair observed that the connection between EU supervisors and the central bank of issue needs taking into account. For EU MMFs denominated in dollars or sterling the connection is weaker in Europe than for euro-MMFs. In addition, while the stress and liquidity strain was the same for the different types of MMFs, there were also inflows in public debt CNAVs coming from outflows of LVNAV and VNAV.

The industry representative explained that this move between LVNAVs and public debt CNAVs, is mainly relevant for US dollar MMFs, as there is no significant market in public debt CNAV in the EU in euros or sterling. Investors in EU MMFs in US dollars are mostly owned or controlled by US companies and treat the European market in a similar way to the US. The US government market is not subject to fees and gates, whereas the institutional prime market is, and so there was a move out of the prime MMF market in order to ensure liquidity for clients who wanted to build up cash into the government market, although it was lower than anticipated.

Another industry representative stressed that, when considering market data, the March 2020 events differed not by fund structure but by currency and were influenced by the macroprudential approach taken to certain types of funds. Dollar funds saw bigger outflows than other currency funds, the greatest being from US VNAVs from which there was a flight to safety, but with a spill-over to LVNAV funds. Of the 29% of assets that flowed out over the month, 60% in Europe went into government liquidity CNAV funds. Flows out of euro and sterling funds were more modest and similar across structures. Banque de France and Central Bank of Ireland data show outflows from LVNAV funds of 16%, and 15% from standard VNAV MMFs. Outflows from sterling were lower still at 11%.

The industry representative added that Europe differed from the US as outflows were mostly justified by operational working capital needs from pension funds and insurance companies for meeting margin calls, rather than the threat of gates and liquidity fees. But EU asset managers were incentivised not to break the liquidity buffer, and pension funds also used MMFs to invest in equities, as their valuation was attractive at the time.

Responding to a question from the Chair about the extent of outflows from MMFs seen in Ireland, an official confirmed these were significant, with large outflows observed across the different structure types. A question for the ongoing international discussions is the tension that exists in the MMF offering between the cash and liquidity management services offered by MMFs, and MMFs being used as a short-term financing source. This means that maturity transformation is being carried out with MMFs, which provides important benefits, but also raises financial stability questions. There is a question of the extent to which these benefits can be retained and if so, how.

2.2 The role of liquidity buffers and liquidity management measures

An industry representative observed that MMFs entered the crisis with significant levels of liquidity thanks to the new EU regulations requiring MMFs to hold high liquidity levels. However, investors redeemed, fearing that investments might be gated, which was an unfortunate side-effect of the MMF reforms. This real-life stress test applied to the MMF reform shows that decoupling fees and gates from liquidity rules is critical[1].

Another industry representative noted, concerning threshold pricing, that the furthest move to market pricing in March 2020 was on the dollar funds: +9 basis points on the upside, -6 basis points on the downside. Sterling and euro fund NAV moves showed low single digits, far away from the 20-basis-point threshold. These should have been easily absorbed, given high cash buffers. The key difference was that VNAV MMFs could use their cash buffers but LVNAVs could not, due to requirements linking the breach of the 30% cash buffer with the imposition of gates and fees. That showed the negative unintended consequences of cash buffer rules. The industry speaker also observed that LVNAV funds are operationally VNAV funds that are priced three times a day and may be requested to move to total VNAV pricing if the 20% deviation threshold is reached.

An official agreed that liquidity buffers and gating requirements are aspects of the regulatory framework to be re-considered. Liquidity buffers combined with gating requirements had a cliff-type effect in the minds of investors. The NAV collar[2] may have acted on LVNAVs in a similar way.

The Chair, referring to the debate in the context of the AIFMD review about expanding the use of swing pricing for open-ended funds, asked whether this could be an option for MMFs, especially if there is intraday liquidity as is the case in the US.

An industry representative advised that Europe also has intraday liquidity. Companies need intraday liquidity, but it is also needed for posting cash collateral with central counterparty clearing houses (CCPs). Swing pricing is redundant for MMFs, for which tools such as pricing at bid and liquidity fees exist. Making the 30% buffer operational so that it does not become a floor and can be used in an effective way should be sufficient.

Regulations as a whole increase the importance of cash collateral, and that is intraday, the industry speaker added.

2.3 The liquidity of underlying short-term money markets

An industry representative observed that the key problem concerning MMFs is structural and relates to the underlying short-term money markets. In times of stress, the system must provide investors with liquidity. In March 2020, MMFs were caught in the same storm as all securities holders attempting to raise cash when the liquidity of even the highest-quality short-term assets had dried up. The normal buyers of short-term paper, such as banks and brokers also needed liquidity to meet cash needs. With no official intervention at the start of the crisis, these markets became very illiquid.

The Chair stressed that if liquidity pressure concerned the whole securities market, it was particularly acute in some parts of the short-term paper market where there is less liquidity. The industry representative stated that when raising liquidity it makes sense to go to the easiest places, which is normally the shorter paper. Longer-dated bond funds came under pressure to raise liquidity and found it difficult to sell longer-dated, lesser-rated paper. They also utilised their shorter-term, higher-quality paper, trying to raise cash in the easiest way possible. Since MMFs only invest in the high-quality short end of the market they tend to hold the highest percentage of that high-quality debt.

Another industry representative noted that the freezing of the whole short-term market was an aggravating factor, and that markets remained stressed longer in Europe than in the US. Limited amounts of securities were sold to meet redemptions, as banks, given balance sheet constraints, did not buy back their own commercial paper (CP). Redemptions were also met by retaining maturing paper, so banks could not issue as much new CP and the ecosystem froze. The situation was different in the US where the buying back of their own CP was made balance sheet neutral for banks, which instantly restored liquidity. European Central Bank (ECB) actions were more indirect, so stress was relieved more slowly.

The industry speaker suggested that while MMF reform is needed, it is necessary to consider holistically the functioning of short-term markets. Dealer-driven liquidity in short-term markets failed in the last two crises, so this must be reviewed together with the

1. According to the EU MMFR, if the level of weekly liquid assets falls below 30% and net redemptions from the fund exceed 10% in one day, the MMF board may enact one of the following options: apply a liquidity fee to redeeming investors, equal to the cost of liquidity, restrict ("gate") redemptions to 10% per day for up to 15 days, suspend redemptions for up to 15 days (or do nothing). In US regulation, the imposition of gates or liquidity fees is mandatory should a fund's weekly liquidity fall below 30%.

2. The MMFR sets a threshold for LVNAV funds in the form of a NAV collar. LVNAV MMF can maintain a constant dealing NAV provided the mark-to-market NAV does not deviate from the dealing NAV by more than 20 bps. In the event that an LVNAV breaches the collar (i.e. its marked-to-market NAV deviates by more than 20 basis points from the constant NAV), the MMFR requires the fund to value its assets using variable pricing and the pricing convention to move to 4 decimal places for the next redemption or subscription.

structure of the CP markets, which is the same as in the 60's, whereas other fixed-income and equity markets have evolved. Without that, regardless of further policy action on MMFs, the next crisis will likely bring another seizing up of those markets.

3. Lessons from the Covid crisis regarding Open-Ended Funds

3.1 Outflows observed in March-April 2020 and liquidity mismatch issues

Regarding open-ended funds, an industry representative noted comments by the European Securities and Markets Agency (ESMA) and the Financial Stability Board (FSB) that the majority of the sector performed as expected in early 2020. There were issues, but suspensions were limited to 0.2% and were due to valuation issues rather than liquidity. Some categories of open-ended funds saw huge outflows larger than 2008 but this was true in absolute terms. In relative terms volumes were less significant: outflows were between 1% and 4% in the worst week of the crisis, with high-yield bonds suffering most. The percentage of assets under management by asset class also shows some asset classes with inflows. This confirms that the situation was challenging, but navigable. There were some outliers and suspensions, but most of them happened in jurisdictions where swing pricing was not available.

An official considered that the March-April 2020 period provides useful insights on the possible systemic risks associated with the mode of operation of the open-ended fund sector, the potential risk around first-mover dynamic and whether that dynamic exists due to the liquidity profile of the sector. Looking at less-liquid funds, even though the reduction in asset prices was less than on equity funds, the outflows were more significant in proportional terms. There is therefore consistency between concerns around the first-mover dynamic and what occurred. The insight from that period is that it is a systemic weakness as it gives rise to a risk of fire sales.

Further analysis from regulators and central banks of last March's events is needed, the official suggested, in order to better understand the stability benefits and costs of different policy approaches on the liability and asset sides and how they may fit together, to be followed by engagement in discussions at international and EU level.

A regulator stated that in 2019 the Financial Policy Committee of the Bank of England established three key principles of fund design, relating to the consistency between fund redemption terms and the liquidity of underlying assets. These three principles are pricing adjustments, notice periods and liquidity classification. An FCA and Bank of England survey explored the application of these principles, capturing data during normal market conditions and the Covid period of market stress, with two key findings relating to the use of pricing adjustments by funds, such as swing pricing and fund managers' approaches to assessing the liquidity of fund assets.

Regarding fund managers' approaches to assessing the liquidity of fund assets, the survey found that managers of corporate bond funds predominantly classified assets as liquid, or less liquid with high valuation certainty. This begs the question of whether managers are overestimating the liquidity profile of their funds, as many corporate bonds do not trade regularly, even in normal times. Whilst liquidity assessments are challenging, there is clearly room for better metrics, and working towards consistency of assessment across funds.

3.2 Potential benefits and challenges of swing pricing and other liquidity management tools (LMTs)

An industry representative stated that the biggest lesson from the March-April events concerning open-ended funds is the need for a far broader adoption and operationalisation of swing pricing. The speaker's institution – a major asset manager - increased the use of swing prices from 200 a month to over 1,000 in March and April, mostly for redemptions in March and inflows in April, and increased the size of swing factors. This had an impact on end investors and redemptions were spread out over time, as they did not want a hit of up to 7% on redemptions.

A regulator noted that many UK funds use pricing adjustments to protect investors from liquidity risk during large net outflows and considered that swing pricing is an effective liquidity management tool. Almost two thirds of funds in the FCA/Bank of England survey applied swing pricing in early 2020. Fund managers also adapted governance processes quickly and flexibly, while identifying areas to consider further. There were however differences in how swing pricing was applied across managers. Funds overseen by the same manager applied the same calculation methods, without considering differences in strategies and asset profiles. Some managers also reported challenges in calculating swing factors in the absence of reliable market and pricing information. This cannot be guaranteed in times of stress, so enhancing this tool for those periods is required.

An official agreed that swing pricing is a useful tool to consider, even if it is not a silver bullet. An important question concerning swing pricing is the extent to which it can cause early-mover or early redeeming investors to internalise transaction costs. If this can be achieved that would allow the neutralising of first-mover advantages, but this issue needs to be further assessed. First, there is work to do on how to deploy liquidity management tools such as swing pricing in an effective way. At present it is the decision of each individual fund with no consideration for the collective effect. Then comes the important question of how to calibrate these tools so that they can be effective in mitigating market stress, rather than just being used as an anti-dilution levy.

Another official agreed that swing pricing is a smart and smooth way to make investors internalise the liquidity externalities of withdrawing money from a fund. Some issues need tackling in terms of implementation such as clarifying the respective roles of fund managers and macro-prudential authorities in the decisions made, harmonising the implementation across asset managers and improving the coordination between the different stakeholders concerned. Finding the right balance is not easy and requires further thought.

3.3 Way forward for addressing the stability issues associated with asset management activities

An official stated that asset managers, pension funds and insurance companies should be considered as holders of possibly highly correlated risks, particularly when market movement comes from developments which cannot be diversified. They continue to be exposed to major external threats such as the possible evolutions of interest rates and also geopolitical and cyber risks. At present the tools do not exist to address these system-wide risks, for example there are no system-wide stress tests yet.

Progress is nevertheless being made in the EU on tackling the vulnerabilities from asset management activities. ESMA has endorsed the recommendations made by the ESRB in this regard. The awareness of the authorities about risks relating to liquidity mismatches and the exposure of open-ended funds to real estate and corporate debt is increasing. The impacts of low interest rates on the industry are also being considered, with more still to be assessed. A review of the Alternative Investment Fund Managers Directive (AIFMD) is also underway and a review of the MMF regulation has been launched, with substantial changes needed particularly in the case of MMFR.

Another official noted that the robustness of the non-bank financial intermediation system is a priority of the Italian G20 Presidency, which has asked the FSB to provide an interim report on possible policy options for MMFs by July with a final report due in the Autumn 2021, following the report published on the turmoil in March and April 2020. The FSB has also been asked to work on the issues raised by other open-ended funds beyond MMFs, bearing in mind the specificities of these products compared to banking activities in particular. The areas to work on include the mismatch between the liquidity of assets and the liabilities of funds, first-mover advantages when there is a non-linear threshold or cliff effect, and ensuring that sufficient liquidity buffers are in place to withstand outflows.

A regulator stated that two clear themes emerged from the assessments conducted by the FCA and the UK's Financial Policy Committee. First, it is vital to continue refining and improving swing pricing as a liquidity management tool. Second, consistent liquidity classification must be developed across the fund sector. These steps will protect investors and ensure efficient market operation, particularly during periods of stress.

A third official noted the need for a macroprudential framework for the non-bank sector, as set out in an article by Central Bank of Ireland Governor Makhlouf included in the recent Banque de France financial stability review. Several issues need addressing including liquidity mismatches, the balance between time-varying and structural interventions, international coordination, and the ways of weighing the costs and benefits of different measures.

Answering a question from the Chair about the responsibility of Central Banks in case of market turmoil, especially when triggered by external factors, and how to avoid moral hazard, an official emphasized that Central Banks will undoubtedly take on such responsibilities when there is a need to intervene, but there should be appropriate regulations in place that avoid frequent and excessive market stresses and all the related costs and challenges to the extent possible. For achieving that, the fund industry needs a strong enough architecture to minimize instability risks.

4. Financial stability risks posed by the broader non-financial sector

4.1 Interconnectedness between the banking and non-banking sector

The Chair noted that the financial stability implications of the interconnections that exist in the financial sector are regularly pointed out. For example in March-April 2020 unexpectedly high margin calls from CCPs have in some cases triggered liquidity squeezes. The issue of the interconnectedness between the banking and non-banking sectors was addressed in a recent paper published by Andrew Metrick and Daniel Tarullo on 'Congruent financial regulation'[3] which proposes better coordinating the regulation of economically similar financial activities, inside or outside the banking system.

An industry representative considered that while banks were well prepared for the crisis, there are some questions around the degree of preparation of non-bank financial intermediaries in the US. Two issues were raised by the Metrick & Tarullo paper in this regard. These are not new and are not post-Covid observations. The first is the interconnections between banks and non-banks that continue to grow and become more critical, and the other is around stress for non-banks coming from a different source than the banks. Central bank support may not come at the right time for a non-bank for example.

The paper highlights that while banks proved to be a source of stability in 2020 thanks to the standards enacted after the financial crisis, financial markets and less-regulated non-bank institutions (such as hedge funds, MMFs, or brokerage firms) remained vulnerable in the patchwork of US regulation, so that the Fed had to use emergency powers to create a range of market-supporting measures. The paper also points out that while non-bank financial institutions and associated funding markets have grown to constitute a large part of the global financial system, regulation has not kept up with this development. The congruency concept developed in the paper, whereby if market participants perform similar activities, the regulatory approach should be coordinated, if not identical is interesting in this regard. For example, concerning the procyclicality and transparency issues raised by the US Treasury market, an interesting proposal on mandated margin levels was made. Another item is about whether 'the orange is worth the squeeze'. While it is possible to regulate the largest entities in a certain way – the biggest and juiciest oranges – these firms tend to be the best prepared for such events. The challenge with congruency is deciding on the right approach for the

3. Congruent Financial Regulation by Andrew Metrick and Daniel K. Tarullo - Brookings Papers – March 25, 2021

whole market, as there are no standard-setting bodies across different economically similar activities.

Congruency is therefore a very interesting approach for addressing the risks posed by non-banks, but there are challenges, and they take time to resolve, the industry representative stated. When thinking of non-bank intermediaries in particular, there are often issues of liquidity mismatch or maturity transformation, which are challenging to address. Another concern is the time that is needed for developing standards across similar activities and the degree of compromise that is required, so the question for regulators and market participants is how to manage risks in an effective way rather than waiting for standards to be developed.

Regarding liquidity mismatch and leverage issues, one application of the congruency approach is increasing transparency. More transparency can be achieved by enhancing information. Clearing can also play a role. The more that is brought into a cleared environment, the more market participants will get an understanding of the risks, the related margin requirements and the benefits of netting. That also contributes to levelling the playing field across the market and fostering harmonisation, until appropriate standards can be developed.

4.2 Potential stability risks associated with direct investments

Answering a question from the Chair about the stability risks posed by investment funds compared to direct investment by institutional investors, an official explained that direct investments can also be a source of instability.

There are three recent episodes that demonstrate this. First, in September 2018, a person operating in the energy market defaulted at the Swedish Nasdaq, having made a wrong bet on relative energy prices in Sweden and Germany and went bankrupt due to unsustainable margin calls. That one person almost destroyed the Stockholm Nasdaq. The second case is GameStop, where people - no one knows if they were traders or people gamifying trade – were trading against professional hedge funds and brought them to their knees. The third episode is Bill Hwang with Archegos, a family office that was so leveraged that a number of financial system giants went into severe problems. These stress tests were small enough to avoid the collapse of the financial system, but big enough to raise concerns, and to show that direct investment can also raise stability issues.