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CMU ACTION PLAN: PRIORITIES AND DELIVERY MECHANISMS

1. Importance of the CMU for the EU economy

1.1 The CMU is essential for funding the post-Covid recovery

An official stated that capital markets are very important for the recovery process in Europe because they complement banking finance with a different profile in terms of risk appetite. As observed in the US, capital markets incentivise more risk-taking particularly in complex and risky sectors such as technology.

An industry representative noted that the economic situation in Europe is quite severe as a result of the Covid crisis. Europe has done a great deal for its citizens by engaging significant monetary and fiscal policy measures, but the data shows a 3 to 4 pt growth shortfall for Europe in 2021, compared to the US and China (Europe will probably have a +3 to 4% growth compared to 5 to 6% for the US and 8 to 9% for China). Tackling the Covid crisis is about providing a long-term path for the growth of the EU economy, which is where capital markets and the Capital Markets Union (CMU) initiative have a key role to play.

A regulator considered that the CMU is an absolutely essential element for the recovery of the EU economy and also for the European Union itself, because if the European economy does not recover sufficiently, citizens may lose some faith in the European project.

A public representative added that Europe needs to develop and implement the CMU also because it is the only way for providing a larger access to finance and liquidity for small and medium-sized enterprises (SMEs) which are vital for the EU economy.

1.2 The structure and functioning of EU capital markets need improving

An industry representative stated that Europe's capital markets have structural weaknesses that need enhancing for achieving the objectives of the CMU. Capital markets are much smaller and much more fragmented in the EU than in the US. In 2020, looking at primary markets, there were 1,415 Initial Public Offerings (IPOs), of which 60% happened in the US and China. Only 7% took place in the EU. Similarly, if we look at the ratio of market capitalization to GDP, the US is at 148% while the EU lags behind at 53%. Europe also has a highly fragmented market structure, with more than 250 venues compared to 60 in the US. This fragmentation is due in particular to the effects of the MiFID directive, which has a much stronger impact on Europe's market structure than the CMU. There are issues also in terms of transparency: only 35% of the market is executed on transparent venues in the EU compared to 60% in the US. The ESMA statistical report on European securities markets (November 2020) has shed some light on these key performance indicators (KPIs), which are important to bear in mind.

Answering a question from the Chair about what is needed to keep more growing companies and IPOs in Europe, the industry representative stated that this is a supply and demand problem. In Europe, much of the company funding in the early stages comes at present from foreign investors, which leads these companies either to prepare an IPO in a foreign country or to go directly into a strategic sale. Europe needs to make equity financing more attractive and to create more demand for equity financing and investment. The task is to build a globally competitive financial system and market structure in Europe that is sufficiently transparent and will encourage companies to choose the IPO route in the end. The CMU will contribute to this objective, but MiFID also plays an essential role in this perspective. The simplification of listing that is proposed in the CMU is important, but it is also crucially important that Europe should build trust in secondary markets and that it should foster demand for early stage investments in European companies by asset managers.

An official considered that much also needs to be done for simplifying and reducing the cost of accessing capital markets for companies. Companies are confronted with too many requirements; some are critical for investor protection, but too many of these requirements are bureaucratic and companies, particularly small and medium size ones do not have the resources to handle so many constraints and costs. The role of venture capital investments also needs taking into account and it is important to enhance the bridge between venture capital funding and stock markets.

2. The new CMU action plan and priorities going forward

Panellists generally welcomed the new CMU action plan proposed by the Commission, considering that it is focusing on the right set of priorities and is adopting an appropriate direction of travel.

Two priorities of the CMU action plan were particularly emphasized by the speakers: the implementation of a European Single Access Point (ESAP) for corporate information and the development of retail participation. The importance of further harmonising taxation and insolvency laws at EU level, of developing pension plans and equity investments was also underlined by certain speakers.

2.1 European Single Access Point (ESAP)

Several speakers emphasized the importance of the ESAP project for developing investment in European companies. The Chair noted that a US industry leader had suggested at a previous Eurofi conference that implementing a single point of access to company information is the policy action that would make the most difference to the EU's capital market development because it would allow investors to find more easily the information they need for investing in European companies.

An official considered that the ESAP could be a strong symbol of the effort and willingness of Europe to develop its capital markets. The objective is to build an ecosystem for capital markets rather than just a database, including structured financial and non-financial reporting, good quality research on issuers and tools to ensure a bridge with venture capital. The industry should associate with the public authorities to make sure that the different structural elements that are needed to create this ecosystem can be provided around the single access point.

An industry representative considered that the ESAP is important both for retail and institutional investors, which is why it is critical to have the right data, including information on sustainability factors, which are increasingly important.

A regulator mentioned that while the ESAP is important, one element which may be far more relevant in the long term for developing investment in EU companies is tackling the bias between debt and equity from a tax perspective. This is a national tax treatment issue but it will need to be addressed at some point at the European level.

2.2 Developing retail investment

Several speakers stressed the importance of increasing retail participation in developing capital markets in the EU and discussed the challenges, conditions and tools for achieving this objective.

Opportunities and challenges for developing retail participation

An industry representative stressed that retail participation is low in Europe and has dropped quite significantly over the last 10 years since the financial crisis, from about 11% to 8%, whereas savings are at a record high with the Covid crisis, which makes it a relevant point in time to have this discussion.

Another industry representative noted that it is very important to look at the supply and demand factors and to incentivise retail participation in an appropriate way. There is a retail investment boom in certain EU countries at present due to the context of very low interest rates and to opportunities created by the market downturn at the outset of the Covid crisis. In Germany 17% of individuals in Germany own equities, which is close to the levels observed during the internet boom at the beginning of the 2000s. There is now a great deal of investment in tech companies and also by the younger generation, which is good, but it is important for this participation to be sustained in the longer term. The issues previously experienced by the Neuer Markt are still in everybody's mind. However in the long term, equity investment is the only way to get a good return.

A third industry representative confirmed that there is an emerging trend among the younger generation of investing in equities which can be positive if it is sustained. This trend is not as established in Europe as in the US yet, but it is certainly coming up and will need to be carefully monitored.

A regulator agreed that more retail participation is needed in capital markets, both because of the ageing population and of the funding needs of SMEs. It should go hand-in-hand with improved investor protection however. At present there is a large influx of investment in certain countries but also an increased risk of loss for investors as stock market prices are rising. It is hoped that the upcoming Retail Investment Strategy by the Commission acknowledges this need and aspires to raise the bar for investor protection. Some proposals such as the introduction of a new category of qualified investors or proposals to soften listing requirements for SMEs should also be handled with caution, as they may jeopardize investor protection to a certain extent.

Special attention should also be paid to the cross-border dimension including passporting regimes for retail financial services and the related cross border supervision, because if things go wrong for some retail investors investing in certain funds registered abroad this creates bad publicity for cross-border investment in general. In order to encourage retail investors to enter into cross-border transactions, they should be able to expect similar high quality regulatory and supervisory outcomes across the EU.

The way the market is structured can also be a challenge for encouraging more retail investment in some cases, the regulator suggested. In the Netherlands for example, most retail investors go through pension funds, so there is a limited number of individual investors and limited leeway for developing their participation further.

Another regulator added that there is a risk in encouraging at the same time retail investment and more capital market financing for SMEs e.g. by lowering disclosure constraints in prospectuses. That can be a danger for investors, because SMEs are typically more risky and many do not have appropriate research coverage.

Conditions and tools for developing retail investment

An industry representative stated that retail participation needs to be guided in order to obtain a long-term engagement of retail investors in capital markets. The European long-term investment fund (ELTIF) is a perfect concept for supporting this objective, but so far it has not been a success with only about 27 ELTIFs launched in Europe and a cumulative asset base that has not gone beyond €2 billion. A review of this framework is much needed based on an assessment of the reasons for the limited success of ELTIFs both on the supply and demand sides. On the supply side ELTIFs need to have the right eligible assets. This includes allowing investment in SMEs with appropriate limits, alongside real estate, sustainable assets and social infrastructure projects. There is also a need to reduce the barriers on the demand side.

The Chair observed that the pan-European personal pension product (PEPP) could be another instrument for channelling retail investment. The industry representative agreed that pension products are relevant in this perspective, because on one hand there is a need for more financing to go through public and private markets, and on the other hand there is a very strong sense that investors need to be protected, as mentioned by previous speakers. The way to solve this puzzle is not to over-burden the regulation that relates to the direct engagement of individuals in capital markets, but to build a pension system that is tightly regulated, with second and third-pillar solutions, in which people can regularly invest and that provides a

default solution. An ELTIF directly targeting SME funding would be an excellent default solution for a European defined contribution (DC) scheme, the industry speaker believed, filling a missing link between the needs of retail investors and the funding needs of SMEs. However, it is currently not that easy for the PEPP to work because PEPP products need to be registered in multiple EU jurisdictions due to domestic specificities. Pension regulation is indeed a national matter and there are also different types of tax treatments across Europe.

Building trust is also essential for fostering more retail participation in capital markets, two speakers stressed. One way of increasing trust, an industry speaker suggested, would be to provide individuals with the possibility to conduct financial health checks in a neutral way on a regular basis, as a social service, which could be a basis for encouraging more retail investment. This could be done through the digital avenue potentially. A regulator considered that harmonising capital market rules throughout Europe and increasing supervisory convergence is also essential for reinforcing trust. Moreover distribution rules need to ensure that advice is delivered in an independent way and in the interest of clients. There is also a need to think about professional investment management as a conduit to channel increased retail participation, professionalising research, and also providing sufficient diversification in order to make retail participation a success.

An industry representative added that the engagement of retail investors in capital markets is an area where care must be given to avoid a gap between the conceptual agenda of the CMU and the actual implementation in the member states. The European authorities need to explain clearly to local political decision-makers the objectives of the CMU in order to obtain sufficient local support for the measures proposed in this area.

3. Items that could be better covered in the CMU action plan

Some panellists suggested that further work on the supervisory architecture in Europe and on the regional dimension would support the CMU.

3.1 Work on the supervisory architecture

A regulator stated that the work on the supervisory architecture could be better addressed in the context of the CMU. For EU markets to function effectively, high quality supervisory outcomes are required, regardless as to whether the supervised entity (firm/business) is primarily offering services on a local or cross-border basis. The geometry of supervision should follow the geometry of the business, which is not currently the case, as there are dozens of sectoral supervisors. There are four criteria for defining whether supervision should be centralised or executed more locally: whether the activities are cross border; whether the risks are cross border; whether the rules are harmonised; and whether there is a risk of regulatory arbitrage. If these boxes are all ticked then there is a strong case for a centralisation of supervisory tasks. This would in particular logically lead to the centralization of certain supervisory tasks concerning the wholesale side of the capital markets. In any case further work to strengthen supervisory convergence is necessary.

In order to supervise effectively cross-border retail financial services, the regulator stated that specific attention must be paid to issues related to the current passporting regimes. It is important for the Commission to study the positive and negative effects of the current passporting system and to look for solutions that will empower national competent authorities (NCAs) to protect investors domestically. While being a cornerstone of the single market, the current system – with 'home' and 'host' responsibilities – may imperil the effective protection of investors that are engaged in cross-border transactions. Cross-border problems require cross-border solutions and individual supervisors are not always able and in the position to supervise effectively these issues, as there is an incentive to look first after one's own citizens and a possible cultural bias against foreign legal systems. Convergence also has its limitations, as it will not make full use of the potential efficiency and effectiveness gains, or fully eliminate the risk of regulatory arbitrage. Therefore, for a well-integrated and functioning CMU it is key that ESMA and the NCAs collectively work out an appropriate approach for addressing cross-border risks. A restructuring of supervision, rather than a full centralisation would be needed, providing appropriate incentives for the various supervisors involved.

A regulator agreed that there are merits to centralised supervision and that criteria need to be defined. This has been proposed in the report of the CMU High Level Forum (HLF) in particular. However care must be taken when using the Banking Union (BU) as a reference for defining the type of supervision that is needed for supporting the CMU. The CMU is indeed attempting to address a different problem from the BU, which is developing the ability for European companies to attract more investment from other Member States. That has more to do with incentives i.e. the incentives for companies to go public and the incentives for investors to broaden their investment horizons. Central supervision would bring some benefits in this regard, but it would not solve the problem entirely, which is why the different actions prioritised in the CMU action plan are needed.

3.2. The regional dimension

An official considered that the main missing block in the Commission's CMU action plan is the geographical aspect. This was pointed out in the report recently published on the CMU by the European Court of Auditors (ECA - 'Capital Markets Union: Slow start towards an ambitious goal') and was recognised by the Council in its March 2021 conclusions.

The architecture of the EU capital markets needs to be reconsidered, the official suggested, because there is a strong divergence at presence in the way capital markets operate across Europe and in the possibility for retail investors and SMEs to participate in capital markets. There are legal barriers such as differing insolvency laws and taxation rules and also cultural differences between the member states that need to be considered, such as different perceptions of insolvency practices. Concentration is sometimes needed at EU level for better market liquidity, but SMEs in the Baltics and the Viségrad countries for example need to be offered equal opportunities, which is not the case at present. The characteristics of the capital markets in

different member states should be further analysed by the Commission in order to identify what legislation is needed and what is not. Regional initiatives such as the consistent legislation established in the three Baltic countries for covered bonds should also be considered.

3.3 A more explicit priority for insolvency and taxation rules

A public representative considered that three main obstacles need to be tackled for developing a true CMU and enhancing the competitiveness of European capital markets at the global level: single supervision, insolvency laws, and the harmonisation of taxation. Europe is indeed competing in a global world and therefore needs to be more attractive and accessible for those seeking options for investment.

Referring to the comments made by a previous speaker, the Chair observed that the local and regional dimensions of the European capital market ecosystem are important to consider and this has been recognised in particular by the CMU HLF. At the same time there needs to be a corpus of rules in certain areas that allow capital to flow freely across the EU and facilitate a common approach for investors. This is the case of insolvency and taxation procedures. The problem with insolvency rules in particular is that international investors who are looking to invest in Europe are put off if they see challenging or lengthy barriers and the problem is increased if rules differ across Member States.

4. Next steps regarding the implementation of the CMU and challenges to overcome

An official stated that that the EU Council Presidency is working on the CMU action plan that was presented by the Commission at the end of 2020 for developing capital markets in the EU. A set of key performance indicators (KPIs) will be developed in particular in order to facilitate the monitoring of progress. There is willingness at the highest level in the EU to strengthen capital markets and momentum is building up around this objective, because member states see the link there is between making progress on the BU and on the CMU. Capital markets can indeed help to complete the structure of the financial system by providing sources of financing for investments with a higher risk profile. There is therefore an increasing position in the Council that the two objectives of the BU and the CMU should go ahead at a similar pace. Regarding the BU, the expectation is that a roadmap is going to be approved by the end of the first half of 2021. The presidency is working on the different elements that are needed for completing the BU such as EDIS, cross-border integration, the crisis management framework, the sovereign risk exposure of banks and the approach regarding the small and medium banks.

An official noted that if the BU and CMU are compared it looks as though the BU is much better accepted and understood by the public, but at the same time Europe is much more advanced in the CMU in terms of ideas. The prioritisation that was established by the Council is the right way forward. What remains to be done is defining the responsibilities in terms of implementation. The ECA report on the first stages of the CMU identifies a gap between the ambition and expectations put forward regarding the CMU and the ability of the Commission to actually foster progress in the different areas of the CMU. This gap should not be reproduced in the further steps of the initiative.

A public representative noted that the Commission, the Council and the Parliament have all displayed a strong ambition regarding the need to make the CMU a reality, which is very positive. There were initially disagreements among the different political groups in Parliament mainly about retail investor protection issues and the risk of deregulation that certain simplification measures of the CMU may entail, but compromises were found. The demand for a high level of protection of retail investors however remains a challenge for the CMU because in some cases it may create more obstacles than deliver incentives and simplifications. There were also heated debates among the EU institutions and market stakeholders concerning supervision and insolvency and taxation rules but agreements were also found. Now there is a common willingness to make the CMU a reality.

Ambitious and concrete deadlines are however needed to achieve the 16 measures included in the CMU action plan, the public representative believed, because these have not yet been precisely defined by the Commission. The speaker moreover had doubts about whether there is such a common position amongst all member states regarding the BU, which would be essential for making progress on this initiative.

The Chair agreed and expressed concern about the Council's conclusions from December 2020 which have pushed forward certain actions of the CMU action plan to the medium term with no clear deadline. This includes the work on insolvency rules, which seems endless.

An industry representative stated that the commitment displayed by the public authorities and different stakeholders for the CMU is very important for moving the initiative forward. The main challenge for the CMU concerns its execution and being able to implement it in a timely manner with sufficient granularity. An effective collaboration between public and private sector institutions is essential in this perspective, as well as a proper balance in terms of obligations and responsibilities. One major challenge in this respect is that many critical actions for the CMU, such as taxation or pension systems, are within the sovereignty of EU member states, which means that the commitment of individual member states is essential for the success of the CMU. The coordinated political will expressed by the EU institutions is a major step forward, but Europe will need to help generate sufficient momentum in the implementation phase and make sure that the key priorities for achieving the CMU are appropriately implemented.

There also needs to be a sufficient protection of intra European Union investments, the industry representative emphasized following the recent proposal of the Commission that aims to clarify the rules that protect and facilitate investment between EU countries and improve dispute settlement. This is critical for a successful implementation of the CMU, the industry speaker concluded.

DEVELOPING RETAIL INVESTMENT

1. Current trends of retail investment in the EU

1.1 Current situation of retail participation in the EU

A regulator emphasised that the volume of retail investment in Europe is low, especially compared to other comparable economies like the US, Australia and so on. Despite the recent trend towards more risk taking in the EU with investors moving assets from guaranteed products to unit-linked insurance products because of the low interest rate environment, there is room for further growth in Europe through insurance-type products or third-pillar pensions in particular.

An industry representative noted that the savings rate is currently at a record high of 17% across the European Union. At the same time, investment participation is at 8%, which is lower than it was 10 years ago. Another industry representative confirmed that savings almost doubled during the COVID crisis and this accumulation of savings was one of the major consequences of the crisis. An investor representative stated that directly or indirectly, most of the long-term funding in the EU economy comes from households. Unfortunately, the proportion of equity contained within household portfolios has been stagnant at 4% over the last 5 years and has not even followed the price increases of the stock market. From the statistical perspective, the CMU project has therefore not been a success so far.

1.2 Importance of retail investment for the funding of the EU economy

The Chair explained the importance of developing retail investment for the economic future of European citizens, for the funding of corporates and the post COVID recovery. The objective is to make retail investment in the EU a success story, however the EU is still very far from this objective

A regulator emphasized that it is essential that the growth of investments in unit-linked products and pension funds should continue because that is a way to foster long term investment in the capital markets and in the European economy. This is one of the main objectives of the CMU. An industry representative stressed the importance of placing the retail investor at the centre of the debate about the post-Covid recovery. Using an investment led approach will ensure the channelling of money to productive activities is a more stable way than funding based on government debt. As Jacques de Larosière said in a previous session of the Eurofi seminar, Europe will not succeed if it seeks to stimulate its economies solely by producing more debt and expanding its monetary base.

An investor representative stated that Europe needs to create a CMU that works for people and offered a strong warning to the industry about excluding more retail investors from the capital markets. Citizen participation in the economy, notably through the capital markets, is an essential part of democracy and capitalism. Capital markets should not be left to professional investors who mostly commit ‘other people’s’ money.

2. Challenges that need addressing for further developing retail investment

2.1 Adapting the cost and complexity of products and services to retail needs

A regulator considered that there is an issue with the cost of products offered to retail investors in some cases, which reduces their potential return. Consumers must be confident that the products they can invest in provide good value for money, which requires driving down margins and overhead costs. If they do not trust investment products, there will continue to be an excessive amount of money locked up in bank accounts, which will not foster economic growth. Some products are also overly complex, which does not help to foster the trust and confidence of retail clients in long-term investment. EIOPA has recently launched a consultation concerning these issues in order to tackle the obstacles to retail investment.

An industry representative agreed that financial products should be offered at a reasonable or even low cost, but it is important not to assume that it is possible to have good quality advice without adequate compensation. Talking with customers to understand their needs and make the right recommendations takes time and has a cost. The right measures need to be found to foster the provision of adequate products and advice. ‘Blunt’ measures such as fee caps do not seem to be the right way forward. For example, the regulation around the Pan European Personal Pension (PEPP) product has a 1% fee cap. This will force the cost of advice into the 1% cap, which will eliminate the incentive to select the right investments and conduct proper risk management.

An investor representative concurred that product costs can be an issue, especially in complex segments such as unit linked products, for which total costs are difficult to figure out. The 1% fee cap of the PEPP however only applies to the default option. With interest rates at zero, having low fees is necessary to offer a remote chance of protecting the purchasing power of savers. In the US, Individual Retirement Accounts have a charge well below 1%.

An industry representative agreed on the need for affordable products and the importance of advice. Advice must however be paid for as was previously mentioned. In countries such as the UK which have banned inducements, advice is now only available to the wealthiest investors. Digitalisation can be part of the solution e.g. with robo-advice, but it is not a ‘silver bullet’. A recent poll conducted in France demonstrated that even people in the younger generations, i.e. between 25 and 35 years old, still prefer to rely on physical advice.

A regulator described how the problems concerning retail investment started during the great financial crisis of 2008. Since then, there has been a continuous issue of trust from retail investors with problems about cost structure, access to products and available information. The reluctance of retail investors to invest in capital markets or to pay for advice can be explained in part by the strong presence of banks in the EU. When customers leave money with their bank there are no costs whereas with investment products there are often fees to pay upfront. In addition, banks are very cautious with their customers and do not always encourage them to invest in products that have some risk.

2.2 Striking the appropriate balance between investor protection and participation

The Chair explained that there is a balance to find between protecting retail investors and encouraging their participation in capital markets. This issue was discussed at the CMU High Level Forum (HLF) in particular.

A public representative agreed that this is a key issue and considered that policy-makers are still seeking the right balance. One of the key challenges for retail investment is to create a regulatory framework that can also be attractive for the industry and offer the industry an opportunity to increase its customer base while providing the necessary protections. These protections should include providing retail investors with sufficient information on the risks and giving them appropriate advice so that they reach a proper understanding of the products and how to manage them.

2.3 Leveraging digital platforms

An industry representative considered that digitalisation will be critical for increasing retail participation in capital markets. A public representative noted that there are many different digital platforms that offer the opportunity to participate in different kinds of investment strategies, especially for younger people. Most of them relate to financial indices and are relatively safe, but some are not positioned in this way.

One of the potential risks associated with digitalisation is gamification. An investor representative noted that the GameStop case has revealed many things, in particular the practice of payment for order flow and the role of market makers and dark pools. An industry representative considered that this case shows that it is highly risky when citizens invest directly in equities without any knowledge or advice. It is important to acknowledge that advice is needed but also that it has a necessary cost. A regulator agreed that in some cases fintechs can create problems for investors, as in the case previously mentioned, but on the whole they also help to streamline and cheapen investment.

An investor representative highlighted the role that digitalisation can also play in fostering more investor engagement, especially for the younger generation who are keen to engage more. It is a shame that in the 21st century, more shareholder and investor engagement does not take place via digital channels. Moreover, exercising voting rights within an intermediated product is very difficult. In the CMU HLF report and in the Commission's CMU action plan, there is a proposal to develop an application of distributed ledger technology (DLT) for shareholder voting and the execution of voting rights, along with the creation of a single definition of shareholders throughout the EU. The investor representative however stressed that this may not go far enough, because Europe has a very fragmented system. The project that the Commission Directorate for Justice and Consumers (DG JUST) is currently undertaking regarding sustainable corporate governance could contribute to improving the situation.

2.4 Channelling investments towards the appropriate economic objectives

An industry representative highlighted the importance of ensuring that citizens' money is channelled in the right direction, notably the transition towards a sustainable economy, the provision of the necessary energy infrastructures and the improvement of the healthcare systems. In this perspective, asset managers should think about building savings solutions that orient capital towards the areas of the economy that need finance, rather than simply selling products. The industry representative considered there to be several positive developments in the CMU action plan in this perspective, notably the priority to channel more savings towards long term investment. In particular, the possibility being considered in the review of the ELTIF Regulation to extend the access of retail investors to ELTIF products is a step in the right direction because it is likely to encourage retail customers to invest more in capital markets and private equity.

The Chair agreed that solutions must be found for savings to contribute to the recovery of the European economy. At the same time Europe must provide a better financial future for its citizens, given the current challenges in terms of ageing population in particular and the consequent pressure this places on pensions.

3. Priorities for developing retail investment

The speakers on the panel emphasized the importance of developing trust and confidence for fostering retail investment in capital markets and generally considered that the CMU action plan published in September 2020 is moving in the right direction in this respect. They highlighted certain areas of the action plan that may particularly contribute to developing retail investment, and proposed some additional policy and industry-driven actions for achieving this objective that would be useful to consider in the context of the CMU action plan, together with some issues concerning the timetable for implementation.

A public representative noted that the Global Retail Attractiveness Index suggests there is a high level of confidence in the EU15 markets, but it is now necessary to develop Europe's information infrastructure and provide reassurance for investors in order to encourage them to participate in capital markets. This issue is currently being debated in the European Parliament.

An investor representative regretted that the Commission's action plan has left out or postponed some of the measures proposed by the CMU HLF report and the ECON Committee's report on CMU from September 2020 that are highly relevant for retail investors. For example, some of the most critical measures from the CMU HLF report have been postponed until after the Commission's 'retail

investment strategy exercise', which will not produce any regulatory recommendations and only start next year. This includes reviews of the investor protection rules in MiFID II and of the highly problematic Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation. It is unclear when this will be addressed, but it will not happen before 2023. This is mainly a matter of insufficient political will, the speaker considered.

3.1 Providing appropriate information and financial education

An industry representative emphasized the importance of meaningful information for retail investors, who are not sophisticated investors. There could be some flexibility in the current legislative framework regarding the MiFID opt in, but this is a topic for a future review. Policy makers must in particular address the problems raised by the PRIIPs key information document (KID), which is a 'nightmare' for investors and could end up being counterproductive. Financial education is also essential as well as creating the right incentives for investors through the tax system. One issue is that often the tax system incentivises investment in insurance products that ultimately invest in government bonds. In addition, tax incentives are mostly in the remit of member states.

Another industry representative agreed on the need for there to be appropriate disclosure and transparency, but was very sceptical about investors engaging directly in the financial markets, which is not a healthy way to increase investment. A guided approach is needed for fostering more retail investment. A suggestion could be for the European authorities to provide individuals with regular individual financial health checks. Individuals could provide their information and objectives and then receive information about their potential financial future and the types of savings that would correspond the best to their financial objectives.

An investor representative agreed on the importance of improving financial literacy and providing investors with adequate information. Unless the idea of a regular state-funded financial health check is put in place, there are only two points at which it is possible to provide retail savers with financial education or information: the retail point of sale or the workplace. There should be a stronger focus on this latter point, the speaker believed, which is quite underdeveloped in most of Europe.

A regulator highlighted EIOPA's current work on pensions. EIOPA received a call for advice from the Commission and is now working on a national tracking system and a pension gap dashboard aiming to help citizens to understand how much they will earn during their retirement period and how much they need to save to fill the gap. Every country in Europe has a problem with their pillar 1 pension system. EIOPA is seeking to create the infrastructure for people to understand these issues. The regulator stressed that information should be of good quality, come in a simple and engaging form, and be comprehensive. In this perspective, information should be based on behavioural research rather than supervisory or market transparency objectives. It is the right moment to do this, the regulator emphasized because the Commission is currently rethinking the system.

Another regulator considered that regulatory requirements have helped to improve transparency and the access to information, but more needs to be done to simplify, streamline and improve the quality of the information for retail investors. Indeed, the way this information is presented is often anything but understandable for the average person and the volume is excessive. This often produces two types of reactions from retail investors: either they ignore the information and simply agree to purchase the product or they give up the investment altogether. Supervisors and legislators are caught between the need to secure the informational consent of the retail investor and the need to keep the information sufficiently simple to be understood by non professionals. In some cases, this balancing act is not achievable. There is a risk here that the information presented to retail investors will be used as a liability shield for financial service providers. Historically, this problem has led to the scope of information requirements becoming progressively larger, which could explain why the average investor or SME still relies very much on the simpler banking system.

The regulator suggested that there are two main options for improving the level of understanding of investors. One option could be to educate all users of financial services, which is impossible. Alternatively, investor information could be simplified to make it understandable by everyone, but there is the risk of over-simplifying inherently complex issues. It is essential to bridge this gap, and the best way to do this is by teaching investors to ask for help and providing them with professional, independent and affordable financial advice that may guide them towards investments with an appropriate risk reward. Another challenge, because of the ageing of the population, is educating investors early enough, so that they can start saving as early as possible.

3.2 Providing investor guidance and advice

Several panellists emphasized the importance of appropriate guidance and advice for retail investors and exposed examples of measures that could be taken in this regard.

An industry representative outlined the importance of intermediation for investors wishing to invest in SMEs in particular. SMEs are an essential for the European economy, but are risky. Intermediaries are required to guide such capital allocations. Some platforms such as Moonfare for example provide access to private equity and private debt investing at a very low-ticket size and could be an appropriate channel for such investments.

A public representative highlighted two interesting ideas that could be picked up in the regulatory framework concerning digital platforms in order to provide investors with further guidance. First, platforms should be required to offer demo accounts. Younger people sometimes perceive these platforms as a kind of game and some form of demo account could give investors a more accurate perception of the risks involved in trading activities. Another suggestion is to have a framework that differentiates between

professional traders and retail investors in the features that may be accessible on these platforms.

An industry representative noted that there are worrying omissions in recommendation 8 of the CMU action plan concerning inducements, advice and disclosure. While it is a good idea to improve disclosure and to seek a level playing field between the various pieces of distribution legislation (MiFID, IDD), the cost of advice must ultimately be paid by someone because there is no 'free lunch'. It is important to preserve the distribution ecosystem in Europe and avoid adopting a radical solution that will ultimately work against what is in the best interests of investors, which is to have access to qualified financial advice.

An investor representative noted that the CMU HLF report contains measures to curb the damaging potential for conflicts of interest at the point of sale. Investors need to be educated at the point of sale, but not in a biased way. One issue is charging commission on execution-only transactions, because there is no advice there. There is also a question about whether biased advice is better than no advice. The problem is that commissions are charged on packaged and complex multi layer products mostly, not on simpler products like index exchange-traded funds (ETFs) and therefore this influences the advice provided. This report also points towards creating a level playing field between insurance products and MiFID regulated products. Under MiFID, there is a prohibition on commissions for independent advice and portfolio management, which is not the case for insurance based products regulated by IDD.

A regulator emphasised the need for a functioning and incentive balanced network of independent financial advisors. Europe must design a distribution network that is truly neutral with the interests of clients at its centre in order to foster more trust and retail investment. The regulator also stressed that the financial incentives of advisors must be divorced from distributors and manufacturers in order to place retail investors at the centre of the whole process.

3.3 Understanding the nature of European investors and ensuring adequate protection

A public representative suggested that the precise nature of retail investors in Europe needs to be identified in order to determine which areas the regulatory framework should focus on. According to the latest data, the average retail investor is of the younger generation, approximately between 35 and 40 years old. These are the people who use the various platforms enabled by digital infrastructure and technology.

A regulator agreed on the need to understand the nature of retail investors, including their limitations. Two elements need to be borne in mind. First, is that it is not realistic to turn every retail investor into a qualified financial analyst, before they are allowed to invest. Second, is to acknowledge that the investment decisions of non qualified investors have nevertheless made for a healthy financial system and that their decisions can be both rational and profitable.

An investor representative stressed that the CMU HLF report had recommended that retail investors in capital markets should be in the scope of the Collective Redress Directive, but this has not yet been done. There have been scandals like Wirecard, in which €20 billion of pension savers' money will disappear without indemnity due to Europe's lack of tools here. The public representative noted that given that retail investors are the least protected participants in the market they should be subject to more regulations that guarantee their safe inclusion in the investment market.

3.4 Clarifying the responsibilities for enhancing retail investment at the EU level

An industry representative emphasized that more clarity is needed on who will be in charge of carrying out which parts of the plan for developing retail investment. The point has been made previously that some of these proposals should be done at EU level and some should be done at national level. The problems concerning tax treatment for example cannot be solved at EU level and must be tackled at the national level. The same goes for financial education.

The Chair agreed that issues regarding tax treatment is not something that is within the Commission's remit. It is essential to persuade national politicians that changes need to be made because of the importance of increasing retail investment for the European economy.

A public representative added that European consumers would benefit from a further consistency of the regulatory framework concerning retail investment at the European level, because at present national regulations differ quite substantially. It should be possible to create a regulatory framework that does not contravene most of these national regulations while providing a common level of specification for regulating retail investment.

3.5 Developing workplace participation and pension products

An industry representative highlighted the fact that the own initiative report on CMU published by the European Parliament contains ideas that are not in the CMU action plan, notably about increasing the financial participation of employees in their companies' capital and workplace schemes. These instruments are important for educating financial investors since company saving can be the first step to broader investments.

An investor representative agreed that the provision of financial education in workplaces is thoroughly underdeveloped in Europe. This is not only about employee share ownership; it is also about corporate savings plans and corporate defined contribution pension products. If Europe had the same asset value level of employee share ownership as the US, the amount of money in SME employee share ownership would be multiplied by 100.

A public representative emphasized the importance of the PEPP in this context. It is essential to determine whether potential providers would be willing to offer such a product and what considerations would inform their decision in this regard. It would be good practice for Europe to consider the examples used elsewhere in the world, where this process is already happening on a broader scale.

AIFMD AND ELTIF REVIEWS

Background

A regulator explained the background to the ongoing reviews of the Alternative Investment Fund Managers Directive (AIFMD) and the European Long Term Investment Fund regime (ELTIF). AIFMD was adopted in the aftermath of the global financial crisis. It governs fund managers rather than products. Alternative Investment Funds (AIFs) are funds which are designed mainly for professional investors and invest in less liquid assets than UCITS funds. 10 years later, AIFMD has proved to be a successful framework for AIFs. Europe has a transparent and robust sector that provides the real economy with a growing amount of financing. ELTIFs were launched in 2015 with the intention of supporting investment in longer term real economy assets, but they have not had the same success. In parallel, Europe is experiencing a rapid and deep transformation of its capital markets as a result of Brexit, digitalisation and the implementation of environmental, social and governance (ESG) factors. Making progress on the Capital Markets Union (CMU) is essential for the post-Covid recovery, which will include updating fund policies such as AIFMD and ELTIF in order to enable AIFs to better contribute to the financing of the EU economy.

1. On-going review of the AIFMD framework

1.1 Achievements of AIFMD and the extent of the review needed

A policy maker updated participants on the Commission's progress on the review of AIFMD. The first report was presented to the Parliament and Council in June 2020, and the review will continue after the conclusion of the stakeholder consultation. The review of AIFMD is not a revolution but rather a targeted adjustment. The Commission has not yet decided whether this adjustment will happen through Level 1 or Level 2. Targeted adjustments will only be made in Level 1 if this is necessary, in order to avoid reopening the discussion on the whole directive. The Commission is currently preparing an impact assessment and will soon be releasing a precise timetable for the review. A package of proposed adjustments could be tabled by the end of the current year. At this stage, the Commission's review is seeking to confirm that AIFMD has delivered on its main objectives: i.e. to create an internal market for AIFs that may contribute to the CMU; to reinforce the regulatory and supervisory framework for AIFs; and to introduce more transparency and more information, and therefore more protection, for both investors and managers.

A regulator agreed that AIFMD is a success story. It has provided a solid framework for AIFs in Europe over the last decade and it has enabled consistent supervision of alternative fund managers. This has provided reassurance for investors and created a credible regulatory framework. An industry representative concurred that AIFMD has created an effective internal market for EU AIFs by providing a stringent framework and a comprehensive set of rules, which has led to increased harmonisation. Any changes to the Directive should be focused. During the severe market disruptions in March 2020, AIFMD demonstrated its ability to protect investors through the standards on liquidity and risk management. A regulator agreed with the previous speakers that AIFMD has allowed the development of a well-functioning internal market for AIFs with robust and internationally recognised standards. There is no need to 'break what is working well', but the opportunity to improve the framework should not be missed, since it is the first time that AIFMD is being reviewed. The review is in particular an opportunity to rethink its set up and improve its effectiveness with a streamlined single rulebook clarifying what is applicable for European asset managers, since many rules were introduced at different times.

An industry speaker acknowledged the need for a gradual improvement of AIFMD, but emphasized the importance of also taking into account the present macroeconomic environment. The amount of fiscal stimulus undertaken by the United States and the comparative speed of recovery in the US and many parts of Asia versus Europe illustrate the considerable amount of private capital that is needed to fund the post-Covid recovery. Banks or governments alone will not provide the financing that Europe needs over the next decade. Some non-European market participants also still consider Europe to be a relatively unattractive distribution destination for funds compared to the US or many Asian countries due to issues around reporting, the lack of a truly integrated single market, and the fact that investor education is generally lower in Europe than in other international markets. The industry speaker thus considered that the review of AIFMD should not be 'too-gradual' as there is a risk of missing some opportunities in terms of access to capital.

1.2 Main focus of the AIFMD review

A policy-maker mentioned that the Commission has identified several areas for improvement. First, there is fragmentation around depository services. The idea of a passport for depositories is an old debate that the Commission has previously sought to introduce. In the past, a consensus has been difficult to find, nonetheless, further integration would certainly improve the operation of the market. Secondly, improvements in reporting are being considered since they would offer supervisors better tools and better data. The Commission is also assessing whether loan origination funds, which are developing very quickly, deserve specific rules. The Commission will moreover evaluate whether liquidity management tools, which are implemented very differently across member states need further harmonisation. Finally level playing field issues will be considered in order to establish whether different financial intermediaries are subject to the same obligations.

A regulator emphasized the other areas of focus for the AIFMD review from the perspective of ESMA. First, there should be greater regulatory harmonisation between the AIFMD and UCITS frameworks. In some areas AIFMD is more advanced and granular than UCITS. This includes risk management and also reporting, where there is an elaborate reporting mechanism for AIFs but not for UCITS funds. The second area of improvement for ESMA is liquidity management tools. It is important to ensure that these tools are available consistently across member states and to the various regulators, as shown by the recent market stress in March-April 2020. Swing pricing, gates and side pockets must be tools available throughout the EU. ESMA's third and somewhat controversial priority concerns delegation. While delegation arrangements can increase efficiencies and ensure access to external expertise, given the global nature of the investment fund industry, its extensive use may also create operational and supervisory risks, particularly in relation to empty shells and letterbox companies. While AIFMD already provides some requirements on delegation, this issue needs to be re-evaluated in ESMA's view.

Another regulator agreed with the areas of improvement identified and the need for further harmonisation. The reporting requirements in AIFMD – i.e. concerning data collection, the information made available to the authorities and the delays for providing the information - can be improved, and these improvements should be extended to UCITS. A more consistent framework should be developed for liquidity management tools across the EU with guidance on how to use them in order to facilitate access to these tools for asset managers.

1.3 Possible areas of improvement of the AIFMD Directive

Delegation arrangements

Several panellists emphasized the importance of delegation for investment funds and the need for possible changes to existing AIFMD rules in this area to be clearly focused. A regulator stated that delegation in fund structures contributes to the efficiency of the fund. It is important to remember, when considering a review of delegation and substance rules, that this topic emerged during the Brexit process. There were concerns about delegation in this specific context, but these were not driven by supervisory issues relating to AIFs in general. The regulator suggested that improvements to the delegation system should therefore be targeted and focus on specific issues such as control measures at manager level. For example, the ESMA Brexit opinion emphasizes the importance of due diligence when choosing delegates and how it should be conducted. It is also essential to ensure good governance and adequate staffing at manager level both in terms of resources and competences and this is important in all cases with or without delegation. The regulator stressed that purely quantitative criteria should be avoided when determining whether there is an adequate level of delegation. For example, ESMA's letter to the Commission referenced high amounts of fees paid to delegates as an indicator of excessive delegation, which is not an appropriate criterion in many cases. What is needed instead is ensuring that there is an effective control mechanism and appropriate governance in place.

Another regulator agreed with the proposals made by ESMA in its letter to the Commission regarding delegation and suggested that the strong delegation framework in AIFMD could be extended to UCITS. The concept of a letterbox entity exists in the UCITS framework, but there has been no development of this concept in the same way as in AIFMD (e.g. with a definition of what delegation means, how supervisors should consider these issues and what kinds of controls and tools should be implemented). Additionally, the work which was completed in the context of Brexit regarding delegation could be used to complement the UCITS framework. The regulator also encouraged the Commission to analyse some of the recently developed delegation frameworks that are used to evaluate the extent of delegation and whether managers maintain appropriate control of key functions.

Retail investor access to AIFs

Answering a question from the Chair about the possible need to make AIFs more accessible to retail investors, an industry representative suggested that while making more products available to retail investors makes sense in general, this does not seem appropriate in the case of AIFs. UCITS already offers a wide suite of investment opportunities for retail investors and has the advantage of being a structure widely recognised in the market that provides appropriate safeguards for retail investors. The particularities of AIFs also need to be taken into account. If AIF products were developed for retail investors, it would be necessary to define appropriate risk limits, considering their expectations in terms of liquidity and investment time horizon, which would be different from those used for professional investors. That would dilute the current AIFMD model which works well. Distributors would also have to provide retail investors with more information on the characteristics of funds and conduct more comprehensive due diligence and suitability testing, which could add complexity to the existing distribution model. The industry representative therefore suggested that there are more appropriate alternatives to opening up AIFs to retail investors, such as making changes to the ELTIF framework, which seems a more suitable vehicle for retail investors. Another alternative could be to broaden the definition of professional investors under MiFID in order to include more sophisticated retail investors.

On the question of increasing retail participation in AIFs, a regulator agreed that it would be preferable to target retail investors with an adjusted ELTIF product rather than with an adjusted AIFMD product.

Depositary activities and supervisory fragmentation

A regulator stated that the introduction of depositary passports could increase supervisory complexity, creating a scenario where there could potentially be a manager in one jurisdiction, a fund in a second jurisdiction and a depositary in a third jurisdiction. The duties of the depositary, especially concerning oversight, make it the external entity which is closest to the day to day functioning of the fund. Implementing

the depositary passport would make the work of supervisors more complex and complicate information flows between different actors in the value chain. The regulator considered it preferable to develop technical solutions which would allow depositories based outside the AIF domicile to be licensed to provide depository services in the home jurisdiction of the fund. Initially AIFMD had the 'Maltese exception', which expired in 2017[1]. This could be a technical way to address the issue of depositary fragmentation without questioning the fundamental rule that, where possible, the depositary should be established in the same jurisdiction as the AIF.

Another regulator was not favourable either to a depositary passport and agreed that improving the current framework is a better option. For example, the segregation requirements that ESMA worked on for depositary functions could be included in the legislation. The regulator concurred with the previous speaker that supervisory fragmentation may be a concern in the context of AIFMD with a fund, a management company and a depositary all potentially located in different jurisdictions with different supervisors. This multiplicity of supervisors creates potential complexity around supervisory interactions if there is a need to intervene, even if day-to-day cooperation works well. This issue needs addressing in the AIFMD review. The system does not need to be entirely changed, however. Rather, it would be preferable to improve coordination with one authority playing a lead supervisory role. This authority could have an oversight role for all EU activities of a given operator for example, which would improve the effectiveness of supervision.

2. On-going review of the ELTIF framework

2.1 ELTIFs have experienced a limited uptake

A regulator mentioned that the ELTIF regime aims to increase long term investment in Europe's real economy, but only a small number of ELTIFs have been launched so far with a relatively small amount of net assets under management. ESMA's register indicates that there are 27 active ELTIFs in Europe, and 16 of them are domiciled in France, which cannot be considered as a success.

A regulator agreed that ELTIFs have not met with the success hoped for by the co legislators. Indeed, very few ELTIF funds have been launched so far. Even in France, in absolute terms the amount of assets within ELTIFs only amounts to €1 billion. A potential explanation for France could be the culture of private equity and infrastructure investment. The relatively poor performance of ELTIFs overall could be related to tax incentives, regulatory requirements or a lack of harmonisation in regional marketing rules. These avenues to explore were highlighted in the CMU High Level Forum report. A second regulator noted that often projects for launching ELTIFs do not go to the end and agreed that the lack of an attractive tax regime could be one factor that affects whether or not an asset manager ultimately decides to launch an ELTIF fund.

A policy-maker stated that the Commission is confident in its ability to improve the uptake of ELTIFs, which need more time to impose themselves in the market. The Commission believes that ELTIFs can materially contribute to several very important EU objectives and priorities: the CMU, the European Green Deal and Energy Union. Increasing long term investment represents an essential step towards these major priorities.

2.2 Recalibrating ELTIF products and their investor target

A regulator stated that an instrument is needed to channel the large amount of savings that has been accumulated in Europe, towards long term investments and equity financing. ELTIFs may not be the full solution but should be part of it. The ELTIF review is an opportunity to reassess how these funds can respond better to investors' needs and to the challenges facing CMU. It is possible that ELTIF seeks to address too many investors at the same time. The fact that it is both a professional and a retail product makes it very challenging because different investor types have different needs: some of the long term characteristics of ELTIF are not well suited for retail investors for example and vice-versa. In addition ELTIFs are in competition with domestic AIF products that tend to be more focused on professional investors. The added value of ELTIFs compared to these domestic products should be more clearly defined. There could be ELTIFs targeted at professional investors with more relaxed rules regarding diversification, concentration limits and leverage limits and others addressing retail needs with the necessary protections and safeguards concerning suitable advice and information.

The regulator emphasized that for retail investors the key point is liquidity management because retail investors are culturally risk averse and they tend to demand more access to liquidity. There is a need however to reconcile this need for liquidity with the long term nature of the ELTIF product. ELTIF should remain a closed ended structure in order to avoid a liquidity mismatch which would not function with very long term investment assets on the asset side. However, these funds could be traded on trading venues to provide some form of liquidity or have some kind of liquidity windows in a secondary market.

An industry speaker considered that involving retail investors should be one of the priorities of the ELTIF review, because retail investment is an important source of capital, which Europe must tap into and agreed that liquidity is important for these investors. However, expanding the scope of eligible assets, which is the usual temptation when tackling this type of issue is not the right answer, because it would not achieve the initial goal of fostering long term

1. Prior to the transposition of AIFMD, hedge funds licensed in Malta were free to appoint a depositary situated in any reputable jurisdiction. AIFMD has restricted this freedom, in that the depositary is required to be situated in the jurisdiction where the AIF is established. Malta negotiated a temporary derogation from this requirement until July 2017 whereby depositaries of Maltese AIFs could be located in other EU Member States, provided that the appropriate supervision was conducted in the depositary's home country.

investment. Some definitions could be clarified and indirect investments such as securitisation could be added, but these are not core issues. The underlying issue with ELTIFs, the industry speaker stated, is that they are operated using technology from the last century, which has a major impact in terms of cost and liquidity. The cost of setting up an ELTIF and completing the legal paperwork is usually about 10 times more than a UCITS fund because a bilateral debt agreement is often over 100 pages of legal contracts and is very difficult to standardise. In this regard, there could be a role for blockchain technology, which could facilitate the provision of real time information on distribution, asset valuation and so on. This technology would facilitate the exchange of information across manufacturers and distributors and it could also be instrumental in creating a secondary market liquidity platform. It is indeed much better to have secondary market liquidity than to try to put liquidity into a fund which by definition is not liquid. The use of blockchain could help democratise these long-term assets.

A policy-maker observed that an expansion of the eligible assets does not necessarily contravene the goal of fostering long term investment. In fact, allowing managers more scope would allow them to better meet the demands of their clients while still preserving the essence of the ELTIF.

A regulator agreed that one of the core issues with ELTIFs is satisfying both professional and retail investors, but stressed that it is essential not to 'throw the baby out with the bathwater'. The positive features of the ELTIF framework need preserving. It is important to ensure that these funds provide access to assets which are intrinsically less liquid, have less information and are riskier. For retail investors to be involved in ELTIFs, which is important from a CMU perspective, it is necessary to have the right safeguards in place, mainly in respect of liquidity and redemption. These funds should remain closed ended and therefore other ways of enabling liquidity should be proposed. ESMA made several proposals for improving ELTIFs in this regard. While the regulator acknowledged that the scope of assets should not be entirely reconsidered, ESMA suggests that there should be some assessment of whether the current rules are too restrictive and whether ELTIFs can have a wider scope from a funding perspective.

Answering a question from the Chair about the importance of financial literacy for developing retail investment in ELTIFs, an industry representative considered that financial literacy is certainly an important factor, but there is a range of issues to address that were appropriately highlighted by the previous speakers. No single measure will address all of the issues raised by ELTIFs, therefore the review must make a combined and holistic consideration of the different issues at stake, including the functioning of the product and using new technologies, as was previously suggested. A regulator mentioned that the suitability test in article 27 of the ELTIF regulation, which applies when a fund is accessible to retail investors could be reviewed. Having protective measures is necessary, but promoters of these funds consider this test to be very cumbersome, as it applies on top of retail fund marketing rules. A policy-maker stated that the Commission is reviewing ELTIF carefully, considering all the aspects mentioned by the panellists, in particular how to achieve a better targeting of ELTIF funds for each type of investor.

Conclusion

The Chair summarised the debate, noting that long term investment is necessary for infrastructure and for securing citizens' retirement and also for the post-Covid recovery. All of the panellists had agreed that AIFMD is a success, and any changes to it should be targeted adjustments. On ELTIFs, the panellists had agreed that the review is an opportunity to rethink the framework and purpose of the regulation.

DEVELOPING EQUITY FUNDING

1. Importance of equity funding for the EU economy and current market trends

1.1 Importance of equity funding for the post-Covid recovery

The Chair stated that developing equity funding is particularly important for tackling the current recession during which saving rates have increased. Because of the major public intervention put in place people did not need to de-save as is usually the case during a recession. The supply and demand shock during the Covid crisis also meant that people were unable to spend. When the worst of the crisis is over, consumption should increase but some of this accumulated spending will also likely be ready to be invested, notably in equity.

An official commented that equity funding is key for the post-Covid recovery. Post-Covid, more people might also be aware of the importance of equity funding. The Covid pandemic has demonstrated that equity is a first buffer of resilience for corporates and helps them to face up to unintended events. The future growth of Europe will be linked to active investment in the economy with a significant proportion of equity. Increased equity financing from European investors would also help to retain control over EU corporates in the Union.

An official added that equity is particularly important for the financing of the young and innovative businesses that will drive structural change in the EU economy. These companies are indeed those that have the potential to put innovative ideas into practice, create jobs, and safeguard the foundations for future prosperity and growth in Europe.

1.2 Current investor trends

An official noted that, looking at the demand side, there is a great deal of money ready to be invested in equity. This is due to continue because monetary policy is creating significant liquidity and investors are struggling to find investments that provide sufficient return. The share of that money invested in EU corporate equity is however still relatively limited.

An industry representative stated that retail investors are essential for the equilibrium of the European capital market. 2020 was a very good year for retail investment. Statistics from a major French e-broker for example indicate that new client accounts increased by +120% in 2020 and 39% of all new clients are between 28 and 35 years old.

Another industry representative confirmed that retail investment increased in the last 12 months, which is encouraging. However, there is still a lack of critical mass of savers ready to invest in small and medium-sized enterprise (SME) equity and a scarcity of equity research available for investors concerning these companies. There are also very few dedicated fund managers for small caps or microcaps and not enough venture capital (VC) available for the necessities of these kinds of companies. In addition, these companies are not well connected with the VC world and not sufficiently aware of the opportunities it offers. Going forward there should also be a stronger focus on the inclusion of SMEs in the portfolios of mutual funds, pension funds, insurance companies and retail investors.

1.3 Main issuer trends

An official commented that, when considering the issuer side, making equity funding more accessible to more corporates, beyond fast growing and technological companies, is an important objective. Many more traditional corporates would also need to have a more sustainable balance sheet. One challenge for issuers, which is a political and economic issue, is that investors still have an expectation of high return despite the current market conditions. It has remained at the same level as before the crisis. At the same time, in Europe at least, due to monetary policy there are very low interest rates. If a corporate in good health is asked whether it prefers a loan at 1% annual interest for eight years or some equity funding, which involves giving away some control over the company and up to 10% annual return, the choice is easily made in most cases.

From an economic standpoint, there is a need to increase the share of equity in corporate balance sheets in Europe so that corporates become more resilient and are able to finance their development. Equity funding does not only come from external investment however, corporates can also generate equity by improving their results, particularly if they are not able to access easily equity markets. There is an on-going debate in many member states about how to create the best environment for corporates to be able to generate profits and save part of them on their balance sheet. This discussion will remain relevant after the Covid crisis and should take into account all companies. If the focus is only on non-viable or fragile corporates, the capital reallocation mechanism will not operate. Some jobs might be saved in the short or medium term, but this will not increase the productivity and resilience of the whole corporate sector in Europe. The best way to do this is to enable some capital movement in terms of allocation. In the case of SMEs, this could include consolidation in some sectors that have been very badly hit by the crisis, because it is good that part of the equity should be brought by corporates in good shape to other companies.

A public representative stated that, even before COVID-19, many companies greatly preferred debt financing over equity, partly because of its more favourable tax treatment but mostly because debt is a financing channel that is easier to access. Companies have an existing relationship with their banks and can easily get access to more credit in many cases. Getting an equity injection is considerably more difficult and many entrepreneurs find equity financing less attractive and do not understand how an IPO would benefit them, because for privately held companies it implies giving up an ownership stake.

The COVID-19 crisis has moreover reinforced and amplified the trend in favour of debt. Governments and regulators have encouraged companies to take on additional debt and banks to hand out additional loans. That has been done for more than a year, so corporate debt levels are now quite worrying. At the same time, the potential for rebalancing the financial structure of European corporations has never been so high. Valuations in equity markets are sky high and many retail investors have rediscovered public markets to invest or speculate in. The time is right for companies to tap into equity markets, the public representative believed. IPOs in the US and the boom in the "blank-cheque" companies, the so-called special purpose acquisition companies (SPACs) going public, also demonstrate that there is some confidence in public markets at the moment. However, there are still some structural issues preventing companies, particularly smaller ones, from fully exploiting the situation. The listing process in the EU is still tiresome, which is probably the biggest hurdle for SMEs or Mittelstand companies at present. In addition, the market for equity research has been getting smaller over the past few years. This trend was visible even before the MiFID II Directive came into force, but it has accelerated since and companies are becoming less and less visible for investors. This issue needs to be addressed as part of the capital markets union (CMU) project and the upcoming MiFID II review.

1.4 Equity market structure developments and challenges

An industry representative outlined the positive developments in EU capital markets related to Brexit: a move of a large part of euro equity trading from London to the continent and an increase in the turnover of the exchanges and the multilateral trading facility (MTF) platforms based in the EU. However, the fragmentation of the EU trading market across multiple venues and financial centres still needs tackling.

A public representative considered that there are structural problems in the European equity market, particularly for smaller companies. There are few exchanges and little equity research for smaller companies. Listing is expensive, complicated and requires a great deal of disclosure that entrepreneurs are not always ready to make public. There are also few banks or investment firms in the EU that can partner with companies to guide them through a listing process because it is not the core business of most European banks. More of them should deal with the diverse situations in terms of equity raising, rather than just focusing on large IPOs. The other problem is that even successful SMEs are more likely to go to the same bank they have always done business with and the banks that SMEs use tend to be smaller institutions in most cases that find it difficult to fully support the growth of their clients. There will be a lag in SME equity financing until answers to these challenges are found.

2. Policy priorities for developing equity markets

A public representative stated that three main actions are needed for improving the attractiveness of equity markets. These are partly legislative and partly market-driven. First, the European ecosystem and the market infrastructure should be improved to facilitate access to stocks and cater for different needs. This should be a market-driven process possibly supported by national governments and money from the recovery funds. Second, listing rules should be easy to navigate and cost efficient for smaller companies in particular. For example a modernisation of listing rules is needed to provide founders with better options for retaining a certain degree of control; dual share classes could be an option for SMEs for example. Third, there needs to be a change in how people regard equity markets. A prolonged period of low interest rates is likely to bring more private capital to the equity market, because other savings provide very little interest. How to further encourage this evolution should be discussed in the MiFID II review. One example of issue that needs considering is that, as a private investor, it is almost impossible to have direct access to the equity markets, because this needs to be done through a financial institution. Some obstacles to equity retail investment can be tackled with legislation, but cultural change is also needed, as well simpler retail products and improved investment services. An industry representative concurred that a combination of regulation and other types of initiatives are needed to enlarge the number of retail investors ready to invest in equity and provide smaller companies with equity.

An official suggested that actions are needed on both the demand and the supply sides for developing equity markets and there is also a need to improve the functioning of markets. First, savers need to be encouraged to take more risks. Currently, financial institutions and distributors are not incentivised to allow savers to take risks, due to MiFID rules in particular. This has been seen for example in France in the context of some recent IPOs such as the privatisation of the French lottery, which was not an extremely risky investment, or with the limited success of envelopes offering privileged tax treatment for investments in shares. Second, more transparency is needed regarding listing rules and the way transactions are executed. The development of SPACs, for instance, should be closely monitored, as well as the way different dark venues are used for equity transactions. Third, the structure of the equity market should be improved to encourage the participation of institutional investors and the growth of funds investing in equity. Larger venture capital funds are needed in Europe. There are not that many pension funds in Europe either compared to the US, the UK and Australia. Europe could also have larger equity investment funds if insurers were allowed to invest more significantly in equity, which is hindered by Solvency II rules that make the holding of equity relatively costly for life insurers. There is a further question of whether it is better to conduct these actions incrementally or if there should be a more complete overhaul of equity markets taking a more holistic perspective. This may need considering because there have been already several attempts to tackle individual issues such as listing and prospectus rules, but the result has not been particularly satisfactory. A step change would be needed for the development of European equity markets, but that requires strong political will.

A second official emphasized the importance of supporting the financing of young and innovative businesses which are drivers of structural change in Europe, putting new ideas into practice, creating jobs and safeguarding the foundations for future prosperity

and growth. Supporting start-up companies and improving their financing opportunities, in particular during the capital-intensive scale-up stage is essential. The official outlined some measures that have been implemented in Germany for addressing these issues.

Before the crisis, German SMEs had quite high equity rates, at above 30% on average. Lost revenues during the Covid crisis mean that these companies now face lower equity ratios, which could affect their ability to invest e.g. in digitalisation and environmentally friendly technologies. To mitigate the consequences of the pandemic, the Federal Government is specifically helping start-ups and SMEs with a package of measures worth €2 billion. This program signals to the market that funding is available if required. Funding was reserved, but not all called. This shows that the VC market in Germany was not affected as badly by the pandemic as initially expected. In addition many start-ups were able to adapt to the situation thanks to their flexibility and some might even have benefitted from the situation, for example online or e-commerce platforms and start-ups in the health sector.

In addition, to support the financing of young and innovative businesses, several regulatory and tax-related measures have been implemented in order to increase Germany's attractiveness for funds[1] investing in these companies and actions have also been put in place to provide directly growing companies with additional capital. In the growth phase, the fund and ticket sizes of European providers are often too small. In addition, these businesses often have inadequate access to capital when it comes to second-stage and third-stage financing. The German government has therefore put in place different funding measures to tackle these issues. The German Future Fund will provide €10 billion over a 10-year investment period for an equity fund for future technologies, which will increase funding opportunities, especially for start-ups, during the capital-intensive scale-up stage[2]. Secondly, the federal government is aiming to strengthen the German VC market, which still has supply gaps, especially in follow-up and growth financing, with several measures in the coming years that will be conducted in partnership with the private sector, KfW and other European partners[3].

3. On-going EU policies (CMU, MiFID): expected impacts on equity financing, priorities and additional actions needed

The panellists generally considered that the measures proposed in the new CMU action plan and the on-going MiFID II review could help to develop equity financing.

An official emphasized the need for the EU to strengthen its capital markets and ensure their international competitiveness in the context of Brexit. The CMU action plan, MiFID quick fixes and the future MiFID II review will all contribute to this objective and also include steps for improving the development of equity markets and, in particular, SME financing. Under the German EU Presidency in 2020, the Council prioritised several CMU initiatives for increasing equity financing: i) Establish a European-wide data hub for investors – the so called European Single Access Point (ESAP) – to facilitate access to the financial and non-financial information of companies without disproportionally increasing their workload; ii) Facilitate the access to capital markets, especially for SMEs, without lowering the high standards of investor protection and market integrity; iii) Strengthen the long term investment capabilities of insurance companies, banks, and other institutional investors in company equity, particularly concerning SMEs; iv) Examine the possibilities for simplifying the capital market regulatory framework; v) Examine if the regulatory framework for European Long-Term Investment Funds (ELTIFs) could be improved to facilitate the financing of SMEs and infrastructure projects through the non-banking sector. The official added that the MiFID quick fix changes will further facilitate investment in EU equity markets mainly by reducing costs and administrative burdens for intermediaries. The MiFID II review, which is expected later this year, also aims to improve the EU capital market structure. Together these reforms should contribute to further increasing liquidity in EU capital markets and improving the equity as well as non-equity financing conditions for EU enterprises, in particular SMEs.

An industry representative agreed that the main actions needed for developing equity markets have been identified in the CMU action plan and the MiFID II review and now need to be effectively put in place. The MiFID quick fix is also a step in the right direction with shorter term actions aimed at simplifying rules, speeding up processes and lowering costs. The quick fix recovery prospectus is a very good example, because for a listed company that is compliant with the transparency and market abuse regulations, all the information is already available and communicated to the market. A public representative however observed that most of the measures in the CMU action plan are relatively similar to previous action plans. More action and fewer plans would be preferable.

Some priorities within the CMU and MiFID II initiatives for developing equity financing were also highlighted by the panellists, as well as some measures that could be reinforced or completed.

An industry representative noted that the CMU action plan rightly puts forward actions for supporting the access of companies to the public markets and for improving the attractiveness of capital markets for all types of companies, bigger and smaller ones. The CMU action plan also proposes appropriate measures for developing retail investment. One important area is the improvement of financial literacy, although this appears to be a long term goal. The aim should be to empower investors through further financial knowledge

1. VAT exclusion to management fees of VC funds, new tax regulations for employee investment schemes, less red tape and more flexibility for investment fund managers

2. It will complete the multi-component funding architecture created more than 10 years ago for the founding and growth of medium-sized technology companies, consisting of High-tech Start-up Fund and ERP/EIF venture capital fund of funds.

3. To this end, KfW established a subsidiary, KfW Capital, in 2018 and bundled its financing in the area of venture capital and venture debt in this institution.

rather than just protecting them. The action plan also proposes the creation of a new category of qualified retail investors who have a sufficient understanding of the risks and the functioning of the market and of basic products such as bonds and shares. Adapting the requirements for these more qualified retail investors will help to decrease administrative burdens for financial institutions, avoid unnecessary safeguards for those investors with good financial knowledge and also contribute to making equity investment more attractive for them. Some measures are however missing in the CMU action plan, the industry speaker felt. This is the case in particular of tax incentives, which can be a very effective tool for fostering equity investment from retail and institutional investors. A minimum harmonising tax incentive for savings in SME shares could widen the pool of equity investment for example. Although this is a member state competence, a clear position from the Commission on this issue would support decision making by national governments in putting in place adequate tax incentives for investors and also levelling the tax treatment between debt and equity for issuers.

An industry representative stressed that more transparency is needed concerning equity transactions. More than 50% of transaction turnover on the Euronext market for example is produced after the closing, which is not sufficiently transparent for retail clients. The equity market is currently very expensive and if people do not believe they can make money with their investments they will not trade anymore. A consolidated tape (CT), as proposed in the recent CMU action plan, would improve transparency, however building it and financing it will be challenging, since market players will need to contribute to its financing. Increasing harmonisation in EU capital markets is also important. The inefficiency and high cost of cross-border post-trading within the EU still needs to be properly addressed. At present, many investors prefer to buy US shares over European ones partly because of this. Referring to previous comments made about venture capital and local markets, the industry speaker considered that while VC can provide attractive returns, it will continue to be a niche product and local markets are also important, but cannot be the only answer for developing European capital markets. What is needed for making a real difference, is developing cross-border transactions and increasing harmonisation within the EU. ESG (environmental, social and governance) is becoming an important factor in equity markets and investor decisions, but harmonisation is still lacking in this area, where establishing EU standards is a further priority.

An official stated that prudential regulations need reviewing because at present they hinder investment in equity by institutional investors. There is some room for improvement in that regard concerning insurance prudential rules, possibly taking a longer view than the one-year horizon of Solvency II for example. Basel requirements are also an obstacle for the holding of equity by banks. France has developed a specific programme to try to alleviate these issues. Since it is too costly for banks to hold equity on their balance sheets, it is transferred to a fund with a State guarantee. Similar measures can also help insurers in terms of prudential treatment, but this means going through participating loans and equity loans, which are not really equity.

Measures are also needed to leverage the large sums of private money present in Europe for investing in European companies and completing the use of public money which should not be excessive in this area, the official emphasized. This could provide a better return for European savers and be a win-win situation. The solvency support instrument proposed by the Commission[4] is a really good idea, technically speaking, although it was not supported politically and had to be removed following discussions at the Council. It aims to finance mainly start-ups and scale-ups with solvency problems in a way that enables them to remain European and eventually be listed in Europe, and is not about saving zombie companies. If some member states were ready to support this type of initiative, together with the European Investment Bank, the European Investment Fund and the Commission, this idea would be worth pursuing.

4. The objectives of the Solvency Support Instrument are the following. It aims to mobilise € 300 billion for the European economy and is designed to help prevent insolvencies. The Solvency Support Instrument is due to channel guarantees from the EU budget in support of viable European companies that suffer from solvency issues due to the coronavirus crisis. This will be done by working with the EIB Group and in the framework of the EFSI. To benefit from the instrument, companies must be established and operating in the EU, be economically viable, have been hit by the pandemic and unable to secure sufficient financing themselves through the market and have had no financial difficulties at the end of 2019 according to the EU State aid rules. Companies operating in Member States and sectors which are more economically impacted by the pandemic, and where national solvency support is more limited, should benefit most.

EU CONSOLIDATED TAPE AND EUROPEAN SINGLE POINT OF ACCESS

1. EU consolidated tape (CT)

1.1 Expected benefits of a CT

A regulator stated that an EU Consolidated Tape (CT) will contribute to building a vibrant European capital market and achieving the Capital Markets Union (CMU) which is essential for funding the EU economy and the post-Covid recovery. At present there is too much market power and profit made from selling market data. The CT should allow market data consolidation in a relatively low-cost way, providing a comprehensive view of the market and facilitating price discovery. This will contribute to increasing fairness and transparency in the EU capital markets. Another regulator emphasized that an EU CT would support best-execution policies, provide market participants with a reliable view on liquidity across the Union and also ensure a rebalancing of market power regarding the publishing and selling of post-trade data.

An industry representative considered the CT vital for making the market more transparent, more competitive and more resilient for investors. The information provided by the CT will help both retail and professional investors to make appropriate investment decisions and will also contribute to improving best execution and liquidity risk management. An EU CT will moreover help to reduce market fragmentation, fostering market efficiency and competitiveness, and expand investor choice. Finally a real-time CT can make markets more resilient by providing reference prices that market participants can rely on to continue trading if there is an outage at a given venue.

A second industry representative agreed that a CT can bring significant benefits. CTs empower investors to measure execution quality and secure best execution; they foster investor confidence and participation by removing information asymmetries from the marketplace; they ensure that liquidity providers can better manage risk and more confidently quote and commit capital to the market; and they can enhance the resilience of liquidity in the marketplace and the operational resilience of markets e.g. in case of outage at a venue. These material benefits will help develop and integrate EU capital markets and deliver on the goals of the CMU.

A third industry speaker, referring to the comments made about the cost of market data, mentioned that the cost at which data is sold by market data vendors is often criticized, but the largest part of that cost is in fact charged by the initial providers of the data e.g. trading venues.

1.2 State of progress of the EU CT initiative

The Chair stated that MiFID II includes requirements to voluntarily establish a CT, but despite this legal requirement no CT has been set up so far, due to a lack of economic incentives and data quality problems. The emphasis put on the CT in the new CMU action plan and in the upcoming MiFID II review should however contribute to relaunching the European CT project.

A regulator noted that ESMA examined market data pricing issues in 2019 as part of preparations for the MiFID II review and concluded that MiFID II has not delivered a reduction in market data costs. The regulator confirmed that no CT has been implemented so far because of a lack of commercial and regulatory incentives for potential providers. The competition landscape of data provision and shortcomings in the quality of over-the-counter (OTC) data also prevented a CT's emergence. The CT is therefore not an easy project to undertake but it is still important for the development of EU capital markets.

An industry representative was encouraged by the new momentum behind the CT. The new CMU action plan, the ESMA report that establishes the need for a real-time CT, and the Commission's commitment to a bond CT are all positive. There will be challenges and road bumps along the way, but now is the time to move this project forward, the speaker believed.

1.3 Scope in terms of instruments

Several panellists supported a CT covering a broad range of instruments - i.e. including equity, non-equity instruments, ETFs – while others suggested that a non-equity CT would be most beneficial.

An industry representative was in favour of a broad approach covering all types of instruments including equities, exchange traded funds (ETFs), bonds and derivatives, possibly in a progressive way, because investors need improved transparency for all these instruments. A regulator agreed that a broad approach is needed and that it could be phased over time. The bond market in particular shows severe fragmentation, so could benefit most from a CT. Another regulator emphasized the importance of an EU equity CT for the creation of a robust single market for equity trading.

For a second industry representative the priority is to set up a fixed income CT. Pricing in equities is more ubiquitous than in fixed income and so a CT would be more valuable in fixed income, given also the scale of the market versus the equity market and how fixed income trades. Fixed income execution is indeed a three-stage process that includes the identification of liquidity, price formation and then execution, whereas the two first steps occur naturally for equities, due to the ability to execute in central limit order books. A fixed income CT would help to mitigate the challenges concerning the identification of liquidity and price formation in the absence of a central limit order book. Cutting and pasting for fixed income markets the solution produced for equities should however be avoided because of the differences between these markets.

A third industry representative agreed that the benefits of a CT are likely to be even more pronounced in the historically opaque non-equity markets, including

the bonds and OTC derivative markets that are also larger than the equity markets. These are gradually being brought out of the shadows and into more open, transparent and competitive trading venues thanks to reforms implemented in the past decade, including EMIR and MiFID II.

The regulator acknowledged the differences between debt and equity markets in terms of market structure, regulation and supervision. The differences between the central order book used for equities and the request for quotes system used for fixed income are significant and lead to a different structure of supervision and also to different needs in terms of IT system. That should then lead to different types of CT. A phased approach could be used to take these specificities into account.

A fourth industry representative stated that there is a need to be specific and focus the CT on use cases where there is most value in consolidating market data and making it more transparent and available. That is mainly in fixed income and ETF products, and also for trading outside the regulated venues (OTC, systematic internalisers (SI)). It could be argued that there is no consolidation issue for equity transactions on trading venues and therefore that an equity CT would only bring limited value in this case.

1.4. Characteristics in terms of venue coverage and data dissemination

In terms of venue coverage, the panellists favoured a CT that would be as comprehensive as possible.

An industry representative suggested that there should be mandatory contributions from all trading venues - regulated markets, multilateral trading facilities (MTFs), organised trading facilities (OTFs) – as well as from Approved Publication Arrangements (APAs) and SIs. Off-venue transaction data must also be captured for markets that continue to trade OTC, such as bonds and derivatives. Other industry representatives agreed that the coverage of the CT should be as comprehensive as possible in term of venues in order to obtain a complete view of the market and address the needs of all market participants in terms of market data.

The panellists were also generally in favour of a post-trade CT. An industry representative explained that a post-trade CT would bring most of the value for the fixed-income market. Quantitative analyses of the post-trade data from fixed income markets can indeed help to mitigate the challenges associated with fixed income execution - i.e. the identification of liquidity and price formation – and achieve best execution, which are key issues for market participants and regulators.

Views however differed among the panellists concerning the timing of data dissemination.

A regulator stated that ESMA views the provision of real-time post-trade equity information as a vital feature of an EU CT and an essential contribution to the CMU. Another regulator concurred that the CT should be as close to real time as possible. An industry representative added that an end-of-day tape is not ambitious enough. A CT is urgently needed in real-time to make markets more transparent and efficient. There will be hurdles in terms of implementation, but this should not be a reason for reducing the ambition. A second industry representative also agreed that there should be real-time dissemination of transaction data in order to reap the full benefits of empowering investors, removing information asymmetries, promoting resilience and enhancing risk management. This is not a matter of microseconds and latency, but of ensuring that data is aggregated and shared with market participants as soon as is practical. There should be targeted and limited deferrals only for larger-size trades, and those should be in minutes, not hours or days.

Another industry representative however believed that end-of-day data should be sufficient for equity markets in particular. First, real-time data is not needed for most equity CT use cases. A report mandated by the European Commission identified 14 CT use cases and recommended on this basis the establishment of a real-time post-trade CT, to be followed by a real-time pre-trade CT. However the industry speaker considered that a large majority of these use cases, which are currently serviced by existing data vendors, actually do not require a real-time CT and could be met by an end-of-day tape. Second, a real-time CT is not a silver bullet and will not solve existing shortcomings in the equity market which are mainly due to the current market structure. And third, a real-time post-trade CT is very complex to build and is not justified for just a few use cases. The supporters of this option often do not realize how expensive implementing a real-time CT is or do not expect to have to bear the costs. Real-time pre-trade data raises different issues, as it is not a discussion about benefits, costs and use cases. It would create a different market structure favouring arbitrage and potentially providing a misleading sense of liquidity with false benchmarks. That would be detrimental, particularly for retail and small asset managers.

1.5. Main features of existing CTs in the US

An industry representative advised that existing CTs in the US provide empirical examples of how to set up and run a CT that are useful to consider. A key lesson when observing the US market is that CTs should be appropriately tailored to the specificities of each asset class. In the US there is a provider for each major asset class. This avoids one-size-fits-all solutions and allows the parallel development of CTs for each asset class and market.

The US has five distinct and separate CT frameworks for equities, options, corporate bonds, municipal bonds, and OTC derivatives, including interest rate swaps. The common characteristics of these CTs are that they are comprehensive, requiring a mandatory contribution of on-venue and off-venue transaction data, and they disseminate information immediately upon receipt, with targeted and time-limited deferrals, and offer either low-cost or free access to data.

There are also several differences that are interesting to learn from. Concerning pre- versus post-trade information, equities and options markets have consolidated quotes, but fixed income CTs are post-trade only. There are also differences in the ownership and governance arrangements. For equities and options the CT is administered by a trading venues consortium that covers all the exchanges. The CTs for corporate and municipal bond markets are run by regulators: FINRA for the corporate bonds and the Municipal Securities Rulemaking Board for municipal bonds.

In terms of revenue model, each of these CTs has a transparent fee structure that is subject to rule filings that are available for market participants to comment on publicly. The revenue sharing concepts however differ across CTs. The equities and options markets have an arrangement whereby revenues are shared with the trading venues. In the corporate bond, municipal bond and the OTC derivatives markets, there is no revenue sharing. Market participants are obliged to report, and the data is disseminated under different fee arrangements that are relatively low cost as there is no revenue-sharing component. In the corporate bond market, those who have a reporting obligation pay a fee that helps fund it.

1.6 Implementation conditions and challenges regarding the EU CT initiative

Data quality issues

A regulator stated that ESMA is focusing primarily on the equity side of the CT project at present as it is formally part of the MiFID II review. In addition, rolling a CT out across all asset classes in one go is very difficult, when considering for example the data quality and completeness issues that exist for different asset classes. For derivatives the appropriate data is not available, for equities the situation is much more favourable and bonds are halfway between the two.

A regulator underlined that the National Competent Authorities (NCAs) have a responsibility for data quality on different data streams that are sent to ESMA and other regulators. Data quality is being improved in this context but it is an extremely challenging task. Similar issues will need to be addressed when building a CT, although this could also be considered as an effective lever for improvement.

An industry representative noted that there is an incentive with the CT to prioritize already available high-quality data from sources that already publish it, but doing so will not deliver the promised benefits of CTs. Data quality practices must be improved, particularly for OTC reporting, and this needs to be done by ESMA and the NCAs. It cannot be done by a CT or simply using technology. Another industry representative acknowledged the difficulties created by data quality issues but considered that the issues can be improved and should not be allowed to derail or delay further the EU CT initiative.

Business and governance model

A regulator summarised ESMA's recommendations regarding the business and governance models of the CT. First, there should be a single CT, as this will be the most cost-efficient and effective solution for Europe. Second, there should be a mandatory contribution of high-quality data. Third, the CT should share all or part of revenues with the regular contributors of mandatory data, with a recognition of which trades are price forming. Finally, it is crucial to have a strong governance framework in place to ensure high-level transparency, accountability and assurance of neutrality and service continuity. A key challenge for the CT project are the divergent views regarding governance and commercial arrangements for users. Setting up a transparent and fair system is another challenge. The CT is also a technically demanding project that will require substantial investments of resources from all concerned, whether that is the private or public sector. Regarding the role of ESMA, MiFID includes a proposal for an authorisation and oversight approach at European level of the CT provider (CTP), which will contribute to ensuring impartiality and neutrality.

An industry representative observed that there seems to be a consensus about mandatory contribution to the CT but that the economics of who pays and who benefits from the CT still need to be worked out. There is huge value in data, so it must be possible to monetise it, but balancing who pays for the building of the CT and who benefits from it will be challenging. It is concerning that while many entities support the CT concept, some of them are not ready to contribute or even to consume data on a mandatory contribution model. In addition, the small number of use cases for a real-time CT, at least in equities, means that care must be given to ensure that agency costs do not offset the benefit. The overarching point is the need for a strong governance that balances the interests of the different stakeholders of the CT i.e. trading venues, market users and regulators. This is complex to set up but should not be underestimated.

An industry representative suggested that a solution for making a CT commercial model viable could be for the CT to be funded on a cost-plus-margin fee model. It cannot be free, so investors will need to pay for it, possibly with the exception of retail ones. The industry representative also agreed with the importance of governance and expressed a preference for a single tape provider with an ESMA mandate put to tender and overseen appropriately. However the CT is resource-intensive and needs a broad industry coalition to contribute to that governance model, rather than a provider overseeing its own fee-setting. A second industry representative considered that there should be low-cost or free access to the data. Certain segments of investors, including retail, should have free access to the data.

Another industry representative observed that there is at present momentum behind what may be referred to as a 'state-run CT solution'. The potential for a commercial entity stepping forward should however continue to be discussed in parallel. This has not materialized because there is no good commercial reason for doing so, due to the current regulation, but if the regulation is improved, then a private entity might emerge. Currently, only 3% of corporate bonds are liquid and 97% end up as post-trade prints that are available four weeks later via the deferral process. There are also few post-trade prints for euro govies that are transparently released to the market. At present, a CT can only sell data in the first 15 minutes of publication, but if corporate bond data only publishes when it is four-weeks' old, then who will pay for that data when they can receive it for free at four-weeks and 16 minutes? This is the main reason why no commercial entity has stepped forward to run the CT. This could be solved by making data sources such as trading venues and APAs give the data away for free after 15 minutes, whereas the CTPs could continue to sell the data, as recognition for their consolidation action. That would provide a commercial reason for a private CTP to step in.

2. European Single Access Point (ESAP)

2.1 Objectives and potential benefits

A regulator considered that there are similarities between the CT and the ESAP projects. Both aim to answer information problems at European level. Securities market NCAs are involved in both as some of them are broad capital markets regulators who also oversee financial reporting and accountancy.

The regulator supported the creation of ESAP, as corporate financial information is currently scattered across Europe. The fragmentation of transaction data seen with the CT is also true for financial reporting information and makes it difficult for investors to access the financial reports of listed firms in another jurisdiction. It would be beneficial for CMU to have them consolidated in a single database where they can be easily found, which is the objective of the ESAP. The ESAP goes beyond linking 27 different databases; the project is to develop a central place where the data can be found, which is quite an ambitious IT project. A phased approach could be used, starting with listed firms and expanding later to non-listed ones. If ESMA would take the lead in developing this central base that would be supported because ESMA already has a positive track-record and experience in providing central databases and this could be an example of EU integration providing investor benefits.

An industry representative agreed that the ESAP project would be beneficial, as it would allow the improvement of company visibility and facilitate investor access to smaller national capital markets in particular, thus providing funding for SMEs across the EU, which is in line with CMU objectives. The ESAP however needs to be more than a data repository. It needs to be a database comprising information in English and in a machine-readable format in order to facilitate the dissemination and use of the data. This involves a role of the ESAP in terms of translation and formatting of the information and also a supervisory role for ESMA.

A regulator stated that this project could be really beneficial for the funding of the European economy and makes sense for Europe. Similar systems already exist in the US and Canada to help companies get more visibility in the market and to facilitate cross-border investment.

2.2 Conditions of success and way forward

The Chair noted that there is a strong consensus on the benefits of the ESAP project in the market, but the difficulty will be in the details of the implementation and how it is calibrated. It must include financial, non-financial and sustainability data that is machine readable. There have been attempts in the past to put in place a common format for reporting, such as the European Single Electronic Format (ESEF), but it was not popular with issuers, so there is a need to be careful about the way this project is implemented. With adequate financial and human resources, ESMA should be in a position to complete this project successfully.

An industry representative emphasized that care is needed with the ESAP project, not to add burdens for companies, particularly SMEs, since that may create additional disincentives for listing on public markets. Adopting a phased approach would help, as well as using technology to translate the information into an English machine-readable format in order to facilitate its provision and dissemination.

A regulator stated that it is important to build this project over time. The objective is to achieve a comprehensive coverage of financial and non-financial information for all listed companies, however complexities should be avoided. The ESAP should be built progressively, starting with existing data related to the transparency directive, prospectus regulation, shareholder rights, MAR and so on. Sustainability data, as well as essential non-financial data should also be included early on, in order to support the European Green Deal objectives.

The regulator agreed that information should be provided in a comparable machine-readable format and easily usable by multilingual, cross-border investors, which will be challenging to achieve. It should also be possible to extract large amounts of data seamlessly to be usable by all kinds of stakeholders. There is also a need for clear data governance and data checks in order to ensure that data is of good quality and corresponds to investor needs.

EU SECURITIES POST TRADING: PRIORITIES AHEAD

1. Evolution of securities cross-border post-trading activities in the EU

1.1 Progress made in EU cross-border post-trading activities

An official considered it vital to use the current situation to determine further improvements. Well-functioning cross-border settlement is key for post-trade financial market integration, and much has been achieved since the Giovannini reports on post-trade barriers to integration, although some points are still pending. TARGET2-Securities (T2S) provides seamless central bank money settlement through a common platform and will increase coverage by adding new central securities depositories (CSDs) and markets in the coming years. The question is how much this facilitates cross-border settlement and what more can be done.

Measuring cross-border settlement directly is difficult as it occurs via a multitude of channels. The ECB's high-level indicators suggest that in quantitative terms the increase has not been significant. T2S cross-CSD settlement data as a proxy seems to be stagnating at around 3% of T2S's total turnover recently. Data on CSD links shows a similar picture to general ECB security settlements. Holdings via CSD links seem stable at around 21% of securities outstanding with no increase since the Central Securities Depositories Regulation's (CSDR) introduction or the T2S go-live. When looking at the cross-border issuance of securities, quantitative data from the eligible asset database suggests that securities' cross-border issuance across national CSDs is stable at relatively low absolute levels, the official explained.

The numbers would, however, not be likely to show the full picture. Qualitative feedback suggests that settlements and holdings often take place via custodians and are not captured, and says that their task has been made easier by what is on offer. There is more to do however to overcome a lack of harmonised procedures in corporate actions and withholding tax in particular, as they are key for improving European post-trade integration. The Single Collateral Rulebook for Europe (SCoRE) initiative on the collateral domain, which also indirectly contributes to better awareness and compliance with high-level market standards for corporate actions, should be highlighted in this context. This, together with the T2S corporate action standards covering pending settlement transactions, forms a single corporate actions rulebook which should be implemented by all stakeholders: custodians, CSD issuers and investors, the official suggested.

An industry representative considered that major global custodians see the benefits of T2S. These have materialised to a large extent, and it is important that settlement in Europe is now largely harmonised. With regard to statistics, cross-CSD settlement alone is not a good measure of the foreign investment flowing into Europe, as much of it comes via custodians or investment banks. Analysis on the proportion of the client base outside Europe investing in Europe shows it is more than half. That indicates that Europe is an attractive place for foreign investors, provided that the regulatory regime and market infrastructure are efficient and do not lead to prohibitive costs. Tax is also one element. Concerning the remaining barriers to investing into Europe for non-European investors, reducing them aligns with the objectives of the capital markets union (CMU). The CSD Regulation (CSDR) is generating many benefits and also some difficulties for getting CSD licences. It has largely made Europe a safer and more interactive place from a post-trade perspective.

Another industry representative stated that fragmentation is a problem not fully solved yet therefore more action is needed on that front. Another industry representative advised that the experience of dealing with multiple regulators and supervisors shows that progress in supervisory convergence and coordination would be beneficial. This includes the use of the passporting system in CSDR.

A third industry representative agreed that further supervisory convergence is needed, as it can be hard at present to deal with different supervisors on one matter. The Commission's CSDR review consultation touches on the most relevant aspects, including passporting regimes and other issues such as withholding tax and corporate actions, where there is evidence and experience as to needed adaptations.

1.2 Main actions underway at the Eurosystem level

An official stressed that the Eurosystem has helped to reshape the payments and settlement systems infrastructure, aiming to establish a single financial market across Europe where payments, securities and collateral can move safely without friction between participants. The Eurosystem has been working over the last few years with market participants to increase the harmonisation and integration of European securities markets, notably addressing the European Post-Trade Forum (EPTF) recommendations. A key project is the Eurosystem Collateral Management System (ECMS), with a go-live for November 2023. It is vital for collateral management harmonisation and will foster a level playing field among market participants. This will replace the existing system of 19 national central banks with one system to mobilise collateral for assisting credit operations and bring operational and cost-efficiency benefits.

In May 2019, at the front end of the securities process chain, the Eurosystem launched a public consultation on a potential European mechanism for the issuance and initial distribution of debt securities in the EU, the European Distribution of Debt Instruments Initiative (EDDI). EDDI would be a pan-European gateway for debt securities aiming to support integration and harmonisation in the EU's issuance and initial distribution ecosystem. Work is needed to support the pan-European issuance process of the future European benchmark with a common regulatory environment, underpinning market infrastructure that promotes security, stability and transparency. By fostering more integration in the European securities market these different Eurosystem initiatives will facilitate the achievement of the CMU.

1.3 Issues related to the CSDR settlement discipline regime

An industry representative noted that the last stage of the CSDR implementation rollout concerns settlement discipline. A key objective of the CSDR is improving settlement rates in Europe by preventing fails, obtaining better matching rates, or ensuring that partial hold and release and other technical features which may affect delivery are implemented. The industry has invested a great deal of effort either internally or via T2S or CSDs for achieving these objectives before the February 2022 deadline.

There are other so-called 'ex-post' measures aiming to motivate players financially to improve settlement rates via penalties for late settlements or mandatory buy-ins. Industry and public authorities learned in 2020 that liquidity is not a stable phenomenon, as the upheaval in the markets made it clear that bid offer spreads and the ability to find or sell securities is not a given. That led to debates about the need to implement mandatory buy-ins by buyers as an ultimate measure if fails persist beyond a certain date. The Commission's consultation, which closed in February, included the topic of settlement discipline. The feedback published shows that although many of the measures proposed are welcomed by a majority of stakeholders including industry participants, strong concerns are expressed regarding a possible mandatory buy-in regime.

Firms both on the buy and sell side are concerned that the cost of mandatory buy-ins will be detrimental to the ability of buyers and investors to buy and sell securities and will hinder the issuance of new ones into the market, which is the opposite of the regulation's aim of making Europe a better place to invest. Internal calculations of potential costs show dramatic impacts for investors, so regulators and market authorities must reconsider in the perspective of the CSDR review proposal due to be published in Q3 or Q4 2021 if this is really the best tool for achieving settlement efficiency, the speaker believed. It is hoped that an appropriate settlement discipline regime (including discretionary buy-ins) will be included in this proposal in order to maintain the attractiveness of Europe because many non-European investors who are not accustomed to all the details of EU regulations will be impacted. Reviewing the current regime and making it futureproof is a pressing concern and an opportunity for the future.

Another industry representative agreed that the settlement discipline regime is an issue that needs to be carefully addressed. Work on the framework has been underway for a long time and there have been many delays in its preparation, demonstrating the magnitude of the challenge of its preparation. However it is essential to take into account the broader context of the EU market concerning settlement fails. The Eurosystem sees significantly higher fail rates than other leading jurisdictions at present, so the time spent on making sure the settlement discipline regime is right is justified.

The majority of settlement fails relate to the non-delivery of securities, so more discipline should be ensured on that end of the market. The buy-in regime which intends to strengthen integrity could contribute to this. It may reduce liquidity, but this is 'ghost liquidity,' which would not have been delivered upon anyway. Another observation is that this proposal concerns the uncleared space. In the cleared space, buy-ins are already part of the system.

1.4 Other areas of improvement concerning post-trading rules

Corporate actions management

An industry representative stated that one of the recommendations of the CMU High-Level Forum (HLF) was to harmonize the definition of 'shareholders' and the management of corporate actions across the EU. That requires common rules governing the interaction between investors, intermediaries and issuers to facilitate shareholder engagement. Many efforts have been made during the last few years by different industry and market working groups for defining corporate action standards. In addition, the new SWIFT ISO 20022 is a useful tool for increasing harmonisation.

The implementation of the Shareholder Rights Directive II (SRDII) and the ECB ECMS project have also contributed to reaching agreement on common rules based on current market practices materialised by the single collateral management rulebook for Europe. Work must however continue to reach a common understanding among the different stakeholders of the content and format of corporate action messages and communications and of entitlement rules and also an agreement on key dates and deadlines across markets.

Withholding tax refunds

An industry representative noted that there is room for improvement on the common procedures and practices for withholding tax refunds, which is in the CMU action plan. The 2017 code of conduct is a good foundation, although non-binding. The goal is improving the current withholding tax procedures' efficiency and leaving the standard tax reclaim as a contingency procedure. Tax topics are difficult, and progress will be complex, but harmonisation is essential to achieve CMU.

An official welcomed this being an explicit action point in the CMU action plan. Concrete proposals are anticipated, and the ECB is ready to help with fact-finding and impact assessment.

2. Prospects of the DLT Pilot Regime

The Chair stated that the core idea of the distributed ledger technology (DLT) Pilot Regime is that an infrastructure provider using DLT technology can apply for exemptions from the MiFID, MiFIR and CSDR legislations when these are not compatible with DLT.

2.1 Potential benefits of DLT technology and other new technologies in the post-trading area

An industry representative explained that work is progressing to achieve efficiency gains with DLT particularly in the settlement area. DLT reduces by nature the need for reconciliation and potentially brings other operational efficiency benefits, but more importantly it can change the conduct of financial transactions more broadly. First it supports peer-to-peer, which is an ongoing trend that is already happening independently from DLT. Work is progressing e.g. on allowing peer-to-peer collateral management and repo trading whereby counterparties no longer have to go through a bank but can trade with each other, which improves the process and the risk profile of the transaction. Secondly, the true benefit of DLT is that it allows the creation of a distributed marketplace, moving away from the single point of failure that existing infrastruc-

tures represent. Further thought about the implications of that change is however needed. A further aspect is the potential for deconstruction of asset risk-reward profiles. With assets such as stablecoins the interest of cash and payment capacity can be processed separately, which is not the case today.

An official stated that DLT has the potential to improve the efficiency of the securities market and support the CMU, while preserving its resilience and safety, but there is a long way to run for implementing it at scale. The direction of travel at the European level is the right one, with the recent proposal for regulating the crypto assets market (MiCA) and the DLT pilot regime proposal. These may be important drivers for the use of DLT in securities markets in the future.

Another industry representative emphasized that technology has been a key driver of efficiency and stability in the securities market since the 90's and this applies particularly well to post-trading. The change from manual and paper-based processes to electronic trading significantly improved market integrity at the time and the same should be true going forward. The adaptations in the 90's were however made without regulatory relief, the speaker pointed out.

A third industry representative mentioned that new technologies can also help to tackle some of the problems that exist with corporate actions and withholding tax procedures. This could allow a step change in terms of safety and efficiency in these areas in the coming years.

2.2 Challenges associated with the use of DLT in the post-trading area

Scalability, security and privacy

An industry representative emphasized that while DLT has many potential benefits in terms of efficiency and safety, its deployment remains challenging. When implementing DLT there is a trade-off between the scalability of the technology and therefore its performance, and the level of security and data privacy that can achieved. In a distributed system, an institutional market participant will have to consider whether it wants to distribute all the data including client data across the system, which is the essence of a DLT system. This causes a data privacy issue, because the organisation's client data would be accessible in the distributed databases or ledgers by peers or even competitors. This can be resolved with strict and robust privacy measures and cryptography, but doing so can reduce the performance of the process, which requires defining the optimal configuration.

Another industry representative commended the European authorities for proposing a regulation for this new market. Europe is one of the most advanced jurisdictions in this regard and the lack of regulation in some other major markets prohibits market growth in these markets. There are however challenges to overcome. Firms want improvements and competition but at the same time do not want this to happen at the expense of system stability and safety.

Finality

An official observed that a key point to the use of DLT systems in the securities market is legal soundness. That means ensuring the compliance of the technical system with applicable regulation, especially concerning the finality of transfer orders. In the absence of a specific regulatory framework for a token economy, all actors must ensure that token activities comply with the traditional rules and regulations. This entails complying with several European regulations, such as the CSDR, the Settlement Finality Directive (SFD) and EMIR, which are not fully adequate in this new paradigm. Changes need to be made to these regulations and to SFD in particular, in order to adapt them to the new reality of DLT-based systems, but doing so with rules designed for traditional assets is not easy. It brings cost for market players and it may not be as safe or efficient as expected.

2.3 Regulatory implications of the use of DLT in the settlement space

An industry representative considered that DLT may allow traditional service providers to provide new services in the crypto space. The review of CSDR is also an opportunity to make CSDR fit for digital.

An official stated that the Eurosystem is supportive of the adoption of new technologies like DLT as they may open up new possibilities for financial markets.

Another official considered that it is vital to emphasise that, for regulation, the status of an asset should not be affected by tokenisation, provided that there are no changes in the underlying assets' legal status. The technology and methodology do not affect the status of assets, but the nature and the structure of the DLT cost system in which the token exists may change the extent to which regulations are applicable. Some aspects of the European securities regulation must be adapted to the new reality of DLT-based systems. First, there is currently no legal European framework around safekeeping and service cost for the DLT environment, and jurisdictions have different legal frameworks. Second, there are different interpretations of services (i.e. asset services, custody and safekeeping) in a DLT environment. New roles, functions and responsibilities will emerge in a DLT environment and must be defined in the revised regulatory framework. Third, the concept and definition of settlement, plus the moment of settlement finality, must be assessed and clarified within a DLT environment. In addition, if a securities token qualifies as a transferable security in a regulated market, it must be recorded with an authorised official CSD. Interoperability and standardisation across DLT platforms and the ability to provide delivery versus payment and settlement in the central banks' money are further questions that must be addressed.

An industry representative believed that the Markets in Crypto-Assets (MiCA) proposal on cryptoassets is a good starting point for the DLT pilot regime. An important and welcome fundamental base principle in MiCA is that crypto assets will be regulated under financial regulation.

2.4 Potential level playing field and fragmentation issues raised by the DLT Pilot Regime

An industry representative noted that traditional settlement providers like CSDs should be authorised to offer settlement services on crypto-assets, thus avoiding the thinking that settlement for crypto-assets should be only for entities under the DLT pilot regime and traditional assets only for traditional CSDs. There is an opportunity to make slight modifications to CSDR to make it fit for digital moving forward.

Another industry representative suggested that the pilot regime is possibly being considered too theoretically. The market is not yet mature enough when it comes to security tokens and other financial instruments operating and being issued on DLT, therefore we need to be open to these new developments. The pilot regime fosters innovation and a review of current regulation to adapt it to the new DLT environment, but it is not certain that it goes far enough, because it is largely based on the existing market structure (e.g. market infrastructures in the form of CSDs), but banks operating MTFs also want to participate in those market evolutions. The true benefits of DLT materialize in a decentralised marketplace, which would mean allowing more players to participate in that evolution.

A third industry representative stressed the conflicts of interest raised by the DLT pilot regime. Allowing the same entity to do trading, risk management and settlement could mean a return, philosophically at least, to the situation before the G20 reforms. There is a need to be careful when providing exemptions from EMIR and CSDR as to what is wished for, especially on the clearing and risk management side. Concerning trading, MiFID II reforms brought 670-plus trading venues into the EU's landscape, so there is no fear by incumbents of new competition.

A fourth representative agreed that the DLT pilot regime must find the right balance between innovation and security and not compromise safety and stability, for which post-trading is essential. The objective should not be to develop DLT as such, but as a catalyst for a more integrated and safer CMU. The legislative framework must also remain technology neutral. This is important to avoid market fragmentation or conflicts of interest.

The first industry representative agreed that the DLT Pilot Regime must serve primarily the CMU objective, rather than focusing on the development of the DLT technology. A potential concern is a pilot regime that would end up reducing harmonisation and integration in the EU securities market, with exemptions for MTFs using DLT granted by each national competent authority and with only limited coordination by ESMA. This may lead to an unlevel playing field between MTFs and incumbent infrastructures and to regulatory arbitrage. It may also increase fragmentation if a large number of MTFs provide settlement services in silos with no open access and no interoperability, going against the integration objectives of the CMU. Ensuring a level playing field requires applying the principle of 'same activities, same risks and same rules'. Some changes to the regulatory framework might also need to be considered. Generally speaking, when adjustments are being considered for fostering technological development, these should have the CMU objectives in mind. There should be an evaluation of whether these changes are likely to foster more cross-border investment and help connect investors and issuers.

Another industry representative stressed the importance of technology-neutrality, which requires a convergence of the traditional regime and of the DLT Pilot Regime with regard to CSDR, SFD, CFD and AIFMD and so on, all of which are based on existing technology. This would ensure that regulation does not inhibit innovation when DLT becomes more a mainstream technology.

2.5 Issues related to the possible winding down of the DLT Pilot Regime

An industry representative suggested that the exit strategy from the DLT pilot regime must be clear before starting.

Another industry representative agreed that the exit strategy must be spelled out beforehand, because it must be possible to stop it or modify it if it is inadequate and the entities entering the pilot regime should know what to expect if the regime does not work out the way it should. The speaker noted that the current proposal limits the scope of the regime to five years, but it is not necessary to wait that long because most of the benefits and issues will emerge before then. The regime could be limited to three years for example, because the longer it lasts the more difficult it will be to wind it down. In addition, winding down is different from a trading or CSD perspective. Winding down a trading venue (i.e. shifting trading onto another venue) is easy and can be done quickly. This is much more difficult for a CSD, especially for instruments that do not have a redemption date, like equities and bonds. Those would have to be limited to three to five years.

A third industry representative mentioned the importance of thresholds, especially concerning shares, in the winding-down perspective. The € 200 million market cap threshold for shares admitted into the regime seems low but can quickly develop into significant volumes and the rule can be bypassed if issuers construct several issuances that never break the threshold individually. This needs to be considered in the context of a possible exit or winding-down strategy, because if a great number of citizens are locked into a system based on the DLT pilot regime, the winding-down will be a challenge. Greater granularity is required in the Commission's proposal on how projects can be discontinued or wound down and also how projects may transition from the pilot regime into the 'real world'.

An official considered the pilot regime to be the right way to gain experience with DLT, allow structured, safe implementation and assess developments. It must be created and used with an understanding by stakeholders that it is a pilot with a foreseen end, and it must not be confused with a potential review of the mainstream regulatory framework, based on experiences eventually gained from the pilot. If the pilot regime gains traction, stakeholders must understand that its generalisation can only be based on careful analysis afterwards of that experience and a review of the mainstream framework, while avoiding regulatory arbitrage and parallel regulatory regimes.

It is also important to highlight the strict thresholds imposed in the Commission's proposed DLT Pilot Regime regulation, which are essential for keeping this a pilot regime and preventing it from becoming a parallel regime and a regulatory loophole to the CSDR. The draft Commission proposal also states that operators of DLT under the pilot regime must have in place an exit strategy. However if permissions or exemptions are revoked or if the market valuation of DLT-transferrable securities exceeds thresholds, the DLT market infrastructure operator may have to undertake substantial changes, which might require a significant period of time. Pilots should be allowed only if they can potentially be wound down afterwards, if needed. This should be the base assumption that should be sufficiently elaborate and prominent in the final regulation, the official believed.

SECURITIES AND DERIVATIVES CLEARING: REMAINING CHALLENGES

1. The role of clearing in preserving financial stability in the EU

1.1 Experience of the March-April 2020 market stress

The Chair emphasized the role of central clearing counterparties (CCPs) as regards mitigating risks to financial stability, particularly market risk, and in addressing the potential default of clearing members. However, CCPs themselves can also be a source of systemic risk, so safeguarding their resilience is of utmost importance. This resilience was tested during the last year with several events occurring, including in particular the immediate impact of the Covid crisis in March 2020, leading to high volatility and in some instances raising issues of procyclicality. The Chair noted that EU CCPs had been comparatively less affected, which may be attributed in part to the existing strong anti-procyclicality requirements under EMIR.

An industry representative stated that the March 2020 market stress resulted in a different landscape from the 2008-09 global financial crisis, thanks to appropriate collateralisation. Trust in the resilience of the system and the collateralisation and transparency organised around the CCPs helped limit the impact of March events to a volatility, liquidity and funding issue, rather than a credit or market risk crisis, which could have happened without collateralisation. CCPs also played a key role in ensuring predictability throughout these times of market turbulence. The speaker's institution – a major CCP – was able to maintain stable and predictable margins, which did not demonstrate any procyclical behaviour, thanks to the embedded anti-procyclicality measures in all its clearing services.

An official agreed that CCPs showed good resilience through the Covid crisis. It was more than a stress test exercise, because such a stress could not have been imagined, and CCPs overcame the challenge. That was also thanks to regulation. One point to underline about initial margins is the magnitude of the impact of volatility on margin calls experienced in March 2020 and the risk of liquidity stress. Quarterly public figures show that the amount of collateral posted to clearing houses to meet initial margin requirements increased by $270 billion globally, or 48% during the first quarter of 2020. Such evolutions require close monitoring.

1.2 Lessons learned from the Covid crisis regarding procyclicality

An official considered that margin increases are necessary to ensure the resilience of CCPs in adverse market conditions. A CCP must collect more margin to protect itself, but increased margin calls may impact the ability of clearing members and their clients to meet them in a timely manner if their liquidity situation is impaired, so the right balance must be found.

Another official stated that the experiences of the 2008 and 2020 crises demonstrate the contribution that CCPs make to keeping the financial system stable, bringing discipline into a formerly bilateral and uncollateralised world, and the importance of higher margins for tackling higher volatility. Existing EU frameworks support the role of clearing however certain aspects may need considering for the future. Tools have been put in place to tackle procyclicality, but less procyclicality in times of crisis comes at the expense of higher average margins throughout the cycle. This is a trade-off that the industry and the regulators need to make, with an ecosystem-wide perspective. The responsibility for avoiding procyclicality should not lie solely with CCPs. Clearing members should also consider making greater use of over-collateralisation, and how to better absorb high margin calls in unavoidable times of high volatility should be thought through to the buy-side. Everyone should indeed be willing to pay a small price for more safety and stability.

The first official agreed that increased margin calls during the Covid crisis raised potential procyclicality issues. There is on-going work at the international level on these questions which is to be supported. The Financial Stability Board (FSB), CPMI-IOSCO and the Basel Committee on Banking Supervision (BCBS) are working jointly on further assessing the procyclical effects of margin calls, why and how they materialise, which entities are most exposed, and in what markets. This will allow for a finetuning of policy in this area and also help to identify ways to mitigate procyclical effects without impairing the ability of CCPs to protect themselves.

1.3 The need for supervisory cooperation and convergence regarding CCPs

An official stated that the regulation put in place with EMIR 2.2 and the CCP recovery and resolution regime is fit for purpose in normal times and during episodes of market stress. EMIR adequately allocates supervisory responsibilities within the EU, while providing rules for ensuring effective cooperation, coordination and information sharing among stakeholders. Improving the current situation would mean enhancing the sharing of information in a more open way among regulators and also with other market stakeholders, but this is probably more a matter of mindset than regulation, the official felt.

Another official agreed that for large CCPs, cooperation at the European level is essential and observed that the revised EMIR 2.2 framework supports this. For systemic CCPs this should be implemented in concrete terms because the tools exist. In the future a strengthening of supervision might be needed at the EU level, but it is important to first evaluate how EMIR 2.2 is working. Data collection is essential in this perspective and it is crucial that all market participants provide as much information as possible.

The Chair considered that supervisory convergence is key for ensuring a level playing field across EU

CCPs and beyond, which is also a precondition for ensuring an adequate level of risk management. The EU supervisory framework should embrace a broad EU-wide perspective, considering all risks posed by both EU and non-EU CCPs to EU financial stability, including through interdependencies and interconnections across markets and jurisdictions.

1.4 Progress made with the CCP recovery and resolution framework

An industry representative explained that the CCP recovery and resolution regulation, which is the second main regulatory framework in the clearing area in addition to EMIR 2.2, reinforces the risk management framework for EU CCPs and their clearing members, thanks to the second tranche of capital contribution by CCPs (also known as 'skin in the game') and clarifications of the tools that can be used by the resolution authorities. A great deal of work remains to be accomplished for implementing this regulation, especially concerning Level 2 regulation, but the speaker viewed it as a competitive advantage for the EU financial system and market participants.

The Chair noted that the new EU CCP recovery and resolution regulation provides ESMA with a number of additional tasks, which include the setting up of 19 technical standards, most of which are to be delivered by the end of 2021, as well as the establishment of a resolution committee to support the process.

2. The role of clearing in supporting the post-Covid recovery and the CMU

2.1 Supporting debt issuances related to the EU recovery programme

An industry representative stated that CCPs have a key role to play in EU recovery and green transition initiatives. Clearing can bring safety and soundness to the securities issuances related to these initiatives from inception and also support these instruments by making them widely acceptable as assets for investors and as a reliable funding tool for EU banks[1].

Clearing may also contribute to developing the international role for the euro, the industry representative emphasized. A few years ago the clearing of euro debt was shifted from London to Paris and the high volumes of euro government debt cleared in Paris[2] have attracted key non-European Economic Area (EEA) players. Now there are not only US and UK, but also Australian, Canadian and Japanese members who have joined the euro debt clearing service in Paris. In the view of the industry speaker, that helps the internationalisation of the euro both from a debt and currency standpoint, so is a concrete contribution to the CMU and an area of development for the future.

2.2 Facilitating cross-border investments

An industry representative noted that CCPs also facilitate cross-border investments, which are key to CMU, because they are the basis for ensuring the EU financial ecosystem's competitiveness and efficiency. It is critical to have a strong EU financial ecosystem that can compete beyond its borders. EU and non-EU CCPs provide critical pipework for investments to flow across borders. For that, it is vital that CCPs can facilitate market needs, whether markets are local, regional within Europe, or global. Market specificities and requirements need to be supported by regulation and supervision that avoid unnecessary barriers to efficiency and access to liquidity.

The speaker's institution – a major CCP - has also been a consistent supporter of implementing a direct supervision of EU CCPs at ESMA level, comparable to what EMIR 2.2 introduces for third-country CCPs. While remaining aware of the political sensitivities, this is important for moving towards more efficient supervision and regulation at EU level, which remains another key CMU objective.

3. Regulatory and supervisory approaches concerning non-EU CCPs

3.1 Changes in the derivatives trading and clearing market following Brexit and pending questions

Concerning derivatives trading, an industry representative stated that the evolutions during the Brexit transition period show the need for further coordination at the EU level. In the equity market market participants anticipated the application of the MiFIR share trading obligation, so 1 January saw a large liquidity move of EU shares into EU trading platforms and a subsequent liquidity split between the UK for UK shares, and the EU for EU shares. There was less coordination however in the application of derivative trading obligations for euro-denominated OTC derivatives, particularly interest rate swaps (IRS). This lack of coordination between European jurisdictions generated a significant shift of trading volumes to US venues, especially from firms active on both sides of the channel. This is a lost opportunity for the EU, the industry speaker considered, as it will be hard to relocate these volumes.

Another industry representative confirmed that there have been tangible changes in where OTC derivative trading is taking place. The majority of trading for both credit default swaps (CDS) and interest rate swaps (IRS) has moved to US swap execution facilities (SEF). For example two thirds of euro IRS are traded outside the EU. The interdealer euro CDS market is also now primarily traded out of the US. This means that EU firms, especially the sales side, have lost access to

1. The example of the role played in this perspective by the LCH Group was given. The Paris-based LCH SA in particular supported the EU's first debt issuances by clearing EU debt issued under the SURE (Support to mitigate Unemployment Risks in an Emergency) instrument from the outset. That was publicised in order to ensure that market confidence was secured pre-issuance and to support trading and collateralisation. Of the €75.5 billion dispersed to the 17 member states under the EU SURE programme, LCH cleared about 10 billion, which are now used as collateral for covering margins across business and services in LCH SA. CCPs may support in the same way the issuances related to the EU Next Generation programme, as well as the issuance of green debt. The issuances of the German, French and Italian government green debts for example are cleared, and this has resulted in growing trading of these assets.

2. In the RepoClear pool

both providing and taking liquidity, but also to offering their services to clients in the UK, which puts them at a competitive disadvantage and is a concern in terms of financial stability.

Concerning the clearing market, an official stated that, despite preparation on the EU market side, there were no significant changes post-Brexit with the exception of the shifting of repo markets to LCH SA in Paris. There is not much more evolution to expect unless the present framework is changed, and it should not only be looked at against relations with the UK, but US markets also.

When considering whether the current regulatory setup and the relationship with UK CCPs and equivalents should change it is necessary to assess what is needed at the clearing level for safeguarding the financial stability of European markets and what this actually means in the CMU perspective. This assessment should be performed by ESMA, the official observed. It requires analysing the structure and setup of the market and defining for example what a European transaction is, i.e. if it is a transaction denoted in euro, one cleared via a financial market infrastructure in the EU, or a transaction that is handled by a clearing member based in the EU. In the same way on the buy-side, it should be determined whether it is relevant to financial stability in Europe if the buy-side client is European e.g. a European pension fund or insurer.

In the 2008 financial crisis, AIG which was not a bank or a clearing member but an insurance company was bailed out by the US authorities, because it was an extremely important counterparty to all the financial market players, which illustrates what to consider when assessing European financial stability risks. Buy-side liquidity is also key, the official believed, as European players typically deal in various currencies.

The Chair noted that in view of the potential implications of Brexit, the ESMA CCP Supervisory Committee has been tasked with assessing whether certain CCPs or CCP services may be of such substantial systemic relevance that the existing framework may not suffice to address and mitigate the related risks for the stability of the EU financial system. In response, a comprehensive evaluation framework is being established based on a range of qualitative and quantitative indicators, on the basis of which an assessment of potential risks will be conducted, combined with a cost-benefit analysis, that will be concluded by the end of 2021. ESMA will reach out to relevant stakeholders in order to gather comprehensive data to support the assessment of the implications for the EU financial markets. This is a challenging task, but one which needs to be undertaken for the sake of stability.

An industry representative stressed that when considering possible next steps for a euro clearing policy, it is worth remembering that the EU clearing members' footprint is limited compared to others. In the IRS segment EU clearing members have a footprint of around 25-30%, which means that a de-recognition decision under EMIR 2.2 affecting this segment, if applicable to EU stakeholders only, would catch around 30% of volumes. It would damage the EU firms, and would not meet the expected political goal, as the EU authorities would lose their supervisory power on a majority of the volume.

Another industry representative agreed that there has not been a great change in market behaviour since Brexit, which is a function of how markets work and are structured. Derivatives are global and EU firms need access to liquidity and the cross-currency risk management supported by these markets. Concerning the IRS market, 14% have an EU firm represented on what is cleared on a day-to-day basis, and around 25% of the euro IRS flows have an EU firm on them. 75% of the euro cleared IRS market therefore originates outside of the EU. That 25% is vital, but EU participants need access to the rest of the world, including EU currencies, euro and others, for the EU markets to remain competitive.

The debate often polarises on the euro IRS market, but there is a broader question of the access of EU firms to all markets, the industry speaker believed. From the data, EU firms clear more in non-euro than in euro, in terms of daily notional cleared and traded amounts, and most EU firms, both sell-side and buy-side, are clearing more than three currencies with UK-based CCPs. EU firms therefore need access to all currencies and the liquidity in those. That is the underlying market reality. Access to diversified CCPs makes EU firms safer and less prone to financial stability risks, shocks and liquidity squeezes. EU firms must maintain their access to these different markets and, reciprocally, non-EU firms to the EU market too. That will contribute to the CMU.

3.2 Next steps regarding the regulatory and supervisory approach to UK-based CCPs

The Chair noted that Brexit effectively transformed UK-based CCPs from EU infrastructures into third-country ones. Under EMIR 2.2, ESMA through the CCP Supervisory Committee has assumed direct supervisory competences over CCPs determined to be of systemic relevance to the EU financial system. To mitigate potential cliff-edge risks, temporary equivalence decisions have been issued by the European Commission, complemented by corresponding temporary recognition decisions by ESMA for UK-based CCPs. This has helped to smooth the direct impacts of Brexit, whilst providing for the opportunity to undertake a comprehensive assessment of the consequences of such transformation.

An industry representative noted that EMIR 2.2 significantly reinforces the supervision of third-country CCPs through tiering and a revised recognition process. This evolution concerning third-country Tier 2 CCPs is welcome, bearing in mind however the issues previously mentioned regarding the access of EU clearing members to CCPs clearing euro-denominated contracts. The EU authorities should carry on working with the industry to define the relevant measures that need putting in place in the perspective of the CMU. This can only be achieved through strong EU players, in cooperation with other non-EU firms, so that all players, clearing members and their clients can benefit from CCP efficiencies and cost margins.

An official stated that EU and UK authorities have recently started working together under the new EMIR 2.2 framework, so it is too early to draw conclusions and assess its functioning. Mechanisms such as comparable compliance have not yet been fully implemented.

Ensuring that UK CCPs fully apply the standards of EMIR 2.2 in years to come remains a key priority, as it is one of the most demanding frameworks for CCPs. This is the beginning, but there is confidence.

A key issue to be tackled over the coming months is the location of systemic clearing activities for the EU – so called Tier 2 activities, the official stressed. A temporary equivalence decision has been granted to UK-based CCPs and during this transition period two main points are being worked on.

The first point is that European institutions need to take a stance on the use of the EMIR location policy. ESMA, the ESRB and the ECB. have begun to assess if some UK CCP clearing segments are of such substantial systemic importance that they should not be recognised as equivalent. The final ESMA report on this question should be published at the beginning of 2022, so that the European Commission can make the final decision ahead of the deadline of June 2022. From a central bank perspective, the question of UK CCPs' systemicity is important, the official believed, because in a crisis, central banks are the lenders of last resort. This question is particularly relevant for products such as euro IRSs or EU CDSs and short-term interest rates referencing EU rates, where positions are concentrated. The current framework of direct supervision by ESMA for tier 2 third-country CCPs is an improvement, but it might not be flawless given the comparable compliance mechanism and the fact that ESMA will not have binding powers over UK CCP risk management practices in times of crisis. UK CCPs, when protecting themselves as requested by national regulation, will not consider the effect of their decisions on EU financial stability. For this reason the benefits of the relocation of certain activities to the EU in terms of financial stability may outweigh the short-term costs incurred.

The second point is that EU clearing members should work on reducing their exposure to UK CCPs, the official emphasized. The Commission has set up a working group of industry representatives and institutions to discuss the benefits and challenges of the location policy's operationalisation and conclusions are expected soon. Initiatives to reduce this exposure have been limited so far, so it is important that these are encouraged both on the clearing member side, for how to operationalise this relocation policy if decided, and on the CCP side, for how to broaden and improve the scope of products accepted for clearing. Cooperation with the UK authorities remains fundamental whatever the decision taken on location and will take place in the context of global colleges set up for systemic CCPs, which allow the association of third-country authorities with the supervision of domestic CCPs. This will facilitate the sharing of data both in normal times and in times of crisis and of regular reports on supervisory activities, and also allow for flexibility in bilateral discussions whenever needed.

The Chair agreed with the importance of global colleges for CCPs as a best practice promoted by CPMI-IOSCO for globally systemic infrastructures. In an EMIR context, given that ESMA has direct supervisory competences over certain UK CCPs that are of systemic relevance for the EU financial stability, this needs to be complemented by a close and robust cooperation between ESMA and the Bank of England. In this regard, there are some remaining issues concerning the application of comparable compliance, such as what happens if, over time, the comparability is no longer ensured, and what the consequences thereof may be.

An industry representative emphasized that while there are discussions about possible EU-UK regulatory divergence related to Brexit in certain areas of finance, these are not relevant for CCPs that endeavour to operate at the highest standards at the global level. The industry representative noted that having regulatory licences from different jurisdictions indeed allows for taking the highest standard of regulatory supervision and applying it globally. When it comes to clearing, convergence at the highest standards is what is requested both from a regulatory standpoint and from the perspective of the organisation, its members and customers.

EMIR 2.2 provides central banks with additional tools, including the possibility for the ECB to impose the use of a central bank account for euro flows associated with a third-country CCP, the industry speaker observed. That is vital, especially for OTC derivatives. What is important concerning clearing, even more so during crises, is the availability of collateral and cash to protect and cover the risks. Having cash in the relevant central bank for the relevant currency further addresses financial stability concerns, to the point that in many jurisdictions cash is deposited and concentrated in the various currencies in the local central bank as well. That is a key financial stability and systemic risk reduction tool. It brings transparency and stability, notably regarding the liquidity draw of the euro markets globally, and helps promote the euro as the growing international currency. Dialogue on supervisory solutions, comparable compliance, and resolving any remaining concerns around that must also continue.

PRIORITIES FOR RELAUNCHING SECURITISATION

1. The securitisation market is disappointing in the EU, despite repeated regulatory efforts and expressed ambitions

1.1 Policymakers have always expressed ambition regarding the securitisation project, which is however a complex financing tool. Finally, so far related regulatory evolutions have proven unable to relaunch the market

A supervisor stated that relaunching securitisation is a burning question. Amendments to the securitisation framework agreed in December have just been published. The proposal achieves a more risk-sensitive treatment for non-performing loan (NPL) securitisations and the expansion of the simple, transparent, and standardised (STS) label to embrace synthetic securitisation. Securitisation supports the objectives of the capital markets union (CMU). Because the EU financing market relies heavily on banks, securitisation provides a useful tool for diversifying funding sources and risks and providing a liquidity upgrade for banks. Securitisation remains a complex product and deserves a robust regulatory framework.

Though, current figures are somewhat disappointing. The primary public asset-backed security (ABS) issuances market fell by around 40% from 2019 to 2020. The low level of holdings by insurers is striking. Although the new securitisation framework entered into force in January 2019, the market is far from mature.

The COVID 19 crisis has also played a role. The securitisation framework has not fulfilled all its promises.

An industry representative agreed that the situation is not satisfactory. The aim was for securitisation to perform the funding and risk transfer function and enhance and deepen the CMU. Unfortunately, this has not happened. Both macro and micro aspects need to be considered. Securitisation volumes have been declining consistently since 2018. Historically, residential mortgage-backed securities (RMBS) have been the leading part of the securitisation market. That is no longer the case. In countries like Holland and the UK, mortgage covered bonds have taken over from securitisation from RMBS. RMBS is now less used by banks and more by finance companies.

An industry representative commented that public numbers are being compared, but the market is also a private market. Only a partial reflection of that market can be seen through the asset-backed commercial paper (ABCP) conduits. The public numbers ignore the activity on the private market, which is quite significant, especially for the banks. Yet, the bigger banking books are using less securitisation currently, doing less RMBS and more synthetic risk transfer activity. It is unlikely that the market will return to the state it was in before the global financial crisis.

1.2 The STS label was introduced in 2019 in the EU to combat the negative stigma related to securitisation

An industry representative stated that such a stigma is, and has been for years, undermining the securitisation market. Some politicians are still very hostile to securitisation.

A policymaker commented that securitisation was stigmatised in the context of the global financial crisis, although this was never entirely justified in the EU context. In 2015, the Commission identified the securitisation markets as one of the essential elements of the CMU. The framework now in place introduced the STS label and has been in force since 1 January 2019. It is too early to draw firm conclusions about whether this framework works. The Commission is committed to continuing to support the securitisation market.

An industry representative noted that the grand total issuance under the STS label is 186 billion so far. A large portion of that is legacy transactions that were relabelled after 1 January 2019 but issued prior to 1 January 2019. Most of those transactions are auto loans. There is a much smaller number of residential mortgages. The hoped-for extension and expansion of the issuer base through STS has not materialised yet. There has not been an expansion of the investor base.

1.3 Despite the adjustments in 2018 of the insurance regulatory framework regarding securitisation holding, the insurance sector related investments remain limited

A regulator commented that the stigma effect is uncertain, but the market is not where it should be. Work at the European Insurance and Occupational Pensions Authority (EIOPA) in this area started in 2013. EIOPA issued some advice to the Commission on a more favourable but still prudent treatment of securitisation. There is clear evidence that, from a fundamental credit risk perspective and in terms of spread volatility, many securitisation products perform very well. Therefore, specific treatment is needed when thinking about capital charge, Solvency II and insurance investment. The STS label has been introduced. The regulatory equipment is there and has been for some time. However, the proportion of investment of insurance undertaking has not significantly increased. It is still around 2% to 2.5% of investment.

An industry representative agreed with the numbers with regard to insurance. The Bank of America numbers suggest a 2.5% to 3% proportion of investment. For comparison, insurance companies in the US take between 10% and 30% of securitisation paper, depending on the particular sector.

1.4 Monetary policy and market conditions also contribute to reducing securitisation issuance

An industry representative commented that the current monetary policy has an effect. When the European Central

Bank (ECB) introduced the pool of additional credit claims eligibility in April 2020, there was a significant decline in the use of securitisation and covered bonds for the purposes of the access to the ECB.

A policymaker noted that there are currently many cheapways of refinancing and risk sharing in the market. This should be borne in mind when considering potential remedies or next steps.

1.5 In the current complex regulatory context securitisation is an expensive financing tool for both issuers and investors, compared with other financing techniques

An industry representative stated that securitisation remains relatively expensive for an issuer, although margins are slightly higher than comparable instruments. Securitisation is also expensive in terms of operational resources, particularly dealing with compliance and monitoring. As such, some small issuers and fund originators are not very well equipped for securitisation. It is also expensive or onerous for investors because due diligence processes are relatively heavy for securitisation. There are alternative solutions, for example transactions such as loan sales. Instead of securitisation, investors and sellers are using simpler structures that have less protection but do not fall under the securitisation regulation.

1.6 The recent evolutions regarding the securitisation of NPL are rather positive, though further clarification is needed

An industry representative noted that there are certain positive changes around retention, the calculation of the retention and the retaining entity regarding NPL. Regarding risk capital, there are no changes in capital for Solvency II. How these details will operate in practice is not yet known, but overall, it is positive. Whether it will be a massive boost for securitisation is uncertain.

An industry representative commented that the issue concerning disclosure for synthetic and NPL was not mentioned in the recent initiative, so clarification is still needed.

2. A review of the regulation of securitisation has started

2.1 The EU commission is first focusing on outlining a clear diagnosis of the features of the legislation that require adjustments

A policymaker stated that the Commission first needs to clarify which legal issues must be addressed. The Commission is working on a report, as obligated in the STS regulation and the capital requirements regulation (CRR) securitisation part. The report is planned for the end of the year. The Commission will need input from EIOPA and the European Banking Authority (EBA). Next steps will be considered after the report. A holistic overview of the various elements is needed. The Commission is aware of the concerns around the prudential treatment.

2.2 Whatever the regulatory evolution envisaged, the regulatory frameworks should remain risk sensitive and the prudential treatment should rely on evidence

A regulator agreed with the suggested approach of the Commission first carrying out a global analysis and then considering possible legal or regulatory changes. Changes regarding securitisation in the insurance framework have only recently been introduced. There has not been an increase in investment or a significant impact, but the period from 1 January 2019 to the present has been particularly challenging. As a supervisor and regulator, excessive changing of regulations is a problem as there might be undesirable or unexpected effects.

EIOPA did not address securitisation in the opinion on Solvency II because additional requirements or specific treatment are not needed for securitisation. Regarding the prudential treatment, EIOPA has not advised the Commission to take hold of the issue. Other changes in the Solvency II framework simplification proposal will amend the way in which some risky mitigation impacts are calculated and may have an indirect effect in facilitating and easing investment in such instruments. EIOPA will continue with its risk based approach. Prudential treatment is defined depending on the riskiness of the product.

EIOPA does not perceive a penalisation effect for securitisations. There is currently not enough evidence of the need to adjust the treatment from a prudential perspective. However, EIOPA is willing to discuss the matter further. The suggestion of not penalising some instruments may end up being the usual different views from a prudential supervisor and a market player. EIOPA’s approach is evidence based.

2.3 Many aspects of existing securitisation-related regulations require adjustments

An industry representative commented that the two initiatives that came into force in the previous week, with regard to synthetic securitisation and NPL, reflect the industry’s proposals to some extent, but not 100%. The changes made to the synthetic framework for STS for on-balance-sheet synthetic securitisation are generally positive, but application is uncertain.

An industry representative stated that the significant risk transfer (SRT) process needs improvement. The processes should be similar in all jurisdictions and be managed consistently. There are still some anomalies in Solvency II. STS has been improved, but non-STS is still penalised. In the past, insurers were relatively present in buying the investment-grade mezzanine tranches, so single A or triple B, but are not anymore. These are not appropriately treated under Solvency II. The liquidity coverage ratio (LCR) does not treat STS, or even non-STS although triple A investments manage very well. This should be made consistent with the treatment of covered bonds.

On transparency and disclosure, there is a problem for private reporting. It is not normal to be obliged to develop reporting alongside the standards of the European Securities and Markets Authority (ESMA). If a firm is dealing with a very sophisticated investor that requires its own reporting with different features, the firm needs to report twice, so its clients need to report twice.

Some regulations are passed without considering what the impact on securitisation could be, for example additional requirements on disclosure or more regulation on credit services for NPL.

2.4 The review recently initiated should encompass a holistic approach to provide a macro view of markets and contribute to defining regulatory evolutions consistent with the regulations regarding similar instruments across the board

An industry representative commented that strong ambition and political will are needed. Otherwise, the market may stay at its current level or even contract further. Having a critical mass in this market is quite onerous, since resources, experts and knowledge are needed. A contraction may mean that resources or knowhow will not be available in the market in the future.

An industry representative commented that it is surprising that a holistic approach and one not needing to change prudential requirements is being discussed simultaneously. It is often noted that securitisation presents systemic risk and care is needed as to how regulations are put in place. RMBS outstanding is about 400 billion, or 10% of the eurozone mortgage market, whereas covered bonds are 2.7 trillion outstanding and fund more than 55% of the eurozone mortgage market. It is difficult to discuss the systemic risk of RMBS when it is such a small portion of the market.

There is a discrepancy in regulatory capital in relation to underlying loans, which, when securitised, attract higher capital. In Solvency II, that is obvious in the context of the so-called non-STS. Even STS mezzanine tranches are heavily penalised. There are many examples that demonstrate that a holistic approach is necessary. For example, it does not make sense that a special-purpose vehicle (SPV) from Australia is subject to reporting to a tax authority when it is issuing RMBS, but it is not subject to reporting when it is issuing covered bonds. It does not make sense that RMBS or ABS use HTML templates for reporting loan by loan, and other asset classes just use a simple Excel spreadsheet. Treatment of similar instruments should be realigned across the board.

2.5 Short term improvements should also be envisaged since the EU legislative process takes time

A policymaker noted that, even if legal proposals were presented today, they would need their time to go through the political process in the EU. The priority should be to see whether the system can work better within the current framework, at the same time evaluating what can be improved going forward.

3. Top priorities for improving securitisation in the EU

3.1 Take the time to assess the current framework

A policymaker emphasised the importance of obtaining a holistic overview before assessing potential legislative changes.

A policymaker stated that there is no one measure that will magically revive the European securitisation market. Time should be taken to assess the current framework, after which next steps can be decided upon. The a priori not negative assessment from industry colleagues is helpful. The Commission is aiming for a very thorough report. Several measures may be necessary.

A regulator agreed with the approach of the Commission.

An industry representative stated that the complexity of the market should be considered holistically across sectors and regulations. There is nothing that will help immediately.

An industry representative commented that the market must be understood, not considering simply public issuance numbers but also private activity. The Commission's report could include a comparison with other markets, for example China, Australia, Korea, the US and Canada.

3.2 Assessing the prudential issue is important

A policymaker commented that, in the context of prudential treatment, the global Basel framework must also be considered.

A regulator stated that the priority is to check the penalisation effects that were mentioned. EIOPA is in the process of adjusting the framework on Solvency II, so it is important to hear the stakeholder view and analyse if there is a need to adjust. EIOPA aims for a stable insurance market with, as much as possible, the possibility of investing, especially in this period of low return.

An industry representative reiterated that a much smaller proportion of European securitisation is taken up by insurance companies than is the case in the US. It is concerning that Australia, which is a much smaller economy, is issuing more RMBS than the entire eurozone. The Chinese securitisation market is now about four to five times bigger than the European securitisation market.

3.3 Proportionality of regulatory measures is also necessary

An industry representative stated that the proportionality principle should be borne in mind when considering adjustments, measures, or clarifications. Disclosure is an obvious example.

3.4 Political will and ambition around securitisation is needed

An industry representative commented that securitisation can achieve positive things, such as a contribution to sustainable finance and the green transition and rebalancing the balance sheets for the banks. Securitisation is a vital instrument for the future solidity of the European banking system. NPLs should increase in the future. Basel “IV” will come into play.